

What the Wirecard scandal reveals about the state of German financial supervision

*The Wirecard scandal has evolved into the largest case of accounting fraud in German post-war history. **Dustin Voss** examines the role of BaFin, the Federal Financial Supervisory Authority. He argues that with Germany's transition from a bank-based to a capital-market based financial system, regulators failed to beef up BaFin's powers to meet the challenges of 21st century internationalised finance.*

It's the stuff of Hollywood movies. A little-known payment processing company from Munich growing into a financial market behemoth, replacing Commerzbank in the prestigious DAX30, even daring to acquire Germany's financial crown jewel, Deutsche Bank. That is, until people started asking an uncomfortable question: where's the money?

Since then, not so pleasant headlines have been dominating the daily newspapers: a Philippines office running a multi-billion euro business from a bus station, €1.9bn in cash missing from its accounts, a record-speed insolvency, €13bn in stock market value wiped out within a week, key figures now either [fugitives](#) or [deceased](#); all adding up to the largest case of accounting fraud in German post-war history.

The collective desire for an international banking powerhouse blinded politicians, accountants, supervisors and investors alike until it crumbled before them like a sandcastle in the high tide (although, admittedly, the fact that Wirecard's early business model [rested upon pornography and online gambling](#) – things that corporate governance codes of more venerable German banks prevented – should have raised eyebrows). Then again, the Wirecard episode seems to be just one of many examples of high-profile corporate financial scandals in recent German history; think of the "Cum-Ex" tax fraud scheme, Volkswagen's "Dieselgate", HSH Nordbank, and various misconduct scandals at other German banks.

Notably, each and every one of these scandals was unearthed either by brave investigative journalists or Anglo-American watchdog agencies, such as the American SEC or the British FCA. Against these smash-mouth pit bulls, the German BaFin looks like a toothless puppy. And yet, a close look at the [history of German accounting scandals](#) in the post-war era reveals that corporate financial scandals at the frequency that we are seeing them today are only a relatively recent phenomenon with the first notable cases emerging in the mid and late-1990s (think of Bremer Vulkan or Philipp Holzmann AG). This raises an interesting question: why have financial scandals in Germany been mounting since the 2000s, or put differently, what prevented them hitherto?

A turning point in financial supervision

It is no coincidence that the increasing publicity of financial scandals coincides strongly with the dissolution of the infamous Deutschland AG. Until the late 1990s, Germany's political economy was characterised by a cartel-like network of close interfirm relationships between large banks, insurance companies and industrial heavyweights. In the early 2000s, Chancellor Gerhard Schröder and his finance minister Hans Eichel embarked on a mission to sever these notorious ties, reduce cross-shareholdings, implement international accounting standards, and help German banks conquer global capital markets.



A Wirecard display at the 2019 Web Summit in Lisbon, Credit: Web Summit (CC BY 2.0)

However, what the ambitious duo seemed to ignore in their endeavours to fortify *Finanzplatz Deutschland* was the fact that these very interfirm linkages actually created a relatively reliable system of checks and balances by tying the financial and personal fates of different firms and their managers inextricably together. [Supervisory boards with labour representatives](#) and creditor consortia (extraordinary shareholder meetings) provided for intensive knowledge exchanges and presented the main arenas for corporate oversight. While there were lots of rents to capture when things were running smoothly, there were also significant financial and reputational losses involved when things went wrong. For a long time, these strong interfirm ties functioned as an effective precautionary insurance mechanism against large-scale fraud without the need for a powerful independent financial market authority.

Obviously, the old Deutschland AG was not exactly a paragon of virtue either, with corporate scandals swept under the rug before they could even see the light of day. And yet, in an instance of supreme irony, the attempt to dismantle Deutschland AG's cartel-like structures only created the breeding ground for substantially more fraud at an international scale. When Germany's large firms made the transition from their cosy, shielded domestic bank-based model to today's international capital-market system, financial oversight fell by the wayside. BaFin, established in 2002 in an effort to unite the regulatory forces of different supervision bodies, never managed to fill the void.

Two optimal solutions to financial fraud

That the supervisory powers of corporate creditors are not what they used be is illustrated by a recent [report in the *Börsen-Zeitung*](#). As it turns out, the 15 members of Wirecard's creditor consortium who supplied a total of €1.76bn did not make use of their right to access the non-public audit report that was submitted to the supervisory board. As *Der Spiegel* reports, the contents of the 2018 audit report pointed out various inconsistencies "indicating or representing infringements of legal regulations".

Why did the creditors not request access to these potentially game-changing documents, one might ask? The sobering response seems to be because they didn't legally have to. In 2005, BaFin terminated a regulation that required creditors to consult a company's audit report in case its annual report did not provide a conclusive picture. Banks themselves had lobbied BaFin relentlessly to abolish this obligation because they felt constrained in their lending activities.

Against this background, it's not entirely surprising that financial authorities across the pond and channel are much more effective in uncovering financial accounting fraud. The German experience demonstrates that there are essentially two optimal ways to preempt financial fraud: one can rely either on a bottom-up informal system of checks and balances based on firm interlinkages, reputational costs and rents; or fight financial misdemeanours top-down and heads on with a relentless and powerful watchdog agency. If you have neither in place, however, things get dicey. With the death of Deutschland AG when German capital markets were opened to the world and banks let off the leash by cutting cross-shareholding ties, BaFin likewise should have been bolstered up for the new challenges. Instead, finance lobbyists managed to weaken it further.

Regulators are now drawing their conclusions. In the future, BaFin is to receive a broadened mandate, which would allow it to launch its own forensic audits without having to await confirmation by the so-called Financial Reporting Enforcement Panel (FREP), another independent but hopelessly underfunded accounting investigator. This move seems to represent a first important step out of Germany's financial supervision limbo. And yet, it remains highly questionable if this measure alone will empower BaFin to effectively restore the public utility function of German high finance. BaFin's internal structures appear to be too captured, as a [recent investigation by the European market supervisory authority ESMA](#) confirms. Since carrots don't work, it would certainly need to be armed with many more sticks in order to live up to the harsh financial realities of the 21st century.

Note: This article gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: [Web Summit \(CC BY 2.0\)](#)
