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The Wirecard scandal and the role of BaFin

A case for unifying capital markets supervision
in the European Union

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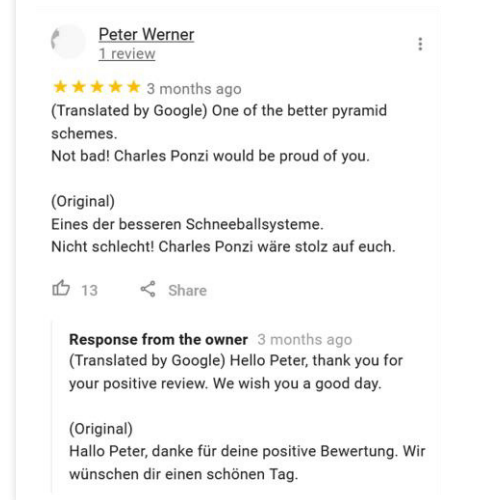
Abstract

The objective of this paper is to derive policy lessons for capital markets supervision in the EU from the 2020 scandal surrounding the insolvency of Wirecard AG, a German payment service provider and member of the DAX that had carried out balance sheet fraud on a large scale. To this end, I provide a synopsis of the events and analyse the handling of the case by BaFin, Germany's financial markets supervisor. I find that BaFin failed as a supervisor in the Wirecard case due to a home-country bias, which led it to shield Wirecard from allegations coming 'from abroad' rather than investigating the truthfulness of the allegations. However, the analysis also indicates that the Wirecard scandal should not be viewed as an isolated incident but, on the contrary, as a textbook example of the structural shortcomings of nationally organised supervision in the context of international economic competition in the EU's single market. In such a set-up, national supervisors are incentivised to protect national economic champions, especially if the latter are facing international competition. Consequently, political reactions on the national level will not be enough to avoid similar cases of national supervisory forbearance in the future. In this sense, the Wirecard scandal provides an argument for unifying capital markets supervision at the European level.

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Figure 1: Actual exchange in the reviews for Wirecard AG in Google Maps, June 2020.



1. Introduction

On 25 June 2020, Wirecard AG, a German payment service provider that had been a member of the DAX index of Germany's 30 leading blue-chip stocks since 2018, filed for insolvency. The week before, EY, Wirecard's auditor, had announced that 1.9 billion euros, roughly a quarter of Wirecard's balance sheet, were missing from its accounts. Earlier in 2020, a special audit by KPMG had questioned the accuracy of Wirecard's financial reporting and raised serious doubts about the existence of large parts of Wirecard's profits reported between 2016 and 2018.

Due to its impressive growth story (reported profits had more than quadrupled between 2013 and 2018 from 82.7 to 347.4 million euros¹, with share prices rising from 17 to 135 euros in the same period, making the company temporarily more valuable than Deutsche Bank) Wirecard had long been regarded "*as a star of the German tech sector*" (FT 2020/06/18). Wirecard's collapse marks the first time that a current member of the DAX went insolvent.

However, Wirecard's supposed business model seems to have been a sham for many years. In fact, Wirecard simply seems to have invented the bigger parts of its reported sales and revenues, not having generated any actual profits since at least 2015. Wirecard's supposed success story was based on accounting fraud. As of March 2021, while many facts remain obscure, it has become increasingly clear that the Wirecard case may be the worst instance of white-collar crime in German post-war history.

One of the more remarkable aspects of the case is that British business newspaper Financial Times (FT) had produced a steady stream of critical and often detailed reports about inconsistencies in Wirecard's business model and accounting since 2015. Moreover, in

¹ Source: Annual financial reports of Wirecard AG, 2013-2018.

several instances not only the press but also supervisory authorities and Wirecard's auditor were informed by whistle-blowers about potential wrongdoings on the side of Wirecard. Yet, neither Germany's financial markets supervisor, BaFin ("*Bundesanstalt für Finanzdienstleistungsaufsicht*", Federal Financial Supervisory Authority), nor Wirecard's long-time auditor, Ernst & Young (EY), were able to stop – or even detect – Wirecard's fraud scheme for years. Accordingly, both organisations came under heavy fire for their respective roles in the affair.

In this paper, I will focus on the implications of the Wirecard scandal for capital markets supervision in Europe. I will ask two basic questions: Was the Wirecard scandal some kind of unfortunate accident, or rather a symptom of deeper problems? And which policy lessons can be drawn from it for improving capital markets supervision in Europe? In order to answer these questions, I will in particular analyse BaFin's handling of the case.

I will argue that BaFin's behaviour in the Wirecard case is best explained by some form of supervisory home-country bias (Véron (2020) calls it "*economic nationalism*") which led BaFin to defend Wirecard against allegations coming from whistle-blowers and the press rather than investigating the truthfulness of these allegations. Moreover, I will argue that this kind of behaviour can be expected from national supervisors in the context of the current European set-up of capital markets supervision, which is characterised by a discrepancy between highly unified regulation (i.e. rule-setting) on the EU level on the one hand and fragmented national supervision (i.e. enforcement of rules) on the other hand. Given the economic competition among EU member states, such a fragmented system of capital markets supervision creates incentives for national supervisors to protect domestic champions against 'foreign' attacks, especially if the supervisory authorities are not independent from their respective governments. In this regard, the Wirecard scandal is a case for unifying capital markets supervision at the EU level.

The paper is structured as follows. In Section 2 I will outline the current system of nationalised capital markets supervision in the EU, as well as the shortcomings of such a system identified by the literature on the topic. In Section 3 I will introduce the company Wirecard and take a look at its business model and organisational structure. In Section 4 I will retrace the Wirecard affair since 2015 and analyse the fraud carried out by the company. In Section 5 I will analyse the conduct of BaFin, the German financial markets watchdog, in the Wirecard affair. Section 6 provides an overview of the findings of the analysis. I will then argue that BaFin did not only act too late, but that its actions were also potentially damaging for Wirecard investors, as BaFin seemed determined from the start to shield Wirecard from any investigations rather than investigate the truthfulness of the allegations. Finally, in Section 7, I will argue that a single European supervisor would have been in a much better situation to deal with a case like Wirecard. Moreover, I will outline some basic conditions for an effective supervisor at the EU level.

Before continuing, it seems prudent to issue a word of caution. As of March 2021, the Wirecard case is still ongoing: investors are preparing lawsuits in all directions, former Wirecard managers are on the run from law enforcement, a special investigative committee set up by the German federal parliament has not yet finished its work, and none of the accusations against the company and its managers have been confirmed by the courts. Accordingly, many details concerning Wirecard and its fraud scheme reported in this paper are preliminary and have to be taken with a grain of salt.

2. Capital markets and their supervision in the EU

2.1. The rationale for capital markets supervision

The main purpose of capital markets is to serve the financing needs of the real economy by providing efficient financial products and services. Accordingly, capital markets financing is generally seen as an important facilitator for the development of the real economy. Yet, capital markets do not seem to work on their own. Rather, history shows that financial markets are prone to crashes and crises on the macro level (Partnoy 2015), as well as to several kinds of inappropriate practices on the micro level, like insider trading, market manipulation, or outright fraud (Leinweber and Madhavan 2001; see also Llewellyn 1999 and Schoenmaker et al. 2012: 362 ff.).

Accordingly, functioning capital markets rely on the prevalence of common rules, just like the financial system as a whole (and maybe like any complex social structure).² Capital markets regulation aims at providing the rules for governing the behaviour of market participants. However, financial regulations need to be enforced, and enforcement is the domain of capital markets supervision. As the current governor of the Bank of England, Andrew Bailey, has stated: *“Frequently, and mistakenly, ‘supervision’ and ‘regulation’ as terms are used interchangeably. That’s wrong. Regulation is to do with the framework of rules and guidance [...]. Supervision is about how we use [the framework of regulations] in practice”* (Bailey 2016: 1). Thus, the main task of capital markets supervision is to enforce the compliance of market participants with the relevant regulations (see e.g. Langenbucher et al. 2020: 23).

2.2. The current state of capital markets governance in the EU

In the years following the European debt crisis, which had started in 2009, decisive steps were taken to unify financial regulation at the EU level, i.e. to centralise the rules for financial markets in Europe as well as the rule-making process (see e.g. Sergakis 2018: 36 ff.). Most importantly, in 2009 the so-called ‘Single Rulebook’ was introduced at the EU level. It provides a single set of harmonised prudential rules for the financial sector that is applicable throughout the EU.

In addition, in 2010 the so-called European system of financial supervision was introduced. It consists of the European Systemic Risk Board, responsible for macro-prudential supervision, and three specialised ‘European supervisory authorities’ (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). These agencies are confusingly called European *supervisory* authorities although their current competencies are mostly in the area of *regulation*. More precisely, it is one of the ESAs primary tasks to build and maintain the EU’s single rulebook. Day-to-day supervision, however, is still mostly the domain of national competent authorities (NCAs), while the ESAs only have a

² The issue of the right degree of government intervention is one of the core controversies in economics. The question has also been answered quite differently in the US, which traditionally tends to give markets as much freedom as possible, while the EU has developed a generally stricter approach after the European debt crisis; see e.g. McVea 2015.

very limited role in executing supervisory tasks (see Ferran 2012: 144 ff.; Haentjens et al. 2018: 1044 ff.; Schammo 2012). What is more, critics point out that *“the governance set-up of the ESAs is such that national interests are still predominant, hindering the exercise of powers in the common interests of the EU”* (Busch and van Rijn 2018: 344).

Hence, while financial regulation in the EU is characterised by a *“high level of harmonization, and on some points even unification”*, financial supervision, on the other hand, *“remains characterized by wide discretionary powers of the supervisory authorities and national supervisory traditions of the Member States”* (Haentjens et al. 2018: 1044). This is also the view of ESMA Executive Director Verena Ross (2018: 2), who stated that, *“While there are common rules applicable across much of the EU financial market, we still note divergent supervisory practices across the Member States and the national competent authorities”*.

Accordingly, today’s capital markets in the EU are still very much fragmented along national lines, making cross-border market access for many European companies burdensome (Micossi 2019). However, integrated capital markets appear to be necessary in order to meet the future financing needs of the EU economy, especially when it comes to increasing competitiveness in economic key areas like digital innovation or artificial intelligence (see Messori 2019).

This general state of financial markets governance in the EU – centralised regulation on the one hand, divergent national supervision on the other hand – does not apply to the banking sector, however. The European debt crisis had revealed, among other things, that national banking supervision had been weak due to, among other things, the incentive to protect national champions (see e.g. Friedrich and Thiermann 2017: 62). Consequently, in the wake of the crisis, European policymakers decided to centralise not only the regulation but also the supervision of European banks as part of the European banking union. Within the banking union, ‘significant’ banks are subjected to the Single Supervisory Mechanism (SSM), i.e. they are directly supervised by a central European supervisor, the European Central Bank (ECB).³ The rationale behind the centralisation of banking regulation and supervision is summarised by Lastra (2019: 15): *“European supervisors can provide a more independent and objective assessment of the problems identified in the course of the supervisory process than national supervisors.”*

2.3. Structural deficits of nationally organised supervision

In contrast to the EU’s banking sector, the supervision of capital markets in the EU is still conducted nationally. Schoemaker et al. (2012: 381) point out that *“a key element in the design of the institutional framework for financial supervision is the appropriate level of (de)centralisation”*. In fact, the literature on the institutional design of capital markets supervision highlights several problems related to the EU’s approach of centralised rule-setting but fragmented (i.e. nationalised) supervisory enforcement – especially in the

³ In this setup, the daily business of supervision of significant institutions is jointly conducted by the ECB and NCAs. Only the supervision of non-significant banks is still mostly the domain of the NCAs. Yet, even in these cases the ECB bears the ultimate supervisory responsibility and consequently also has the power to take over the supervision from NCAs if it deems it necessary (see e.g. D’Ambrosio 2019).

context of economic competition between EU member states within the EU's common economic area, the single market.

According to the literature, the EU's set-up of fragmented capital markets supervision has led to several shortcomings on the macro level, which effectively decrease overall supervisory effectiveness:

- Over the years, each EU member state has developed its own unique system of supervision, which reflects national legal idiosyncrasies, historical contingencies, policy preferences as well as instances of regulatory competition. The traditional argument in favour of nationally organised supervision is that supervisory practice should indeed reflect these historically grown national peculiarities (see e.g. Moloney 2018: 293). However, the different national approaches have also led to **significant disparities in national supervisory performance**. For example, several studies have found huge differences between EU member states in terms of the quality of financial reporting enforcement (see e.g. Brown et al. 2014; Johansen et al. 2020; Leuz and Wysocki 2016). This insight is almost self-evident in the case of the peculiar German two-tier financial reporting enforcement system (see Section 5.2), which some studies have found to be especially weak (see e.g. Hitz et al. 2012: endnote 2).
- A system of nationalised supervision has **difficulties supervising cross-border entities**, as different national supervisors need to closely coordinate their conduct. This coordination is a logistical challenge in itself but may be further complicated by the economic competition between member states, different supervisory traditions and approaches, and also quite simply by disagreements between supervisors (see Schoenmaker et al. 2012: 382). Under such a system, supervisory deficiencies in one country necessarily downgrade the overall supervisory performance – the supervisory chain is only as strong as its weakest link.
- The EU's different national supervisory regimes have resulted in **differing levels of investor protection** (Colaert 2015: 1594 ff.), even though harmonisation of safety and protection standards has been one of the main rationales of economic integration in the EU.
- Finally, a fragmented supervisory landscape is also **inefficient**. A system comprised of 27 supervisors instead of one, and without a functional division of labour, produces unnecessary costs (see Schoenmaker et al. 2012: 382). Given the fact that supervisors are regularly faced with resource constraints and a lack of sufficient expertise,⁴ this inefficiency is a real impediment to effective capital markets supervision in the EU.

Moreover, the EU's system of nationalised capital markets supervision also produces inefficiencies on the micro level:⁵

⁴ As financial experts are expensive, it is difficult for supervisors to match the financial engineering skills of private financial institutions; see e.g. Masciandaro and Quintyn (2016: 996).

⁵ Many of the following aspects are regularly discussed in the literature in terms of financial *regulation* rather than *supervision* (e.g. regulatory arbitrage, regulatory competition, regulatory capture). However, I believe that in all of these cases the points raised in the literature apply to financial supervision just as well.

- The persistence of disparate national supervisory practices and performances **enables supervisory arbitrage**, i.e. the possibility for a company to choose a home jurisdiction where it expects to find favourable supervisory conditions, while at the same time enjoying unrestricted access to the EU's single market (see e.g. Busch and van Rijn 2018: 303; Fleischer 2010).
- Supervisory arbitrage, in turn, is linked to **supervisory competition**, where supervision becomes a means of economic competition between member states. Especially Anglo-Saxon observers have viewed such competition positively, as it could potentially lead to supervisory experimentation and innovation (see e.g. Lee 2005; Moloney 2018). Many continental policymakers, on the other hand, tend to take an opposing view, highlighting the risk that supervisory competition may result in a supervisory race to the bottom, as economically competing member states are incentivised to exhibit a specifically light supervisory approach in order to keep the supervisory burden for their domestic companies as light as possible (see e.g. Friedrich and Thiemann 2017: 63).
- Nationally organised systems make it easy for national governments to **restrict the institutional independence of the supervisor** and to exert **political influence**: *“Institutional independence refers to the status of the [supervisory] agency as an institution separate from the executive and legislative branches of government. An agency that forms part of the executive branch, such as the ministry of finance, typically lacks independence”* (Quintyn et al. 2007: 8). The lower the institutional independence and the higher the influence of the government on the supervisor, the higher the chances that political (i.e. national economic) considerations will affect, and ultimately trump, purely supervisory considerations. BaFin, for example, is part of the German federal government, reporting directly to the German Ministry of Finance (MoF).
- National supervisory systems are prone to **supervisory capture**, referring to a situation where there is close proximity between the supervisor and the supervised company over a longer period of time, which at one point may enable the supervisee to subtly influence the supervisor: *“The lack of common enforcement standards risks regulatory capture, facilitating unduly close relationships between supervisor and supervisee, particularly if the supervisee is in competition with firms supervised elsewhere”* (Krahn and Langenbucher 2020: 3).

All in all, the current organisation of capital markets supervision in the EU tends to **limit supervisory independence**, i.e. *“the independence with which the [supervisory] agency is able to exercise its judgment and powers”* (Quintyn et al. 2007: 9). This is due to the fact that this setting – with centralised rule-setting, nationalised enforcement, and economically competing member states in the context of the single market – exposes national supervisory authorities to political and economic forces which tend to view strict supervision primarily as a burden for economic prosperity. Such a setting systematically distorts the incentive structure of national supervisors by pressuring them into adapting political and economic considerations.

This may ultimately lead to a **supervisory home-country bias**, where the behaviour of a national supervisor will be partly – or even primarily – influenced by national economic

considerations, while purely supervisory goals (like market integrity or investor protection) will only come second. Under such a home-country bias, national supervisors are less likely to go about their supervisory tasks neutrally and impartially, as they are incentivised to ‘support’ their domestic supervisees, especially if the latter are in a situation of international competition. As Krahnen and Langenbucher (2020) put it: *“Too tempting (and incentive-aligned) may be supervisory forbearance in country A if this helps the supervisee in A to thrive when under pressure from a competitor that is supervised in country B.”* Véron (2020) has labelled this phenomenon *“economic nationalism”*. As I will argue, BaFin’s handling of the Wirecard case seems to be an almost archetypal example of a national supervisor acting under a home-country bias.

A supervisory landscape which is prone to home-country biases also diminishes the prospects of capital markets financing in the EU, as it is likely to reduce investor confidence in market integrity: nationally organised supervision is likely to make investors wary that ‘the rules of the game’ will not be enforced evenly and impartially everywhere. As Ross (2018: 2) notes, *“For the European single market to function smoothly and efficiently, regulatory and supervisory practices between the competent authorities of the European Member States need to converge. The presence of gaps in the regulatory landscape can present a risk to the development of a real level playing field in the financial services industry”*. In the same way, uncertainty about the fair and even application and enforcement of the regulatory framework is also likely to discourage companies from engaging in cross-border operations or seeking financing in other member states (see ECB 2015: 17).

Schoenmaker et al. (2012: 382) conclude: *“This fragmented supervision [in the EU] undermined the Single Market, imposed extra costs for financial institutions, and increased the likelihood of failure of financial institutions with potentially additional costs for taxpayers.”*

3. Wirecard within the payments industry

In this Section I am going to introduce the company Wirecard by taking a brief look at its business model and its reported figures, as well as its organisational structure.

Wirecard was a payment service provider (PSP) which (allegedly) earned its money by enabling merchants (online and in brick-and-mortar stores) to accept electronic payments (e.g. via credit cards) and by processing the underlying transactions. However, the exact workings of Wirecard’s business model have always remained obscure, as the company *“rarely dwelled on the arcane details of its payment processing operations”* (FT 2020/05/05). Even when Wirecard was already a stock market darling and about to enter the DAX, the details of its business model remained nebulous even for experts. When German business newspaper Manager Magazin (2017/02/23) confronted several Wirecard analysts with alleged irregularities in Wirecard’s accounting in 2017, one of them replied: *“Unfortunately, I’m afraid that this is far too profound. Billing at Wirecard is incredibly complex and difficult to understand.”*

However, most people did not seem to be worried about this lack of clarity – after all, the payments industry is characterised by rather high opacity in general, despite its central role

for the economy. Technological complexity, fast change, and a confusing number of different actors, ranging from the world's biggest banks to small technology start-ups, all add to the picture (see e.g. DeGennaro 2006, Kjos 2007). In this regard, Wirecard was no exception. What is more, and maybe more importantly, Wirecard had been able to publish its financial statements from 2009 to 2018 with an unqualified report by its auditor, EY.⁶ None of EY's audits had led to any objections (see MoF 2020a: 6). For everyone who trusted EY's accounting, Wirecard looked solid.

In retrospect, however, it seems highly likely that one of the main reasons for Wirecard's lack of transparency was the fact that large parts of its operations were based on fraud and deception. Accordingly, it is difficult to reconstruct Wirecard's "real" business model. Yet, as it is important to understand the gravity of the allegations that have been continuously made against Wirecard for years (see Section 4.1), I am going to describe its business model at least rudimentarily.

3.1. Wirecard's business model and reported figures

Invisible to most people, the functioning of electronic payments rests on a whole industry of specialised service providers (see DeGennaro 2006, Kjos 2007). Whenever a customer buys something and chooses some form of electronic payment (e.g. a credit card), a cascade of processes is set in motion requiring the interaction of a number of different actors, which earn money by charging small fees for each service performed. This market for electronic payment services is continuously growing even in developed economies like Europe and the US due to an underlying shift in consumer behaviour away from using cash. However, the payments industry is also a highly competitive environment where "*economies of scale have come to dominate many sectors of the business*" (Kjos 2007: 8). In Europe and the US, competition has intensified in recent years, mostly due to new technology-savvy players entering the market, comprising fintech start-ups as well as the world's biggest tech companies (for an overview see e.g. van Steenis et al. 2019: chapter 1). Consequently, today's payments market is not only characterised by fierce price competition but also by rapid technological innovation. While the top 25 acquirers in the Nilson Report's list of the biggest PSPs process about 70 percent of all transactions, Wirecard recently only reached the 82nd place (see Credit Suisse 2020: 19).

⁶ The auditor's report is an integral element of a company's audited financial statement. In its report, the auditor expresses his opinion on the financial information disclosed by the company. These reports can be qualified, meaning that the auditor disagrees with the company's management on certain points. Or they can be unqualified, meaning that the auditor has concluded that the company's financial statements truly present its situation in all material aspects.

Figure 2: Key figures of Wirecard AG, 2017-2018. Source: Wirecard Annual Report 2018 (p. 1).

Segments		2018	2017		
Payment Processing & Risk Management	Revenues	1,479.9	1,064.8	in EUR million	38.99%
	EBITDA	481.3	322.7	in EUR million	49.13%
Acquiring & Issuing	Revenues	609.3	488.5	in EUR million	24.73%
	EBITDA	79.9	86.6	in EUR million	-7.69%
Call Center & Communication Services	Revenues	9.1	9.9	in EUR million	-7.65%
	EBITDA	-0.5	1.0	in EUR million	-154.08%
Consolidation	Revenues	-82.2	-74.6	in EUR million	10.27%
	EBITDA	-0.1	0.0	in EUR million	370.70%
Total	Revenues	2,016.2	1,488.6	in EUR million	35.44%
	EBITDA	560.5	410.3	in EUR million	36.61%

Wirecard stated that its unique selling proposition was to offer more or less all the different processes along the payment chain from a single source (see e.g. Wirecard annual report 2018: 37 ff.). In its financial statements, Wirecard reported its payment functions in two different segments, which made up the bulk of Wirecard's business (see also Figure 2):⁷

- Wirecard's "*Payment Processing & Risk Management*" segment consisted of "*products and services that are involved with acceptance or transactions and the processing of electronic payments and associated processes*" (Wirecard annual report 2018: 35), i.e. technical payments processing. This segment accounted for about 70 % of the 2,016.2 million euros reported by Wirecard as total revenues for the year 2018 (ibid.: 2).
- The "*Acquiring & Issuing*" segment, on the other hand, included the issuing of prepaid and debit cards to private and business customers as well as "*settlement services for credit card sales for online and terminal payments*" (ibid.: 35). This segment accounted for about 30 % of Wirecard's total reported revenues in 2018.

These figures make it clear that the technical processing of electronic payments was Wirecard's most important business by far. Hence, for its growth story to continue, Wirecard needed to make sure that the number of payments it processed would continue to go up.

Geographically, Europe was Wirecard's biggest market until 2018 but had since been overtaken by Asia, where growth (at least on paper) was significantly stronger than in the more mature European market. In 2019, Europe accounted for 45 % of Wirecard's reported revenues, Asia for 48 %. However, as it stands today, most of the supposedly growing business operations in Asia, as well as the related revenues, had been a sham. Moreover, Wirecard's regular operations, which were located outside of Asia, seem to have produced constant deficits since at least 2015 (see Section 4.2) – a fact which was hidden because Wirecard only reported consolidated figures for the whole group (see Section 3.3).

⁷ In addition to its payment services, Wirecard also reported on a third segment called "call center & communication services", which, however, is negligible in terms of revenues. See Wirecard annual report 2018: p. 2.

3.2. Third-party acquirers and Wirecard's use of escrow accounts

In order to understand the fraud scheme related to Wirecard's operations in Asia, it is helpful to understand the role of the acquirer, and especially the role of so-called third-party acquirers (TPAs) within the payment process.

Strictly speaking, the term "acquirer" refers to a company which finds and signs up merchants to accept certain forms of electronic payment (e.g. to accept specific credit cards or mobile payment options) and which earns a small service fee for each transaction processed.⁸ Acquirers are important for merchants because the latter are faced with a wide range of electronic payment methods used by customers today. Customers in the EU might, for example, want to pay with a debit card (e.g. maestro), or with a credit card (Visa, Mastercard, etc.), or, increasingly, with one of the newer mobile payment services like Google Pay or Apple Pay. Acquirers make sure that merchants can accept some or all of these payment options and that the respective payments between the bank of the merchant and the bank of the customer are processed correctly.

As the business ultimately involves the transfer of funds, both Visa and Mastercard (as well as other payment networks) require that participating card issuers and acquirers be financial institutions. Hence, any acquiring company must either hold a banking license itself or team up with a regular bank. In the case of Wirecard AG, the company was able to become a licensed issuer and acquirer for both Visa and Mastercard in Europe because it had access to a German banking license via its subsidiary, Wirecard Bank AG, which was valid for the whole EU (in line with the so-called "EU passporting" framework).

However, in order to be able to provide its payment services to businesses worldwide (i.e. being able to offer a big online retailer the possibility to accept card payments from different parts of the world), a PSP would theoretically need banking licenses in all regions of the world, which is obviously not feasible. This is why acquirers regularly team up with local banks, giving rise to the business model of so-called third part acquirers (TPAs). Payment companies use these TPAs, which hold local banking licenses, in order to offer their services in regions where they do not own banking licenses themselves. This practice of acquirers working together with banks in various forms of partnerships in the absence of banking licenses is common in today's market (see e.g. Kjos 2007: 14 f.).

Wirecard also made use of TPAs in regions where it did not possess banking licenses, for example in Asia. Here, Wirecard would sign up merchants (or buy local acquiring companies with an existing customer base), just like it did in Europe, and for each transaction processed Wirecard would charge a small fee from the respective merchant in the usual way. However, Wirecard would leave the operational handling of the transaction to a TPA partner that holds a banking license in the region. The TPAs would "*process credit card transactions for customers referred to these TPA partners by Wirecard*" (KPMG 2020: 14). Wirecard would then pay its TPA partner a commission for its service and also provide

⁸ Most of today's acquiring companies offer a range of payment services, including the processing of payments and settlements, which is why in industry jargon the term "acquirer" is used almost indiscriminately for any company providing some sort of payment service.

the TPA with operating cash and with collateral for the risks the TPA assume (e.g. counterparty default risks and financial risks stemming from chargeback cases).

In order to organise the transactions between itself and the TPAs (transfers of fees and commissions, provision of operating cash and collateral), Wirecard said it used so-called escrow accounts. Escrow accounts are bank accounts which are operated by a third party (a trustee), who, normally, has a responsibility towards both the TPA and the original acquirer and who initiates payments between both parties conditional on the fulfilment of predetermined contractual obligations. As we know today, however, large parts of Wirecard's supposed TPA business in Asia did not exist in reality – and neither did the large amounts of cash Wirecard said it had stored in some of its escrow accounts (see Section 4.2).

3.3. Wirecard's organisational structure

Wirecard was organised as a group, with Wirecard AG, based in Aschheim, near Munich, Germany, being the group parent company. While Wirecard AG was tasked with strategic group management and especially with the control over its subsidiaries, it acted solely as a holding company and did not perform any business functions itself. Rather, Wirecard's actual business was conducted by its many subsidiaries, which, in their entirety, were controlled by Wirecard AG (see e.g. Wirecard Annual Report 2016: 52-53).

This set-up allowed Wirecard to resort to so-called consolidated reporting, meaning that a consolidated financial report for the whole group was published, rather than discrete numbers for the individual subsidiaries. This practice is stipulated in § 297 of the German Commercial Code (*“Handelsgesetzbuch”*, HGB). According to § 297 of the HGB, in the consolidated financial statements of a group, *“the assets, the financial position, and the earnings of the companies included in the group have to be presented as if these companies were one single company”* (translation by the author).

What is more, Wirecard's group structure was quite complicated. When BaFin and Bundesbank last assessed whether to classify Wirecard as a financial holding company in 2017 (see Section 5.1), a total of 46 subsidiaries were fully consolidated within the group (see Wirecard Company Report 2016: 170-171), which were spread over 23 different countries (ibid.: 54). In 2020, the number of subsidiaries had grown to 56. This complex organisational structure seems to have led to rather inefficient processes (see FT 2020/09/23), but its opacity certainly helped to obscure the financial flows which today seem to lie at the heart of Wirecard's fraud scheme (see Section 4.2).

Among Wirecard's subsidiaries, only two were subject to institutional supervision in the EU: Wirecard Bank AG (Germany), which held a banking license and which was being supervised by BaFin; and Wirecard Card Solutions Ltd. (UK), which was being supervised by the British Financial Conduct Authority (see MoF 2020a: 4; Wirecard Company Report 2016: 120).

4. The course of the Wirecard affair

This Section provides an overview of the allegations made against Wirecard over the years in order to be able to analyse BaFin's handling of the case.

4.1. A history of allegations, denials, and official investigations

2008

Already in 2008, representatives of the “Schutzgemeinschaft der Kapitalanleger”, a German association for the protection of small capital investors, accused Wirecard of manipulating its balance sheet. However, it turned out later that these representatives had also made bets on a fall of Wirecard's share price. Wirecard tried to counter the allegations with a special report by EY, which at this point became Wirecard's auditor. Yet, Wirecard could never completely dispel the allegations (see Der Spiegel 2016/04/30).

2015

The more recent history of allegations against Wirecard begins in April 2015, when Dan McCrum, a reporter for British business newspaper Financial Times (FT), starts a blog series called “*The House of Wirecard*” (FT 2015/04/27), in which he raises a number of questions regarding Wirecard's accounting practices. In October that year (FT 2015/11/12), he critically examines a recent Wirecard acquisition, an Indian company called Hermes (which had not been specifically known for its expertise in the payments business), bought for around 330 million euros. The FT points out that this price seems high given the company's low turnover.

2016

The first major Wirecard scandal emerges in February 2016. A hitherto unknown organisation called “Zatarra Research & Investigations” publishes a 100-page report⁹ in which the anonymous authors accuse Wirecard of a range of misconduct, from corruption and fraud to obscuring the sources of revenues stemming from illegal gambling. In addition to that, the report claims that, “*Wirecard has consistently acquired businesses for significantly greater than apparent value*” and refers explicitly to Wirecard's dubious acquisition in India. Moreover, the report claims that in several instances these companies were purchased from former Wirecard employees or other figures with ties to Wirecard. Against this backdrop, the report sets a target price for Wirecard: “*€ 0.00 per Share*”. Wirecard comments that the report was “*wholly untrue*”. Yet, the Zatarra report triggers Wirecard shares to fall by more than a fifth on 24 February 2016, from 42 to 33 euros (see FT 2016/02/25). Several short-sellers, who had bet on falling share prices, profit from the plunge.

After the event, BaFin starts an investigation into potential market manipulation. The FT (2021/01/07) quotes a BaFin memo prepared for the German Ministry of Finance (MoF), in which BaFin notes that a “*plethora of suspicious market participants*” had been trading

⁹ Since Zatarra Research has ceased operations, there is no longer an ‘official’ source for the report. However, the document has circulated in interested circles for years. Therefore, it is still possible to find the document online. One source, as of March 2021, is the following website: <https://www.heibel-unplugged.de/wp-content/uploads/2020/06/Zatarra-research-Wirecard-PDF.pdf>.

Wirecard shares in a “*remarkably profitable*” way. BaFin further states: “*It is striking that the suspect individuals (which besides natural persons also include Anglo-American ‘hedge funds’) all appear to share a rather homogeneous cultural background — mainly Israeli and British citizens.*” BaFin concludes: “*It cannot be ruled out that this is a matter of a network-like structure (‘insider ring’)*”.

Accordingly, BaFin’s investigation results in the suspicion of market manipulation. In May 2016, BaFin files criminal charges with the Munich public prosecutor’s office for possible market manipulation by market participants (MoF 2020a: 12). In December 2018, two and a half years after the criminal charges were filed, the public prosecutor finalises its own investigation with the result that the 2016 publication of the Zatarra report, and the subsequent plunge of Wirecard’s share price, were indeed a case of market manipulation and hence had a criminal background. Subsequently, the public prosecutor applies to the Munich District Court for a penalty order against the publisher of the Zatarra report, who, in the meantime, had been identified as Fraser Perring, a well-known short-seller (see FAZ 2018/12/10). Yet, in mid-June 2020 (after the publication of KPMG’s special report but before Wirecard’s confession that 1.9 billion euros were missing) the Munich District Court closes the case against Perring as a “*less serious case*” (see Manager Magazin 2020/05/11).

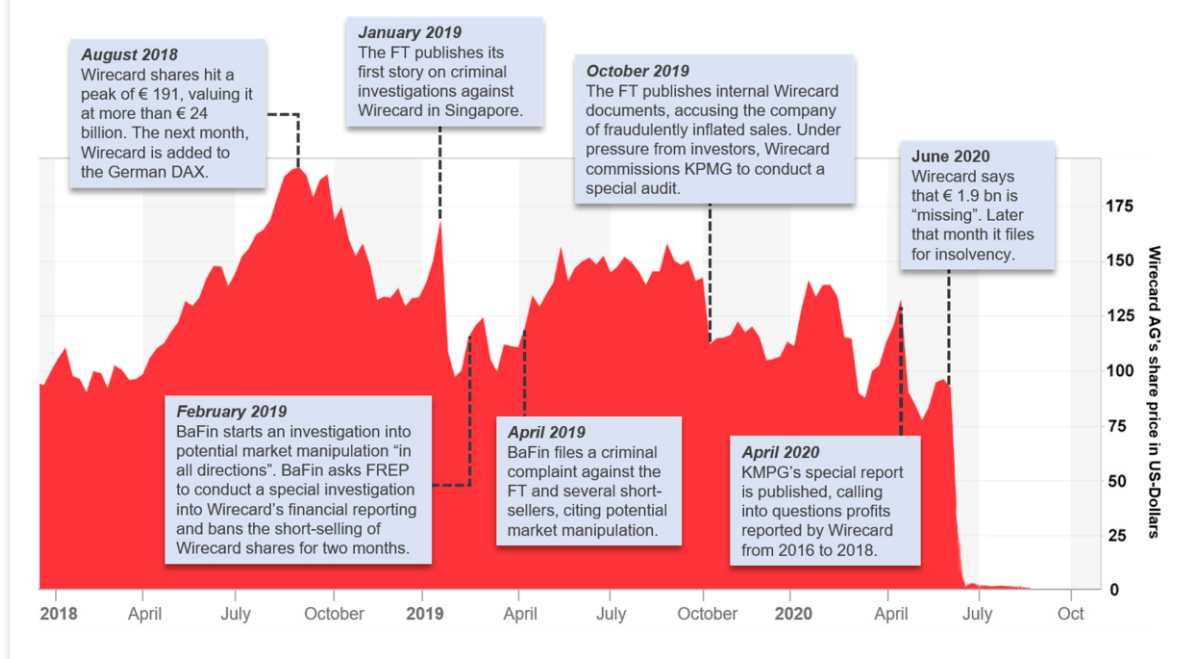
2017

In February 2017, German business newspaper Manager Magazin (2017/02/23) publishes a long story on putative inconsistencies in Wirecard’s accounting. According to the report, Wirecard’s books contain ominous receivables positions worth 250 million euros, which do not correspond to the respective liabilities from Wirecard’s TPA business. BaFin conducts a brief analysis of possible market manipulation following the report but seems to have laid its suspicion to rest (see MoF 2020a: 12). As it turned out later, a whistle-blower had brought the issues reported in the Manager Magazin article to the attention of the German Financial Reporting Enforcement Panel (FREP, see Section 5.2) already in 2016, which, however, seems not to have scrutinised the allegations (ESMA 2020b: 43). Overall, 2017 marks a specifically fortunate year for Wirecard investors: its share price more than doubles (see FT 2020/06/25).

2018

At the beginning of 2018, a group calling itself “Southern Investigative Reporting Foundation” publishes renewed allegations against Wirecard concerning irregularities in Wirecard’s acquisition of Indian company Hermes. The allegations are immediately denied by Wirecard, yet they result in a temporary decline in Wirecard’s share price of over 10 %. Again, BaFin starts an investigation into potential market manipulation. However, in May 2018 BaFin announces that the suspicion of market manipulation has not been confirmed (MoF 2020a: 13). In August 2018, Wirecard shares reach their all-time high. The market value of Wirecard reaches that of DAX heavyweights Deutsche Bank and Lufthansa.

Figure 3: Important events during the Wirecard affair 2018-2020 vs. Wirecard's share price in US Dollars (red graph). Sources: BMF 2020, FT 2020/06/25, Yahoo Finance.



2019

On 30 January 2019, the FT publishes its first story on alleged criminal investigations against Wirecard in Singapore (FT 2019/01/30) causing Wirecard's share price to drop from € 167 to € 108 within two days. Citing information obtained through a whistle-blower, the FT claims that a Wirecard accountant had used forged and backdated contracts to produce suspicious payment transactions. Wirecard issues a statement saying that the FT's report was "*false, inaccurate, misleading and defamatory*" (see Deutsche Welle 2019/01/31). One week later, however, Singapore police raid local Wirecard offices (see FT 2020/06/25). In March 2019, Singapore prosecutors announce that they are probing eight Wirecard subsidiaries for suspected "*forgeries, falsified documents, money laundering, and the round-tripping of funds to support false transactions that were believed to have taken place between 2014 and 2018*" (FT 2019/12/19). As of March 2021, the investigation in Singapore is still ongoing.

The Singapore episode seems to have been the starting point for BaFin to initiate another investigation into potential market manipulation on 1 February 2019 (MoF 2020a: 13). In a memo prepared for the Bundestag's Finance Committee, the finance ministry points out that BaFin's investigation was conducted "*in all directions*", i.e. also against Wirecard AG itself (ibid.). In practice, however, BaFin's next steps suggest that the agency was convinced from the start that Wirecard had been wrongly accused of malpractice in a coordinated attempt of journalists and short-sellers to manipulate its share price.

On 15 February 2019, BaFin asks the Financial Reporting Enforcement Panel (FREP, see Section 5.2) to conduct a special audit into Wirecard's accounting. However, this move is not made public at the time and becomes publicly known only after Wirecard's insolvency (FT 2020/05/19). Two other BaFin acts, however, get a lot of publicity right away. On 18

February 2019, BaFin bans the short-selling of Wirecard shares for two months, citing “*short attacks*” on Wirecard, which, according to BaFin, were “*coinciding*” with critical press reports and which were risking “*to escalate into general market uncertainty*” (BaFin 2019). It was the first time ever that BaFin issued a short-selling ban. The measure was approved by ESMA (2019). Four days before the issuance of the short-selling ban, on 14 February 2019, BaFin had informed the German ministry of finance (MoF) about its investigation into potential market manipulation and about its initiation of a special audit by FREP (MoF 2020a: 13). One day after the issuance of the short-selling ban, BaFin informs the MoF about the measure again – as well as about unspecified “*further steps*” (ibid.: 14).

In March 2019, Wirecard takes legal action and sues the FT and its reporter, Dan McCrum, over their Singapore reporting. Wirecard claims that the FT had made use of, and misrepresented, business secrets (see Reuters 2019/03/28). On 10 April 2019, BaFin follows suit and takes a ‘further step’ by filing a criminal complaint against two FT journalists, including Mr McCrum, and several short-sellers, accusing them of potential market manipulation (see MoF 2020a: 14; FT 2019/04/16). Two days earlier, on 8 April, BaFin had again consulted with the MoF on the Wirecard investigation. On 15 April, BaFin again reports to the German finance ministry about Wirecard (MoF 2020a: 14-15).

In the meantime, the FT (2019/03/29) had started reporting new allegations, which this time concern Wirecard’s TPA, and which call into question the existence and volume of clients and revenues. Additional details on the matter are provided in two further articles in April (FT 2019/04/24) and June (FT 2019/05/20). In the latter, the FT presents an internal Wirecard spreadsheet which indicates that revenues and profits from its operations in Asia stemmed almost exclusively from only three dubious TPAs. According to the FT, which had sent reporters to the supposed offices of the companies, one of the three TPAs was “*based in a largely unmanned office suite in Dubai*”, while another shared an office “*with a Manila tour bus company in the Philippines*” (see FT 2020/05/05). Wirecard denies all wrongdoing.

On 15 October 2019 the FT (2019/10/15) is able to present even more evidence regarding Wirecard’s TPA business. The FT produces detailed internal Wirecard documents coming from a whistle-blower which point to a concerted effort by Wirecard to fraudulently inflate sales and profits at its subsidiaries in Dubai and Ireland, and to delude its auditor, EY. In the face of mounting pressure from investors, Wirecard’s supervisory board commissions KPMG, an EY competitor, to conduct a forensic special audit into Wirecard’s books regarding the alleged accounting fraud.

In December 2019, the FT (2019/12/19) provides more details on the allegations regarding Wirecard’s 2015 acquisition of Indian company Hermes. According to the FT, Wirecard had bought Hermes for around 300 million euros from a Mauritius-based investment fund called EMIF 1A. However, EMIF 1A itself had purchased Hermes only six weeks earlier – and had only paid 37 million euros for the company. Hence, when EMIF 1A re-sold Hermes shortly afterwards, it pocketed a profit of around 800 %. The suspicion, which had already been raised in the 2016 Zatarra report, was (and still is) that EMIF 1A had acted as a middleman for Wirecard managers who enriched themselves through the deal. In addition, such a fraudulent acquisition would have also contributed to inflating Wirecard’s balance sheet, as a relative worthless company would be accounted at an excessive value.

2020

On 28 April 2020, the KPMG special audit report is published (KPMG 2020). In the report, KPMG points out that it was not able to verify the existence of “*the lion’s share*” of Wirecard’s profits reported between 2016 and 2018. Still, Wirecard announces that KPMG did not find incriminating evidence concerning balance sheet fraud (see ESMA 2020b: 40). Yet, on the following day Wirecard shares fall by more than 25 %, from 132 to 98 euros.

Only after the publication of the KPMG report does EY, Wirecard’s auditor, check directly with the respective banks in the Philippines whether 1.9 billion euros of cash, which, according to Wirecard, were stored in escrow accounts, are really there – they are not. On 16 June, EY informs Wirecard that it found out that the respective account balances, which Wirecard had submitted, were forged. On the morning of 18 June, Wirecard issues an ad hoc announcement, saying that the publication of its 2019 annual report will be delayed “*due to indications of presentation of spurious balance confirmations*” concerning cash balances in the amount of 1.9 billion euros.¹⁰ Within minutes, Wirecard shares crash by around 60 % (see FT 2020/06/18). On 19 June, Wirecard’s long-time CEO, Markus Braun, steps down. On 21 June, the central bank of the Philippines announces that none of Wirecard’s missing funds appear to have entered the Philippine financial system (Reuters 2020/06/21). In the early morning of Monday, 22 June, Wirecard issues another ad hoc announcement saying “*that there is a prevailing likelihood that the bank trust account balances in the amount of 1.9 billion EUR do not exist*”.¹¹ Markus Braun is arrested the same day. In the evening, Wirecard shares have dropped to just below 15 euros. Three days later, on 25 June, the company files for insolvency, sending its share price to 3.50 euros. Only on 28 August, however, does the price of Wirecard shares fall below 1 euro – four years after the Zatarra report had indicated a target price of “€ 0.00”.

The aftermath

After Wirecard’s collapse, the affair immediately becomes a political scandal in Germany. Shortly after the insolvency, news breaks that BaFin staff traded Wirecard shares throughout 2019 and 2020. In an answer to a parliamentary inquiry, the MoF states that one fifth of all BaFin employees traded financial instruments related to Wirecard in 2019 and the first half of 2020 (Deutscher Bundestag 2020b: 6). In this period, Wirecard was the most traded share among BaFin staff (amounting to 1.7% of all trades by BaFin staff in 2019, and 2.4% in the first half of 2020, respectively).¹² What is more, BaFin employees did not only trade shares but also all kinds of derivatives based on Wirecard’s stock, including warrants, bonus and knock-out certificates, various leverage products and contracts for difference (see Capital 2020/09/18). Moreover, at least two of these derivatives benefited

¹⁰ Wirecard ad hoc news published on 18 June 2020, online: https://ir.wirecard.com/websites/wirecard/English/5110/news-detail.html?newsID=1984117&fromID=5000&_ga=2.81744279.1634547323.1606730619-115870925.1603217105

¹¹ Wirecard ad hoc news published on 22 June 2020, online: https://ir.wirecard.com/websites/wirecard/English/5110/news-detail.html?newsID=1985593&fromID=5000&_ga=2.153925304.1634547323.1606730619-115870925.1603217105

¹² However, at that time Wirecard was also the most traded share in Germany’s retail market overall (see Deutscher Bundestag 2020c: 4).

from a falling share price – which comes as a little surprise, to say the least, given that BaFin had banned the short-selling of the share for two months in 2019. While most of the trading by BaFin staff appears to have been legal, in October 2020 the MoF announces that BaFin would ban its staff from trading financial instruments in the future (see Reuters 2020/10/01).

Meanwhile, in June 2020 the European Commission asked ESMA to carry out a fact-finding analysis of the events surrounding the collapse of Wirecard and of the supervisory response of the German authorities in the area of financial reporting enforcement (ESMA 2020a). ESMA conducts the analysis in the form of a “Fast Track Peer Review” (formally on BaFin’s application of the Guidelines on the Enforcement of Financial Information). The fast-track peer review is a new “supervisory convergence tool” introduced in 2020 (see ESMA 2020b: 7). ESMA publishes its report in November 2020 (ESMA 2020b).

Concerning the trading of Wirecard stock by BaFin employees, ESMA reports that, “... *a very small proportion of staff with designated access to insider information within BaFin’s MAR [market abuse regulation] team traded Wirecard shares or derivatives in 2018, 2019 or in the first half of 2020*” (ESMA 2020b: 59). The market abuse regulation team is tasked with monitoring markets in terms of potential market manipulation. However, according to ESMA (ibid.), “... *no BaFin staff directly responsible for supervision of Wirecard or involved in the decision-making process concerning Wirecard traded Wirecard stocks or derivatives.*”

On 1 October 2020, the Bundestag, Germany’s federal parliament, sets up a special committee to investigate the affair. Only a few days later, on 6 October 2020, the German federal government presents its “*Action plan of the federal government to combat balance sheet fraud and to strengthen control over capital and financial markets*” (MoF 2020d). Among other things, the plan aims to overhaul the current system of financial reporting enforcement by giving BaFin more competencies.

In January 2021 BaFin files criminal charges against one of its employees on suspicion of insider trading related to Wirecard. The employee allegedly sold structured products related to Wirecard on 17 June 2020, just one day before Wirecard announced that 1.9 billion euros were missing from its accounts (see Der Spiegel 2021/01/28). On 29 January 2021, several papers report that German finance minister Olaf Scholz has decided that BaFin’s president, Felix Hufeld, will be replaced (see Der Spiegel 2021/01/29).

4.2. Wirecard’s alleged fraud scheme

The emerging picture clearly looks like Wirecard was involved in all kinds of fraud. Today’s allegations against the company can be divided into three main categories (for a detailed description of the allegations see ESMA 2020b: 42 ff.). What they have in common is that they potentially contributed to a seemingly endless story of successful corporate growth.

- Wirecard seems to have fraudulently inflated – or rather, invented – customers, transactions, and revenues stemming from its TPA business (see Section 3.2).
- Wirecard seems to have acquired relatively worthless companies at excessive values, thereby inflating its own balance sheet and possibly diverting company funds into the pockets of middlemen with ties to Wirecard.

- Wirecard seems to have used subsidiaries and other companies with ties to Wirecard for so-called round-tripping, in which unused or worthless assets are sold on a round-trip between the involved companies at around the same price. While no economic substance is produced, the round-tripping activities are fraudulently reported as productive sales and purchases on the books of the companies involved.

In this Section, I will briefly go into the first of these categories, Wirecard's dubious TPA business, as it was here that the breath-taking sum of 1.9 billion euros went missing.

Officially, in recent years Wirecard's Asia business had been the company's main driver of growth. At the end of 2018, the region accounted for 48 % of Wirecard's reported revenues, while its more mature operations in the European market were growing at a much slower rate. As mentioned above, Wirecard did not possess banking licenses for its business in Asia, making its local operations reliant on domestic TPA partners (see Section 3.2). While still in November 2019 Wirecard told investors that it was working with around 100 TPA partners in 60 countries (see FT 2020/05/05), the FT had reported earlier that year that the alleged revenues and profits from Wirecard's operations in Asia stemmed almost exclusively from only three different TPAs (see FT 2019/03/29; FT 2019/04/24; FT 2020/05/05). This was later confirmed by KPMG (2020). According to the FT (2019/04/24 and 2019/05/20), in 2016 and early 2017 the three TPAs in question accounted for more than 541 million euros of revenues, around 50 % of Wirecard's total reported revenues of that period, and for more than 90 % of Wirecard's reported profits.

According to KPMG's special audit (2020: 14 f.), revenues supposedly stemming from these three TPAs were funnelled to the group through three Wirecard subsidiaries. However, these three Wirecard subsidiaries only received 85 million euros of cash from the three TPAs, i.e. only a fraction of the alleged total of TPA revenues Wirecard had reported for the period between 2016 and 2018. In the same period, however, Wirecard had provided these TPAs with around 250 million euros of credit (see FT 2020/05/05). Wirecard said that the rest of the TPA revenues – a sum of around 1 billion euros, equivalent to almost one quarter of Wirecard's reported revenues from that period – had not flowed into its regular accounts but instead into escrow accounts located in the Philippines. There hardly seems to be any good reason for storing such vast amounts of cash in escrow accounts, which are operated by third parties, rather than in regular company accounts – except, of course, to hide the real size of cash flows. Yet, for years Wirecard was able to convince its auditor, EY, that this was a regular and legitimate business practice.

When KPMG started conducting its special audit in 2019, it did the obvious and asked for bank confirmations of the alleged payments to the escrow accounts, which Wirecard was unable to provide. KPMG concluded: *"Bank confirmations and account statements from the bank managing the trust accounts were not submitted to us [...]. For this reason, the individual payments that, according to the information provided, had been made by the TPA partners into the trust accounts could not be verified"* (KPMG 2020: 15). Moreover, Wirecard also failed to present KPMG with evidence that the underlying basis of its supposed TPA revenues did really exist, namely the individual payments from customers to merchants, which supposedly had been processed by Wirecard's TPA partners. KPMG (2020: 28) concluded that it was *"unable to verify the existence of these customer relationships"*.

As it stands today, the most obvious explanation for the disappearance of the 1.9 billion euros is that the underlying transactions never took place. According to newspaper reports, there are, in fact, “no indications” today that Wirecard’s supposed TPA business existed at all (see *Süddeutsche Zeitung* 2020/11/27). If that is true, the purpose of the TPA sham does not seem to have been to divert funds, but rather to inflate Wirecard’s revenues, and hence to fuel the company’s growth story. This still had the effect of driving Wirecard’s stock price higher – a process through which senior Wirecard management must have become rich in recent years. Markus Braun alone, who had been CEO since 2002, is said to have held as much as 7 % of all Wirecard shares as late as 2017 (see *Manager Magazin* 2017/02/23).

As we know today, Wirecard’s real business seems to have performed quite poorly. Citing an unpublished report from Wirecard’s administrator, who was appointed by the court after the company had filed for insolvency, the FT (2020/09/23) describes Wirecard’s regular operations as chaotic and unprofitable: *“On paper, the formerly high-flying company generated €1.9bn in pre-tax profits between 2015 and the first quarter of 2020. However, if its fraudulent Asian operations are excluded, the remaining businesses accumulated €740m in pre-tax losses over the same period, according to the report. The losses were never disclosed because Wirecard only reported numbers for the whole group rather than its individual operations.”* *Süddeutsche Zeitung* (2020/11/27) reports that recently Wirecard was “burning” 400 million euros per year and was only able to survive on bank loans.

5. Analysis: The role of BaFin in the Wirecard affair

In this Section I am going to analyse three specific aspects of BaFin’s handling of the Wirecard case which I think are especially important in order to evaluate BaFin’s role in the scandal: (a) BaFin’s handling of the Wirecard case within the German system of financial reporting enforcement; (b) BaFin’s decision, in February 2019, to temporarily ban the short-selling of Wirecard shares; and (c) BaFin’s decision, in April 2019, to file criminal complaints against the journalists responsible for the critical FT reports, as well as against several short-sellers.

5.1. BaFin’s supervisory responsibilities concerning Wirecard

BaFin is the institution responsible for the supervision of the different segments of the financial system in Germany: banks and financial institutions (exercised together with Deutsche Bundesbank, the German central bank), insurances, and capital markets. All in all, BaFin is responsible for supervising about 2,700 banks, 800 financial services institutions and over 700 insurance companies. BaFin is an independent institution governed by public law but, as part of the German federal government, subject to legal and technical supervision by the German Ministry of Finance (MoF). Ultimately, the MoF bears political responsibility for BaFin’s activities (see ESMA 2020b: 53).

In terms of bank supervision, BaFin is responsible for “institutional supervision”, i.e. for the ongoing micro-prudential supervision of credit and financial institutions as defined by German and European law. However, BaFin and the Bundesbank had concordantly decided not to classify Wirecard as a financial holding company. This joint decision had last been

renewed in 2017 (see MoF 2020a: 12; Reuters 2020/06/29).¹³ Due to this classification, Wirecard fell outside of BaFin's banking supervision responsibilities and was subjected to BaFin's general capital markets supervision instead. The effect of this classification, however, was that, *"... the very extensive monitoring rights BaFin would have enjoyed, had the Wirecard parent company been considered a financial holding company, were not available"* (Langenbucher et al. 2020: 19).¹⁴

In addition to BaFin's supervisory responsibilities concerning banks and capital markets, since 2015 BaFin has also been tasked with the protection of the *"collective interests of consumers"* (meaning that BaFin cannot follow up complaints from individuals). This multifaceted mandate of BaFin has often been criticised as there seems to be an inherent trade-off between safeguarding the solvency of financial institutions and optimal consumer protection (see Schnellenbach 2017). The concern is that, in case of doubt, consumer protection will lose out to the goals of financial stability and bank solvency, since, in contrast to the latter two, it is not systemically significant.

5.2. Financial reporting enforcement in the context of Wirecard

Due to the fact that Wirecard had not been classified as a financial holding company, BaFin's only formal role in directly overseeing Wirecard was in the field of financial reporting enforcement. Issuers of securities traded on regulated markets within the EU are subject to the European Transparency Directive,¹⁵ which aims at providing market transparency by obliging these issuers to provide regular and regulated information to the public, e.g. in the form of yearly and half-yearly financial reports. § 106 of the German Securities Trading Act (*"Wertpapierhandelsgesetz"*, WpHG) states: *"BaFin is responsible for examining whether the [financial reports of listed companies in Germany] comply with the statutory requirements, including German proper accounting principles or other accounting standards permitted by law"*. However, despite the regulations stipulated in the WpHG, Wirecard was able to report grossly manipulated figures for years. As ESMA (2020a) puts it: *"High quality financial reporting is core to investor trust in capital markets and Wirecard's collapse has undermined this trust"*.

¹³ In fact, this decision to not classify Wirecard as a financial holding company has attracted a lot of attention in the wake of its collapse. If Wirecard had been regarded as a financial holding company, this would have subjected the company to BaFin's much more powerful competencies in the field of banking regulation rather than BaFin's limited possibilities concerning general capital markets supervision. Retracing this mostly legal debate on BaFin's classification of Wirecard would, however, exceed the scope of this paper. In brief, I am of the opinion that BaFin's classification of Wirecard was correct, given the fact that Wirecard, due to its organisational structure, simply did not meet the narrow definition of a financial holding company set out in the CRR.

¹⁴ In the field of institutional supervision (i.e. banking supervision), BaFin is equipped with a range of prudential tools. For example, according to § 44(1) of the German Banking Act (*"Kreditwesengesetz"*), companies under institutional supervision have the obligation to provide BaFin with *"information on all business matters on request, to submit documents and, if necessary, to provide copies"*. Moreover, BaFin can, *"even if there is no special reason, carry out examinations at the institutes and superordinate companies"*. Finally, the employees of BaFin can *"enter and inspect the business premises"* of the respective companies (translations by the author). In the field of capital markets supervision, on the other hand, BaFin lacks such rigorous competencies.

¹⁵ Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013. Online: <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex%3A32013L0050>

The workings of the German system of financial reporting enforcement have already been described in detail by ESMA (2017). Hence, I will be brief on this topic. In Germany, financial reporting enforcement is exercised by two different bodies. In accordance with Art. 24(1) of the Transparency Directive, the Financial Reporting Enforcement Panel (FREP), a privately organised company, is the designated NCA for examining whether the financial statements of a company comply with the relevant accounting framework, i.e. with the IFRS. BaFin, on the other hand, is the designated NCA for taking measures in case infringements are discovered (see ESMA 2020b: 25). Each year FREP picks a number of financial statements to examine based on a combination of risk-based and random selection as well as on the goal to have every company regularly reviewed (“rotational selection”) (see FREP 2018b). In addition to that, BaFin can instruct FREP to conduct a special examination into a company’s financial reporting, and BaFin is obliged to do so if there are concrete indications of a violation of accounting regulations.

The WpHG stipulates an idiosyncratic two-stage reporting enforcement process, in the first stage of which examinations are carried out solely by FREP, while BaFin is confined to a “*wait-and-see role*” (see ESMA 2020b: 29 ff.; FREP 2018a; Langenbucher et al. 2020: 19 ff.). FREP’s review process, however, relies at least in part on the constructive cooperation of the company under scrutiny. Moreover, FREP works on a small annual budget of 6 million euros and has only 15 employees. Not surprisingly, then, the average duration of FREP proceedings is eight to twelve months (see FREP 2020: 2), and even longer durations seem to have been the norm. For comparison: KPMG’s special audit into Wirecard, which was conducted between October 2019 and April 2020, and which employed forensic methods, supposedly involved 40 employees and cost around 10 million euros (see FT 2020/06/28). BaFin, on the other hand, can only act (i.e. carry out a review by itself) in the second stage of the process. The second stage is triggered when a company under review fails to cooperate with FREP, or when the company does not accept FREP’s findings, or when BaFin has “substantial doubts” about the accuracy of the examination result or the proper conduct of an examination by FREP (see Deutscher Bundestag 2020a; ESMA 2020b: 25).

In December 2014, FREP had selected Wirecard’s 2014 annual financial report for examination on the basis of rotational selection. FREP finalised the review in December 2016, concluding that there were no indications of incorrect accounting. Until 2019, neither FREP nor BaFin made attempts to examine Wirecard’s financial reporting again. When BaFin decided to start its investigation into potential market manipulation related to Wirecard in February 2019, however, its first step, on 15 February, was to initiate the first stage of the enforcement process by instructing FREP to examine Wirecard’s 2018 half-year financial report (MoF 2020a: 14). Coincidentally, FREP had already selected Wirecard’s 2018 annual financial report for examination with the intention to address the allegations raised in the FT (ESMA 2020b: 39). Yet, according to the FT (2020/06/28), only a single FREP investigator worked on the Wirecard case. Not surprisingly, little progress was made. This situation seems to have changed only after the publication of KPMG’s special audit in April 2020, which indicated huge inconsistencies in Wirecard’s balance sheet. Still, only in July 2020, almost one and a half years after the investigation had been initiated – and after Wirecard had already filed for insolvency – did FREP finalise its results. FREP found both Wirecard’s 2018 half-year financial report and its 2018 annual financial report to be erroneous (ESMA 2020b: 42).

After it had finalised its examination, FREP informed Wirecard of its findings. Wirecard replied on 15 July 2020 that, “*due to the current circumstances*”, it was unable to comment on the results. FREP classified this answer as a nonacceptance by Wirecard of the results of the examination. This classification finally allowed BaFin to initiate the second stage of the enforcement process and start an examination of Wirecard’s financial reports on its own, which it did on 24 July 2020 (ESMA 2020b: 42). As of March 2021, BaFin does not seem to have finalised its investigation.

The most important question here is whether BaFin could – and should – have acted earlier. FREP had examined Wirecard’s 2014 annual financial report during 2015 and 2016 and had not found any errors. Hence, when the Zatarra report was published in 2016, an FREP examination was already on the way. ESMA (2020b: 8-9) criticises FREP for failing to sufficiently take into account the allegations raised by the report. More importantly, both FREP and BaFin did not pick Wirecard for another examination in the period between 2016 and 2018, in spite of the ongoing allegations. ESMA (2020b: 8) has criticised this aspect as well: “*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.*”

Naturally, in retrospect it is always easy to conclude that someone should have acted earlier. Still, in my opinion there were, even at the time, several warning signs that the allegations against Wirecard were not completely made of thin air.

- Firstly, while the 2016 Zatarra report may have been intended to induce a negative market reaction, it is still remarkable that the report detailed its allegations on almost 100 pages. While often simple rumours are enough to lead to market reactions, it seems rather unusual that someone took the trouble to fill 100 pages with graphs and sources.
- Secondly, while it can still be argued if the anonymous Zatarra report was reason enough to pick Wirecard for a risk-based examination, another incident cannot be overlooked, namely the fact that FREP was informed by a whistle-blower about inconsistencies in the accounting of Wirecard’s TPA business in 2016. Still, FREP failed to draw the obvious conclusion and go into the matter. When the whistle-blower’s accusations were reported in detail by Manager Magazin (2017/02/23) in 2017, BaFin conducted a brief inquiry into the matter but still failed to instruct FREP to conduct an examination (see Section 4.1).
- Thirdly, while it is true that many of the allegations against Wirecard came from sources that may have been interested in a decline of Wirecard’s share price, these allegations still were often backed and enriched by detailed reporting in the press. In its special report, ESMA (2020b: 19) seems to suggest that BaFin may have simply been unaware of the FT’s reporting, as it recommends that “*FREP and BaFin review articles in international newspapers (including online newspapers)*”. However, I think that it is much more plausible that BaFin was well aware of the FT reports – but dismissed them.

To sum up, there were enough warning signs already in 2017 and 2018 that should have led BaFin to ask FREP to conduct another examination of Wirecard’s books. The fact that both FREP and BaFin seem to have been more or less unaffected by the constant flow of critical

and detailed information coming from the press is, in my opinion, an inexcusable failure. This result is even more staggering given the fact that it would not have even involved any additional effort to have Wirecard's books checked by FREP – it would have merely meant a shift in examination priorities. While it is unclear if a special examination by FREP would have really changed the course of events, given FREP's limited capabilities, in its absence one must conclude that both FREP and BaFin failed to make prudent use of the only instrument they jointly had at their disposal (initiating an FREP examination), however limited the effectiveness of that operation may have been.

5.3. BaFin's decision to temporarily ban the short-selling of Wirecard shares

On 18 February 2019, two and a half weeks after the FT's reporting had sent Wirecard's share price plummeting and BaFin had initiated its investigation *"in all directions"*, BaFin issued a *"General Administrative Act of the Federal Financial Supervisory Authority on the prohibition on establishing and increasing net short positions in shares of Wirecard AG"*, effectively banning short-selling Wirecard shares for two months (BaFin 2019). ESMA (2019) approved of the measure.

The temporary prohibition by the supervisor to trade certain financial instruments is a profound intervention in the market and needs a special justification. From an economic point of view, short-selling has the important market function of incorporating negative views about a company in the price of its shares, and consequently the ban temporarily disabled this function (see Langenbucher et al. 2020: 24). As a result, investors probably paid an overly high price for Wirecard shares in the period of the ban. Yet, it could be argued that, after the sharp and repeated fluctuations of Wirecard's stock price, BaFin's decision was a proportionate measure to calm markets for a limited period of time in order to thoroughly assess the situation. However, BaFin does not seem to have issued the ban in order to buy time for such an assessment. Rather, when it issued the ban, BaFin already had an explanation in place, which it formulated in its General Administrative Act (GAA). The GAA's justification of the ban starts with the observation that Wirecard had been *"targeted by 'short attacks'"* already in the past, namely in 2008 and 2016 (obviously referring to the affairs of *"Schutzgemeinschaft der Kapitalanleger"* in 2008, and Zatarra in 2016; see Section 4.1). These attacks, BaFin goes on, had been *"followed and facilitated by negative reporting in the media"*. The GAA further states:

"Since the end of January 2019, there have once again been various negative reports about the company in the press. The share price of Wirecard AG has fallen sharply over the past two weeks. [...] A significant price drop could be observed following the publication of an article in the press claiming that the staff of one of Wirecard AG's subsidiaries in Singapore had manipulated accounts in order to falsely report a higher turnover. The press reports have coincided with increased net short positions and with a corresponding high level of volatility in the share price of Wirecard AG. Since 1 February 2019, a significant increase in net short positions in shares of Wirecard AG has been observed, with a further sharp rise since 7 February 2019. In recent days, there has been a further substantial increase in the net short positions. These positions are held by various holders, in particular from abroad, and partially at levels below the notification threshold. [...] In the current situation, there is a risk that this uncertainty will increase and escalate into general market uncertainty" (BaFin 2019).

In this statement, BaFin makes three things clear: firstly, that it was convinced – while not saying that the FT’s reports had been inaccurate – that there was a connection between the negative reports in the press and ‘short attacks’ on Wirecard, a phenomenon which BaFin says could already be observed in the past. Secondly, that the current short attacks on Wirecard were threatening the orderly functioning of the markets in general, which is why a ban was necessary. And thirdly, BaFin points out that the attacks on Wirecard were coming “*in particular from abroad*”. The subtext of this is clear: in BaFin’s view, foreign press and speculators colluded to attack Wirecard. This reading of BaFin’s motivation for the short-selling ban is reinforced by the fact that BaFin went so far as to file a criminal complaint for market manipulation against the responsible FT journalists just some weeks later (see Section 4.1).

BaFin’s high level of certainty already in mid-February that a coordinated attack on Wirecard was taking place is surprising. After all, the short-selling ban came only two weeks after BaFin had initiated its investigation, which was supposedly aimed ‘in all directions’. As the Handelsblatt (2021/03/05) puts it: “*The short sale ban in February 2019 seemed like the financial supervisory authorities were taking sides in favour of [Wirecard].*”

However, thanks to the Bundestag’s special committee into the Wirecard affair, we know today that BaFin did have some reasons for taking this view: at the beginning of February 2019, BaFin received information from the public prosecutor’s office in Munich that Wirecard might be blackmailed by journalists. Shortly before, a lawyer from Wirecard had reported to the Munich prosecutors that Bloomberg journalists allegedly wanted to extort six million euros from Wirecard, threatening to “*accept an offer from the Financial Times and join in the negative reporting on the company*” (Business Insider 2021/02/12). The Wirecard lawyer, however, was not able to present any credible witnesses for that claim. As it stands today, the public prosecutor’s office also made no attempt to check whether Wirecard’s claims were plausible. Astonishingly, however, it still forwarded the information about potential blackmail to BaFin. As we know today, the whole story about alleged blackmail seems to have been made up by Wirecard to cast doubts on the allegations against it. Yet, at the time, BaFin seems to have based its decision to issue the short-selling ban to a large degree on the information coming from the public prosecutor’s office (Handelsblatt 2021/02/14).

Again, there may have been a reason why both BaFin and the public prosecutor seemed willing to regard the claims about possible blackmail as credible. Only two months earlier, in December 2018, the public prosecutor had applied for a penalty order for market manipulation against market participants involved in the publication of the 2016 Zatarra report – thereby supposedly confirming BaFin’s assumption that Wirecard had been under speculative attacks already in 2016. When the new situation around Wirecard began to evolve in February 2019, the idea must have suggested itself to the authorities that something similar to the 2016 Zatarra incident was going on.

Still, it must be expected from both authorities – the market supervisor and the public prosecutor’s office, whose job it is, after all, to uncover and prevent market *manipulation* – that they do not base their actions on claims coming, without evidence, from a company which itself had for years been in the centre of detailed fraud allegations. In this regard, it

is incomprehensible why the public prosecutor's office nevertheless seems to have passed the information coming from Wirecard on to BaFin unfiltered and without further evaluation. For BaFin, the information about potential blackmail must have led to the impression that its assumptions – that Wirecard was a victim of coordinated attacks – had been correct all along.

Yet, even if the allegations against journalists coming from Wirecard had been credible, it can still be doubted if a drastic intervention in the market like a short-selling ban was proportionate. The Bundesbank for example, while not having a formal role in the decision-making process, informed BaFin prior to the ban that it did not support the measure, as it saw no indications of a risk of 'general market uncertainty' stemming from the events surrounding Wirecard (see Handelsblatt 2020/11/24).

5.4. BaFin's decision to file criminal complaints against FT journalists and short-sellers

On 10 April 2019, BaFin filed a criminal complaint against two FT journalists who had been behind the reports on criminal investigations against Wirecard in Singapore, as well as against several short-sellers, accusing them of potential market manipulation related to the price drop of Wirecard's shares in February 2019 (see MoF 2020a: 14; FT 2019/04/16). This step met with particularly harsh criticism. Legal action by public authorities against critical journalists may be a common tool of autocratic regimes but it is, for good reasons, normally considered taboo in pluralistic Germany. There are, in my view, only a few potential explanations for BaFin's decision to choose this 'atomic option' of legal action against the press.

One explanation would be that BaFin, contrary to common sense, simply deemed the step to be just like any other measure in its toolkit. In this case, however, BaFin's top management must have been completely naïve regarding the political gravity and the public repercussions of such a move. In my opinion, this option can be disregarded, especially as BaFin seems to have regularly reported its planned measures to the MoF.

Another explanation would be that BaFin was indeed so convinced that Wirecard was under a coordinated 'short attack', which included the FT, that it simply deemed the criminal complaint unavoidable. This is what the previous discussion on the short-selling ban would suggest: based on its recent experience, BaFin was quickly convinced that Wirecard was again being attacked by foreign speculators who were colluding with the press.

However, in the case of the criminal complaint against the journalists, certain circumstances should have led BaFin to reconsider this rather drastic step. Most importantly, BaFin filed the criminal complaint in April 2019, i.e. after prosecutors in Singapore had already raided local Wirecard offices and had announced that they were probing several Wirecard subsidiaries. Hence, BaFin made its decision to sue when it was already clear that the FT's reporting about a criminal probe against Wirecard in Singapore, which had been the reason for the drop in Wirecard's share price in the first place, was actually accurate. For this reason, BaFin could not possibly think, at the time, that journalists were colluding to make up negative stories in order to manipulate Wirecard's share price. However, from BaFin's perspective there was still the possibility that, while the FT's reporting may have been

accurate by and large, the timing of the reporting could have been coordinated with short-sellers. Anyhow, BaFin stuck to its decision.

6. Evaluation of BaFin's role in the Wirecard affair

6.1. Summary of the findings

Let me recap the main findings of the analysis so far:

- Wirecard fell outside of BaFin's mandate of institutional supervision, subjecting it to general capital markets supervision instead. Within this area, the only formal role for BaFin in overseeing Wirecard was as part of Germany's idiosyncratic and cumbersome system of financial reporting enforcement.
- Between 2016 and 2018, amidst growing allegations against Wirecard, BaFin failed to employ the only tool it had at its disposal – instructing an FREP examination into Wirecard's books – however limited the effectiveness of this tool may have been.
- BaFin really started acting regarding Wirecard only in early 2019, after severe market turbulences had made it impossible to continue ignoring the mounting allegations and their effects on the stock market. In February 2019, BaFin initiated an investigation which the MoF has said was aimed “*in all directions*”.
- While BaFin also instructed FREP to investigate Wirecard's books (a process BaFin knew would take months), BaFin's short-term measures, a short-selling ban and the filing of a criminal complaint against FT journalists, were directed towards those who had criticised Wirecard. Both steps had the clear objective of protecting Wirecard.
- One reason why BaFin was seemingly ready to jump to a conclusion only weeks after it had supposedly initiated its investigation into the matter, and to side with Wirecard, may have been the fact that the public prosecutor's office in Munich had informed BaFin about the (ungrounded) claim by Wirecard that journalists were blackmailing the company only shortly beforehand. Although Wirecard was unable to substantiate the allegations, BaFin appeared ready to view them as credible, as the allegations apparently confirmed BaFin's long-held suspicion that Wirecard was a victim of repeated attacks by foreign speculators.
- In any case, the speed with which BaFin sided with Wirecard in February 2019 contradicts the statement that it had conducted its investigation ‘in all directions’.

6.2. The role of the press and potential damage of BaFin's actions for Wirecard investors

BaFin, the German capital markets supervisor, was neither able to stop nor even to detect the biggest case of white-collar crime in German post-war history. Without the persistent coverage of the FT, and the stubbornness of their reporter Dan McCrum, who has been

covering the case since 2015,¹⁶ Wirecard's racketeering probably would have remained undiscovered for an even longer time. Apart from the press, also whistle-blowers and short-sellers provided critical information to the public and the supervisor (who neglected it, however), highlighting the importance of a methodical assessment of information coming from such sources (see also ESMA 2020b: recommendations for guideline no. 6, p. 20 f.).

Those Wirecard investors who followed the FT's reporting closely were probably able to avoid the worst. Yet BaFin, intentionally or unintentionally, undermined the warning functions both of the press, by casting doubt on the credibility of the journalists behind the news reports, and of the markets, by preventing stock prices from falling further with its short-selling ban. For Wirecard investors, the signal that emanated from the actions of the supervisor was as clear as it was fatal: Wirecard seemed to be an innocent victim of foreign speculators and a colluding press. At the end of the day, many investors probably would have been able to save large parts of their investments had they abandoned Wirecard in early 2019. Those, however, who felt reassured by BaFin's measures and stayed on were set to risk losing considerable amounts of their investments.

Bernd Ziesemer, a former editor of Handelsblatt, a leading German business newspaper, did not mince words when assessing the course taken by BaFin (FT 2020/06/21): *"BaFin ... failed particularly miserably as an institution. For too long, it found all kinds of bureaucratic excuses to avoid looking into Wirecard seriously. When it finally did, BaFin's regulators did not target company management but rather the journalists behind the critical reports"*.

6.3. Inadequate financial reporting enforcement in Germany

In its current form, the German system of financial reporting enforcement relies on two impotent NCAs acting in a burdensome and lengthy process. While FREP is underfunded and lacks governmental powers, BaFin has the necessary powers but lacks the initiative to use them. Consequently, even if BaFin had wanted to do more regarding the allegations of accounting malpractice against Wirecard, which I doubt, its hands were tied. Such a system may be comfortable for companies interested in avoiding strict scrutiny but is inadequate for responding appropriately to serious allegations of fraud (i.e. in the form of a quick and forensic investigation into the company in question).

After the collapse of Wirecard, it became widely accepted that the current German system of financial reporting enforcement is not up to its task and needs to be reformed (see e.g. ESMA 2020b; Langenbucher et al. 2020; Véron 2020). Consequently, a fundamental reform of the system also became one of the pillars of the German government's "action plan" introduced after the Wirecard insolvency (MoF 2020d). In terms of financial reporting enforcement, the plan aims to abolish the current two-stage process by assigning BaFin the

¹⁶ Dan McCrum's year-long investigation of the Wirecard case is a fascinating story in itself. His account of the period involves legal disputes and corporate pressure, former intelligence officials, undercover operations, threats and traps, and heavy psychological pressure (see FT 2020/09/03).

main role and equipping it with adequate resources.¹⁷ If the reform is implemented, it will undoubtedly greatly improve the effectiveness of the German financial reporting enforcement system.

6.4. A home-country bias in the conduct of BaFin

The German finance ministry eagerly pointed out that BaFin's investigation following the slump in Wirecard's share price in early 2019 was conducted "*in all directions*", i.e. neutrally and open-ended. In my view, however, there are clear indications that BaFin, in fact, did not carry out an unbiased assessment of the situation – but rather seems to have jumped to the conclusion that Wirecard was under a coordinated attack from short-sellers and reporters coming "*from abroad*".

While it is true that BaFin instructed FREP to look into Wirecard's books, its main actions, a short-selling ban on Wirecard shares and a criminal complaint against critical journalists, were aimed at those who had accused Wirecard of misconduct. Given the controversial nature of the measures, the gravity and detailedness of the allegations against Wirecard, and the otherwise long processes in the Wirecard context, the fact that BaFin took these measures so quickly is, in my opinion, the strongest indication that BaFin never seriously examined the allegations against Wirecard. Rather, BaFin seems to have filtered all information concerning Wirecard according to whether it fit its existing narrative about Wirecard as the victim of coordinated speculative attacks from abroad.

The question is: why did BaFin act like that? As has been discussed, one reason could have been the fact that the public prosecutor's office in Munich, at the time, had just applied for a penalty order against the participants of the 2016 Zatarra report. Moreover, the public prosecutor's office had presented BaFin with claims by Wirecard that the company had been blackmailed by journalists. Both instances seemingly fit BaFin's narrative, as stated in its GAA, that Wirecard had repeatedly been under 'short-attacks' from abroad. Although this narrative may have seemed like an obvious explanation for the events unfolding in February 2019, BaFin clearly failed to examine other explanatory approaches, for example those that had been discussed in the press and which were much less flattering for Wirecard. It must be expected from a public supervisor that it indeed investigates each new allegation 'in all directions', i.e. impartially and objectively, rather than dismissing explanatory approaches that do not seem to fit its existing narrative. Therefore, the actions of the public prosecutor's office (which are, in my opinion, themselves questionable) are not sufficient to excuse BaFin's serious missteps in the Wirecard case.

In my opinion, BaFin's conduct in the Wirecard affair, and its willingness to side with Wirecard early on, is better explained by a more structural approach, namely the concept of a supervisory home-country bias (see Section 2.3). This concept expects national

¹⁷ More specifically, the plan states: "We will fundamentally reform the two-stage balance sheet control procedure, which is geared towards consensual participation by the audited companies, in favour of a balance sheet control process that is more strongly shaped by the state. BaFin must be able to act directly and immediately with sovereign powers vis-à-vis capital markets companies. BaFin needs the right to audit all capital market-oriented companies, including the right to information against third parties, the possibility of forensic audits and the right to inform the public earlier than before about its balance sheet control procedures" (BMF 2020d: 2; translation by the author).

supervisors, acting in the context of economically competing nation states, to be under pressure to align their supervisory behaviour with political, i.e. national economic, considerations. From this point of view, BaFin's behaviour in the Wirecard case may reflect the effort to – knowingly or unknowingly – safeguard perceived German economic interests. This is also what Véron (2020) suspects: *“Economic nationalism – the impulse to protect and promote national corporate champions whose success is somehow deemed to be aligned with the national interest – twisted the incentives of authorities and led them to neglect their primary mandate, in this case the protection of investors and of the integrity of the German securities market.”*

According to the literature on the deficiencies of nationally fragmented supervision, there are two main factors which make supervisory home-country bias more likely: (a) ‘supervisory capture’, where the supervisor is ‘captured’ by the supervisee, and (b) an insufficient institutional independence of the supervisor from the government.

(a) Supervisory capture refers to a situation in which supervisor and supervisee are unduly close over a long period of time, something that enables the supervisee to subtly influence the supervisor at a certain point. Naturally, such a capture is hard to prove in the case of BaFin's handling of the Wirecard case ex post. If at all, the previous discussion revealed at most two small indications for Wirecard's supervisory capture of BaFin. Firstly, at times BaFin seems to have taken over Wirecard's views regarding the FT's reporting. For example, BaFin had filed its criminal complaint against the FT journalists shortly after Wirecard had done the same. Secondly, members of BaFin's market abuse team, which monitors the market in terms of potential market manipulation, demonstrably traded Wirecard shares while the company was under investigation, thus raising questions about possible conflicts of interest. However, I am of the opinion that these two indications are too thin to believe that BaFin was indeed ‘captured’ by Wirecard.

(b) Apart from regulatory capture, the literature suggests that a home-country bias also corresponds to the degree of institutional independence of the national supervisor vis-à-vis its government: the lower the institutional independence of the supervisor, the higher the chances that it will exhibit a home-country bias. This strand of reasoning seems to explain BaFin's orientation:

- In a large empirical study on the independence and accountability of national supervisory agencies (Quintyn et al. 2007), the German supervisor achieved an independence rating of only 47 %, while on average the independence of national supervisors was rated at 68 % (ibid.: 20-21). This result is not very surprising given that BaFin is part of the German federal government, directly reporting to the MoF, which ultimately bears (political) responsibility for BaFin's actions.
- As BaFin's higher authority, the MoF has several ways to apply leverage on BaFin. For example, the members of BaFin's Executive Board *“are not civil servants but rather hold defined terms contracts of eight years”* with the MoF (ESMA 2020b: 54). Consequently, the extension of the employment contract of BaFin's top management depends on the approval of the ministry. After the failure of BaFin in the Wirecard scandal, Germany's finance minister, Olaf Scholz, eventually decided that BaFin's president, Felix Hufeld, will be replaced.
- While there is no apparent sign of direct political influence on BaFin by the MoF during the Wirecard scandal (see ESMA 2020b: 10), it is still noticeable how closely

BaFin and MoF consulted with each other before and after BaFin took its actions (see Section 4.1). In the words of ESMA (2020b: 8-10): *“For BaFin [...] 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. [...] the risk was present because at any moment the MoF had the possibility to influence BaFin in case of disagreement with the actions BaFin undertook or intended to undertake”*.

In this regard, it seems likely that BaFin, due to its limited institutional independence, approached the affair with some form of supervisory home-country bias, trying to support a domestic ‘champion’ facing international competition.¹⁸ The fact that BaFin, in its reports to the MoF, emphasized the *“homogeneous cultural background”* of the alleged speculators attacking Wirecard (see Section 4.1) also fits in with this explanation.

7. Policy implications for capital markets supervision in the EU

Wirecard was a payments group with a complicated business model which blurred the boundaries between finance and technology, and it operated in different geographical markets, within and outside of the EU. Moreover, Wirecard was based in a jurisdiction with a supervisor that partly lacked the right tools as well as the right resources and whose supervisory conduct was apparently biased by national economic concerns, leading it to neglect primary supervisory considerations to the detriment of investors.

What follows from this is that an effective supervisor does not only need the right tools (which BaFin lacked), it must also be willing to use them impartially and effectively. Yet, as the Wirecard case shows, in the current institutional set-up of capital markets supervision in the EU, which is characterised by national supervisory enforcement and economic competition between EU member states, national supervisors have strong incentives to disregard purely supervisory considerations for national-economic goals – which may ultimately lead to a supervisory conduct that is neither impartial nor neutral.

According to the literature, this incentive structure to protect national companies is especially strong if national supervisors are institutionally tied to their respective governments. In this regard, the concept of supervisory home-country bias suggests that BaFin would have probably continued its course of supervisory forbearance in the Wirecard case even if it had had more extensive powers. It also implies that a merely national reaction to the Wirecard scandal – e.g. reforming the German system of financial reporting enforcement – will not be enough to alter the underlying incentives which led a national supervisor to defend a national champion against allegations ‘from abroad’. This assessment

¹⁸ Supervisory home-country bias is an analytical concept which tries to explain the conduct of national supervisory authorities with structural incentive systems. It is not suited, however, to deduce the actual motives of actors in a given situation. Accordingly, while from an analytical perspective there seems to be a clear indication that BaFin, as an agency, acted under some form of home-country bias while handling the Wirecard case, which affected its incentives, this does not allow us to infer that BaFin management knowingly acted with an explicit protectionist agenda.

of BaFin's role is certainly not flattering for the German supervisor. However, the more important insight here is that due to the structural forces stemming from the current set-up of capital markets supervision in the EU, a national supervisor acting like BaFin did in the Wirecard case cannot be regarded as an unfortunate accident but must rather be expected.

In this regard, the Wirecard case is, at least in my reading, a case for the unification of supervision at the European level. An independent single supervisor at the European level, which is neither entangled in a specific national economy nor answering to a single national government, would have been in a much better position to deal with a case like Wirecard. A single European supervisor would by definition be immune to a supervisory home-country bias. The fact that Wirecard was regarded as a national German champion or that the critical reporting about Wirecard mainly came from a British newspaper would not have been decisive factors. A single European supervisor would also be better positioned to supervise cross-border groups, it would be more efficient, as current national resources could be pooled, and it would be much more resistant to regulatory capture. Considering all these advantages vis-à-vis the status quo, unifying capital markets supervision in the EU would be a decisive step towards a level playing field for investors as well as for companies seeking cross-border financing, and hence for more integrated capital markets in Europe.

7.1. Conditions for an effective single European capital markets supervisor

An attempt to outline a possible future system of unified capital markets supervision in the EU would certainly put a strain on the limitations of this paper. It would also be futile, as more competent observers have already discussed such a project (e.g. Avgouleas and Ferrarini 2018; Busch and van Rijn 2018; Friedrich and Thiemann 2017; Langenbucher et al. 2020; Masciandaro and Quintyn 2016; Schoenmaker and Véron 2017). Consequently, I am going to limit myself to highlighting three basic conditions for an effective single European supervisor which can be derived from the Wirecard case.

Independence from national interference: The most important lesson from the Wirecard scandal for financial markets supervision is that national economic considerations and effective – i.e. impartial – supervision hardly go together. One of the main criticisms of the ESAs is that national interests of the member states still dominate their governance. By contrast, the successful centralisation of bank supervision in the EU is largely credited to the institutional independence of the single supervisor, the ECB. In the same way, the success of a single capital markets supervisor at the EU level will depend on the degree that economic interests of individual member states are barred from impacting its behaviour.

Appropriate mandate: By trying to protect Wirecard, BaFin actually made matters worse for Wirecard investors. As has been seen, there seems to be an inherent conflict between the supervisory goals of sound institutions and systemic stability on the one hand, and effective investor protection on the other hand. While investor protection should be an equal goal along with objectives like financial stability, market efficiency, and market integrity, it may be worthwhile to reflect whether it should be organised in an institution separate from the supervisor.

Appropriate tools: The Wirecard case has highlighted that a proper mandate alone is not enough. Meaningful supervisory conduct involves profound competencies as well as sufficient resources. In this sense a single European supervisor would need, at the very least,

the ability to conduct (or to commission) swift forensic investigations into the books and the conduct of market participants in the event of serious allegations. A more far-reaching solution would not limit the single European supervisor to emergencies and special investigations but task it with permanent conduct-of-business supervision of significant market actors in the EU.

8. Summary

Wirecard, which had long been regarded as a German economic champion, seems to have committed all kinds of misconduct for years, in particular large-scale balance sheet manipulation. The analysis of the case has shown, however, that BaFin, the German financial markets supervisor, seemed ready from the start to protect Wirecard rather than to investigate the truthfulness of the allegations made against the company. More precisely, BaFin's handling of the case appears to have been based on the prepossession that Wirecard was the victim of a series of concerted "*short-attacks*" orchestrated "*from abroad*". In the course of the events, BaFin's ill-advised measures are likely to have worsened the situation for Wirecard investors, who were led to assume that the allegations against the company were indeed false.

In my opinion, BaFin's inadequate handling of the Wirecard case is best explained by the concept of a supervisory home-country bias. The concept emphasises how the incentives of national supervisory authorities can be distorted in the current European set-up of nationally organised capital markets supervision in the context of economically competing member states in the EU's single market. Such a nationalised set-up of capital markets supervision allows for close proximity between national politics and supervision and can foster insufficient institutional independence of the supervisor (as seems to be the case in Germany). In such a set-up, national supervisory authorities are structurally incentivised to take into account not only "pure" supervisory objectives, but also national economic interests. This may ultimately result in a supervisory home-country bias, where national supervisors try to protect domestic businesses from international competition. In this regard, BaFin's supervisory home-country bias in dealing with the Wirecard case does not come as a surprise but can be regarded as a textbook example of the shortcomings of nationalised capital markets supervision in the EU.

The best way to avoid a similar supervisory failure in the future would be to detach capital markets supervision from national politics by unifying it at the EU level, as demonstrated by the successful example of centralised bank supervision in the EU. A single European capital markets supervisor would be in a much better position to effectively supervise national "champions" as well as cross-border groups; it would also be more efficient. Moreover, unified capital markets supervision in the EU would greatly enhance the prospects of more integrated capital markets in Europe.

List of Abbreviations

BaFin	German Federal Financial Supervisory Authority (“Bundesanstalt für Finanzdienstleistungsaufsicht”)
CMU	Capital Markets Union
CRR	Capital requirements regulation
EBA	European Banking Authority
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European supervisory authority
ESMA	European Securities and Markets Authority
EU	European Union
EY	Ernst & Young
FREP	German Financial Reporting Enforcement Panel („Deutsche Prüfstelle für Rechnungslegung“)
FT	Financial Times
IFRS	International Financial Reporting Standards
KWG	German Banking Act („Kreditwesengesetz”)
MoF	German Ministry of Finance (“Bundesministerium der Finanzen”)
NCA	National competent authority
PSP	Payment service provider
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TPA	Third-party acquirer
WpHG	German Securities Trading Act (“Wertpapierhandelsgesetz”)

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