STATEMENT OF MARY BURKE[1] TO THE JOINT COMMITTEE, AS DIRECTED UNDER SECTION 67(1)(d) OF THE HOUSES OF THE OIREACHTAS (INQUIRIES, PRIVILEGES AND PROCEDURES ACT), 2013
29 April, 2015

Introduction

Good afternoon.

The Joint Committee has asked that I address a number of lines of inquiry falling under two broad categories of themes.

1. In the context of **Regulatory, Supervisory & Government Themes** these are:

    - Appropriateness of the regulatory regime;
    - Effectiveness and appropriateness of supervision policy and powers;
    - Appropriateness of the macro-economic and prudential policy;
    - The effectiveness of the use of supervisory powers;
    - Nature and effectiveness of the operational implementation of the macro-economic and prudential policy; and
    - Adequacy and impact of international organisations' oversight on banking regulation and supervision activity.

2. In the context of the **Banking Themes**, these are:

    - Integrity of financial reporting;
    - Analysis of liquidity risks under adverse scenarios;
    - Capital structure and loss absorption capacity; and
    - Effectiveness of the external audit processes to identify and report to the board and management, any concerns related to significant risk exposures, including property, funding and liquidity.

Preliminary comments

In addressing these areas I would note that, as I work within the regulatory authority rather than the banking industry, there is rather more that I can say about the regulatory and supervisory regime in principle and in practice, than I can about certain matters that are internal to banks, save to the extent that these were externalised and exposed to me in the course of my interaction with them in the course of regulatory and supervisory activities. I should also note that, as I have held a number of roles within the Irish Financial Services Regulatory Authority ("IFSRA") and the Central Bank ("the Bank") in the period covered by the Inquiry, my ability to give direct evidence on certain issues will vary depending on the extent of my personal and particular involvement with the subject-matter, if any, and my particular role at any given time. The Committee might note in the latter regard that the positions I have held are as follows:

[1] Head of Prudential Policy, Central Bank of Ireland

- Head of Banking Supervision - May 2006 to October 2008;
- Head of Banking Supervision (International Banks) - October 2008 to June 2010; and
- Head of Prudential Policy - June 2010 to date.

I should also note that certain matters are aggregated within themes and lines of inquiry, so that, mixed within these, there will be themes which presumably are not ones I am expected to address, and lines of inquiry on which I can give no direct evidence. So, for example, I note that the Regulatory, Supervisory & Government Theme includes "Government" within the overall theme, and lines of inquiry thereunder in relation to such matters as appropriateness and effectiveness of "macro-economic policy."

Next, given what I see as overlap between a number of the areas identified in the Regulatory, Supervisory & Government Theme, I have grouped certain aspects for the purposes of this statement.

I am also aware that the Bank has provided considerable background documentation on the technical detail and contents of the legislative, regulatory and supervision framework. Therefore, I have not sought to replicate that in this statement, nor have I considered it necessary to provide the Committee with documentation which does not add to my statement, and which, in any event, may be before the Committee already, having been provided by the Bank.

Penultimately, it may be of assistance for me to say, by way of overarching comment, that, while I may take issue with aspects of the fine detail of the respective Honohan and Nyberg reports, I accept generally the thrust of the findings contained in them.

Finally, I have been directed to provide a statement of no more than 5,000 words. Given the number and breadth of the issues to be dealt with, and the word-count strictures of this statement, these issues are necessarily dealt with at a high level. Nonetheless I hope the Joint Committee will find my treatment of them below to be useful. The treatment below, excluding this introduction and these preliminary comments, and comprising my statement to the Joint Committee on the directed lines of enquiry, is within the directed word-count.

1. Regulatory, Supervisory & Government Theme

R1: Effectiveness of the regulatory, supervisory and governmental regime structure

R2: Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

R1a. Appropriateness of the Regulatory Regime

The regulatory regime implemented by the IFSRA was positioned as "principles based". The approach to regulation adopted across the organisation appeared to me to be broadly similar to that previously applied by the Bank and did not represent a significant shift in prudential regulation/supervision. From my perspective, the focus on defining it as principles based seemed driven by a desire to 'brand' the organisation and its strategy rather than any fundamental change in approach (beyond the changes associated with consumer protection). While not defined, as articulated at the time, principles based regulation placed an emphasis on good governance and the responsibility of boards and management in regulated institutions to put in place governance, internal controls and risk management to appropriately manage their institutions. It was also seen as in keeping with the Government's "Better Regulation Agenda" and as a key message in promoting Ireland as a financial services centre.

Other factors which I consider influenced the approach to regulation and supervision were IFSRA's mandate to promote the financial services industry and the existence of the International Financial Services Centre (IFSC). The desire to portray Ireland as business friendly led, I believe, to a reluctance to introduce prescriptive rules and a particular focus on keeping costs down in the context of industry funding of the regulatory authority. In addition, the strategic decision that there should not be two different regulatory regimes - one for domestic firms and another for those in the IFSC - meant that a different approach was not taken to the domestic financial services sector. This decision was driven by a concern that the IFSC might otherwise be categorised as an off-shore centre with associated negative connotations.

However, principles based regulation was not without rules - primarily related to capital and liquidity - and was of course framed within the overall regulatory framework and its rules. The cornerstones of banking regulation in May 2006, the point at which I was transferred to the Banking Supervision Department ("BSD"), were the EU Capital Adequacy Directive ("CAD"), the Central Bank Acts and the Building Societies Acts. A key document supporting the regulatory regime was the Licensing and Supervision Standards, originally issued by the Central Bank in 1971 and most recently updated in 1998. However, it should be noted that these standards were non-statutory and as such not enforceable. Steps were taken to strengthen the regulatory framework with the issuance of a regulatory document on Impairment Provisions for Credit Exposures in October 2005 and the imposition of the Requirements for the Management of Liquidity Risk in September 2006. That being said while work had been initiated in other areas such as Directors' Compliance Statements and the Corporate Governance Code in 2004/05, this did not lead to their imposition on industry.

EU legislative initiatives also changed the regulatory landscape. The Capital Requirements Directive ("CRD") came into operation on 1 January 2007 and became fully effective in on 1 January 2008. This was a complex framework which, amongst other things, facilitated the use of banks' internal models for the calculation of regulatory capital and mandated supervisory cooperation through colleges of supervisors, particularly in the context of capital decisions for EU banks and banking groups.

Since the emergence of the crisis in 2007 the Basel Committee of Banking Supervisors has fundamentally revised the Basel framework, the EU has now implemented CRD IV, revised the European System of Financial Supervision and has established a Single Supervisory Mechanism while Ireland has revised its supervisory model, given additional powers to the Bank and established a resolution regime. Given the scale of changes to the regulatory framework at international, EU and domestic level, it is only reasonable to accept, albeit with the benefit of hindsight, that the pre-existing regulatory regime, both domestically and internationally, was not fully appropriate, in terms of the areas covered, the detail prescribed and the regulatory tools available, including those for crisis management and resolution.

R1b/R2a. Effectiveness and Appropriateness of Supervision Policy and Powers in Principle and Practice

Here, I have aggregated my commentary in relation to lines of inquiry R1b and R2a.

In my view, revision of the regulatory framework, in and of itself, is not, and would not have been, a *panacea*. In fact, given the nature of the issues we now know to have arisen in Irish banks I would suggest that the regulatory powers available to IFSRA, and the Bank before it, were broadly sufficient - aside from those with respect to crisis management/resolution.

In my view, the issues were the strategic approach, and the willingness (or lack thereof), as well as the logistical wherewithal (or lack thereof), to use those powers to prescribe detailed rules/requirements, or to challenge and intervene in a manner which would impact banks' business models. In the case of IFSRA and the Bank, this was I believe influenced by a number of external factors including the international approaches to regulation/supervision, government strategy/policy, promotion of Ireland as a financial services centre, industry influence on the shape of regulatory policy, costs, and, in the run-up to the crisis, an overoptimistic macro-economic view. The effectiveness of the regulatory regime is directly linked to the culture of the supervisory authority and the resources allocated to supervision. Unlike the regulatory framework which is set out in legislation and published standards, these are aspects which are not necessarily visible, and can be lost in statistics and in the prose of strategy documents and annual reports.

While IFSRA had introduced more rules domestically and the EU regulatory framework was changing, compared to the prescription we have today, the regulatory framework tended towards principles and provided considerable discretion to regulated entities.

However, in my view, a more onerous or prescriptive regulatory framework would, in and of itself, not necessarily have delivered a significantly different outcome if – as was the case - the supervisory resources, both in terms of staff numbers and specialist expertise, were not in place to monitor, challenge on adherence, and enforce where compliance was not delivered. It is worth focusing on this in more detail:

In 2006, "BSD" had an approved staff complement of 53.5 with actual numbers averaging around 50 to supervise approximately 80 banks[2]. In allocating staff relatively more were focused on the main domestic retail banks. For example, in 2006, not allowing for vacancies:

- A three person team was responsible for Bank of Ireland and Anglo Irish Bank;
- A three person team was responsible for AIB and IL&P; and
- A four person team (albeit three full-time equivalent persons) was responsible for eight credit institutions and a branch, including INBS and EBS.

Supervisory engagement with credit institutions comprised a mixture of on-site and off-site engagement. On-site engagement comprised

- Inspections; and
- annual review meetings.

Off-site work comprised reviewing

- prudential returns;
- financial accounts;

[2] Approximately 50 Irish-licensed, the balance operating on a branch basis under the EU Freedom of Services framework

- external auditor information; and
- third party reports.

However, a significant amount of the off-site engagement was dedicated to assessing, and opining on, commercial proposals from banks which required regulatory review and decision. These would have included proposals on

- capital and funding;
- restructuring;
- outsourcing;
- acquiring-transactions; and
- new activities,

as well as dealing with queries on interpretation of legislation, requirements and guidelines.

In addition to on-going supervision, in the absence of separate Policy or Enforcement Divisions, BSD was effectively a one-stop-shop for all direct and indirect supervisory issues in relation to banking, together with

- the implementation of CRD;
- liaison with other regulatory authorities;
- domestic and EU policy development;
- participating in European committees;
- processing applications for authorisation;
- activities associated with promoting the Irish financial services sector; and
- responding to wider issues including the escalating financial crisis.

The level of resources and the associated level of available specialist expertise was not such as to be capable of delivering intrusive supervision - even in a 'business as usual' mode of operation. However, during my tenure in BSD, which commenced in 2006, a business as usual scenario never in fact applied. Initially, there was the additional burden of transposing and implementing the CRD (including establishing policy on CRD option/discretions, assessment of IRBA model applications, participation in colleges of supervisors, implementing an online reporting system) and from August 2007 the crisis mounted, with ever increasing issues and problems heaped upon an already under-resourced and over-stretched department.

While an additional complement of 3 staff was agreed in 2007, my request for additional staff in May 2008 in the face of the financial crisis and the demands being placed on the department was effectively refused. In the context of manpower planning I requested an increase of 6 staff in order to establish dedicated two person teams for each of AIB, BoI, IL&P and Anglo. I was clear in supporting documentation that I did not view this as an adequate number, but - conscious that Mazars were then conducting an organisational review, including a review of resources – I positioned this as an interim request. Even though my request was already 'self-censored' in terms of seeking only a modest and critical number of extra staff (in the knowledge of previous experience in seeking additional resources, the fact that the CEO had instructed that there would be no increase in staff complement, and the Mazars review), the outcome was an increase of only 0.4 persons. This resulted from a revised approach to accounting for part-time staff or staff working atypical hours. A subsequent oral request that staff who had previously worked in BSD be reassigned to the department was also rejected.

It is difficult to convey the scale of pressures management and staff in BSD were working under, particularly from autumn 2007 onwards. It was not a question of somehow multitasking; it was an unrelenting onslaught of demands with staff working long hours which ultimately became unreasonable and unsustainable. Resource constraints were such that IFSRA was unable to conclude on Internal Capacity Adequacy Assessment Process ("ICAAP") assessments, as required by the CRD, for banks by end of 2007. In order to ensure that there were no regulatory capital releases as a result of the delay in evaluation of the banks' ICAAP submissions BSD issued letters to banks in December 2007 setting a minimum capital requirement from 1 January 2008 using Basel 1 as the reference point. The letter explained that a number of issues impacted on progress, not the least of which was the demand that (the then) market conditions had placed on key resources. Throughout 2008 staff were on an almost daily basis being assigned additional responsibilities and/or reassigned to deal with a particularly difficult and/or urgent issue. Every new issue or new request was a priority on top of existing priorities, and issues with one institution were being dealt with at the expense of issues with others.

It was only immediately following the introduction of the Government Guarantee that an increase of 20 in staff complement was agreed. At that point a separate department dealing with the government guaranteed banks was established, and over the following years, BSD was restructured on a number of occasions. Overall staff numbers approved for banking supervision increased over the following years to 140 in 2010. However, citing numbers alone understates the true impact of this increase in staffing levels, as it is important to recognise that with the establishment in 2010 of separate policy and enforcement directorates, resources in BSD were freed from these responsibilities.

Even where rules/requirements imposed were sanctionable under the Administrative Sanctions Procedures ("ASP"), in the period 2003 to end 2008 no prudential enforcement cases were pursued against credit institutions. I consider that there were a number of factors in this - strategically the IFSRA Authority saw the ASP process as being primarily a tool in the consumer protection arena, concerns regarding market reaction as the crisis mounted and the absence of resources to mount and pursue such cases. Post the introduction of the Government guarantee sentiment at executive level changed and sanctions were being actively encouraged albeit not in respect of core prudential regulation. However, it was only as the resources issue was addressed from 2009 onwards that prudential enforcement cases became more routine.

In assessing the effectiveness of the supervisory regime, it is important to understand the culture of the organisation and the different levels of engagement with industry to which this gave rise. IFSRA's relationship with banks appeared to me to operate at two levels:

- at a frontline operational level with BSD; and
- at senior executive level.

In the case of banking, as noted by Governor Honohan in his report *"Irish Banking Crisis Regulatory and Financial Stability Policy 2003 - 2008"*, direct representations were made to senior regulators regarding demands from line supervisory staff. Senior banking executives had regular direct contact with senior executives in IFSRA, often without the knowledge of, not to say engagement with, supervisory staff. On occasions we, in BSD, would be aware of meetings with bank executives because a bank contact subsequently mentioned it to the supervisory team; because a briefing was requested, often at short notice; or because a recognisable bank executive happened to be seen as being present in the Bank's offices. This was a cause of tension in the department even prior to my appointment and continued to be so during my time in BSD. As BSD could not rely on senior executives to advise us of such meetings, in October 2006 I requested that their support staff would advise us, inter alia, of the date and time of meetings with credit institutions, the proposed attendees and agenda, whether a briefing was required and whether BSD was to be represented. In practice, this resulted in marginal, if any, difference, particularly as the crisis escalated. Staff were regularly requested by senior IFSRA executives to review decisions/issues based on these discussions or told by contacts in banks that issues had been, or would be, discussed, with our senior executives. To me, at its most benign, this indicated a disconnect between the BSD and senior IFSRA executives which, in practice, banks used to their advantage. I believe that it also signalled a manifest lack of support for staff, undermining them in their dealings with banks.

R1c/R2b. Appropriateness, and Nature and Effectiveness of Operational Implementation of, Macro-economic and Prudential Policy

As issues relating to macro-economic policy are aggregated in lines of inquiry R1c and R2b with issues relating to prudential policy, and as the former is more appropriate for witnesses speaking to the "Government" part of this theme, I am taking it that, on this basis (and not being an economist), I am to address prudential policy, being the policy with which I had a more direct personal involvement.

In terms of any interrelationship between the two, if one views macro-economic policy drivers primarily as fiscal policy and interest rate setting, IFSRA had no, and the Bank little role in macro-economic policy save for decisions it contributed to at the ECB.

However, one could take a wider interpretation as including advice to government on macro-economic issues or measures to influence the money supply via macro-prudential policy. Even using this interpretation, when working in BSD, I saw no evidence of a strong link between macro-economic and prudential policy. Given the demands placed on BSD resources as a result of the implementation of CRD IV, at some time in 2005/early 2006 a decision was taken that BSD would cease to be actively involved in work related to the Financial Stability Review[3]. However, this would have been in the knowledge that the relevant economic department within the Bank had access to supervisory data regarding individual banks.

The Financial Stability Committee was a formal structure for cooperation between IFSRA and the Bank on financial stability related issues. However, the main focus of meetings tended to be on drafting of economic articles and publications rather than proactive advice or recommendations on measures which could/should be taken in a financial stability context by the government, IFSRA or the Bank itself. In my view its role in seeking to influence macro-economic or prudential policy was minimal.

In terms of prudential policy, IFSRA took a number of policy measures aimed at strengthening the regulatory framework including the introduction of Liquidity Requirements as mentioned above. The regulatory capital framework was based on the EU standards of the CAD and subsequently the CRD. The CRD provided options and discretions to

[3] An annual publication which aimed to analyse and assess the overall health of the financial system.

regulatory authorities on certain issues. IFSRA, in implementing these options and discretions, required that banks hold more capital than the standard prescribed in the CRD in the case of residential mortgages where the LTV ratio was over 75% and the property was not a principal private residence. In addition, in exercising the option available under the CRD that "exposures associated with particularly high risk such as investments in venture capital firms and private equity investments shall be assigned a 150% risk weight"[4] , IFSRA applied it to speculative commercial real estate exposures. The proposals on these, and all other, options and discretions were the subject of a public consultation in October 2006. It is interesting to note that only 6 submissions were received and, to the extent that they addressed these matters, none suggested that more onerous measures should be taken. The Governor of the Central Bank was also consulted on these proposals and, following consultation with the relevant economic division of the Bank, the Governor confirmed that the proposals represented the best that could be achieved in the circumstances. Aside from the overarching policy framework, in 2007, decisions were taken in the case of the domestic IRBA banks to impose super-equivalent capital floors under the new CRD regime in 2007. While these interventions can now be seen as insufficient, it is worth noting that IFSRA was the only public authority which took both institutions-specific and generally-applicable measures to try to cool property related lending and economic activity.

R6: Relationship with and oversight by international stakeholders

R6a. Adequacy and impact of international organisations' oversight on banking regulation and supervision activity

My experience of international organisations' oversight of banking regulation and supervision activity relates to an IMF process in 2006, and of Committee of European Banking Supervisors (CEBS), (latterly the European Banking Authority (EBA)) peer-review processes in 2009, 2010 and 2013. The key international organisation in terms of a broad review of banking regulation and supervision was the IMF.

The IMF conducted a Financial System Stability Assessment in 2006. The fieldwork by the IMF Financial Sector Assessment Program (FSAP) team was conducted in Dublin from 2 to 14 March 2006 with their report issuing on 7 July 2006. Given that it was only in May 2006 that I transferred to BSD, I cannot comment on the manner or depth of the IMF's engagement with IFSRA and/or the Bank. Ultimately, while the assessment report flagged some macro-risks which could have implications for banks' asset quality in the event of a significant slowdown in growth (i.e. rapid credit growth driven by mortgage credit in the extended boom in the housing market), it considered this as extremely unlikely and that major domestic lending institutions had adequate capital buffers to cover a range of large but plausible hypothetical shocks reflecting the risks identified. The IMF mission also highlighted the need to continuously review the adequacy of supervisory regulatory resources to take account of market and regulatory developments and the growth of the international financial services sector. The IMF has acknowledged shortcomings in its methodologies at this time and I see no reason to disagree with their assessment. On the impact of the report, I don't recall that the 2006 assessment triggered any significant directional change either in terms of regulatory policy or supervision. Having said that, I know that concerns were raised and discussed at the level of the IFSRA Authority and with executives regarding the scale of bank-lending, and also the need to exercise CRD options and discretions in the areas of property lending in a conservative manner. Also, a number of inspections were undertaken in the area of residential mortgage lending and commercial property lending. However, I cannot say what direct impact the IMF assessment may have had on these decisions or whether they would have occurred anyway, absent the IMF assessment.

[4] Paragraph 66 Annex Vi Directive 2006/48/EU.

The IMF also conducted periodic Article IV consultations, which consisted of bilateral discussions with public authorities, and published the associated staff reports. In the period under review reports were published in 2007, 2009, 2010 and 2012. Of their nature, these were less in-depth and focused more on economic developments. Nevertheless they touched on certain elements of regulation and supervision. In that context, as might be expected, the 2007 report has a similar tone to the 2006 Financial System Stability Assessment, whereas those from 2009 onwards reflected a different reality.

Aside from the IMF Assessment, the CEBS/EBA conducted peer reviews. CEBS established its Peer Review Methodology in October 2007[5]. A peer review encompasses an assessment and comparison of the effectiveness of the supervisory activities and of the implementation of the EU regulatory framework by competent authorities vis-à-vis their peers. The first peer review on compliance with EBA Guidelines on the implementation, validation and assessment of Advanced Measurement ("AMA") and Internal Ratings Based ("IRB") Approaches for regulatory purposes, was published in April, 2009, with a peer review of colleges published in October 2010. In the period under review the only other review was the Peer Review of the Implementation of Stress Testing Guidance (GL 32) published in November 2013. In these cases no significant issues were raised regarding IFRSA/the Bank, and therefore their impact was commensurately neutral.

2. Banking Theme

B1: Effectiveness of banks' board governance, client relationships and business models

B3: Effectiveness of banks' funding, liquidity strategies and risk management

B7: Impact of banks' external audit processes in supporting effective risk management

B1b. Integrity of Financial Reporting

As is the case with all companies, financial reporting obligations on credit institutions are governed by company law and relevant accounting standards rather than requirements of IFSRA or the Bank as banking regulator. However, credit institutions were required to submit their annual audited financial statements to IFSRA/the Bank within 3 months of the accounting year end, together with a reconciliation of their audited accounts to their regulatory return for the same period. At that point in time banks' financial statements would had been audited and signed-off by their boards. The purpose of this reconciliation was to operate as a check on the *accuracy of the relevant regulatory return*, rather than to *second guess or review the work of the auditors*.

While BSD reviewed and queried periodic regulatory returns, in a supervisory regime which was not structured to analyse and challenge in depth the information underpinning regulatory returns, reliance was placed on the audited accounts and the annual reconciliation. The focus was more on examining any material differences between the regulatory returns against the audited financial statements rather than an open-ended examination of any and all financial reporting. While issues were followed up with a number of institutions, I don't recall any fundamental issues arising as a result of such reviews.

B3b. Analysis of Liquidity Risks under Adverse Scenarios

[5] Subsequently revised in July 2009 and in June 2012 by the EBA.

In September 2006 the Financial Regulator imposed *"Requirements for the Management of Liquidity Risk"* as a condition on the licences of all Irish licensed credit institutions. Institutions were given a lead-in time such that the requirements became effective on 1 July 2007.

These introduced a maturity mismatch approach and comprised quantitative and qualitative requirements for the management of liquidity risk including setting out responsibilities of the Board. The requirements did not prescribe particular scenarios that institutions were required to stress against. However, in summary, they required that banks address stress testing in their liquidity policy; complete stress testing on a quarterly basis on both a bank-specific and industry-wide basis; consider whether both moderate and severe entity-specific stress tests should be conducted; and document acceptable mismatches between inflows and outflows under each scenario together with the required strategic response. The outcome of stress testing was required to be reported to the institution's Board on an annual basis.

While this structured approach to regulation of liquidity was a significant advance on the previous stock ratio, in that it forced institutions to examine their liquidity profile and consider the impact of various stresses, even in a severe stress scenario banks generally did not plan contingencies for the complete closure of the wholesale market to them. In terms of contingency planning banks were focused, in particular during 2008, on maximising their ECB and, to a lesser extent, other central bank, eligible collateral so as to have access to central bank market operations for liquidity purposes.

<u>B3e. Capital Structure and Loss Absorption Capacity</u>

The minimum regulatory capital requirements for banks, and the structure of capital to satisfy those requirements was set out in EU directives, viz., the CAD and subsequently the CRD/Capital Requirements Regulation. In terms of the quality of regulatory capital, in the case of the relevant banks, this comprised Tier 1 and Tier 2 capital including subordinated debt which is viewed as loss-absorbing. The subordinated debt would have been available to meet losses, had it not been guaranteed under the Government Guarantee.

In terms of loss-absorption capacity, the issue in the context of the Irish banking system was the quantum, not the quality of capital, and this is directly linked to asset quality, associated loan loss provisioning and value of collateral.

In considering loan loss provisioning it is worth noting that International Accounting Standard 39, which operated on an incurred loss basis, is being replaced with International Financial Reporting Standard 9 with effect from December 2018. IAS 39 limited the ability of banks to create a general provision for losses as there had to be *specific evidence of impairment* before losses could be provided for. IFRS 9 is intended to facilitate the *recognition of future expected losses* on a more timely basis.

In summary banks' risk management and credit control systems did not anticipate the impact of the economic downturn on the value of property related portfolios and, in not planning for the concurrence of events and the depth of the recession, overestimated the extent to which their portfolios were genuinely diversified. Ultimately, the resulting loan impairments, provisioning and write-offs completely eroded their capital base.

<u>B7b. Effectiveness of banks' external audit processes to identify and report to the board and management, any concerns related to significant risk exposures, including property, funding and liquidity</u>

In the context of performing the annual audit of financial statements, auditors issue a report to those charged with governance of the company which should address, inter alia, significant deficiencies in the internal controls and accounting systems which were identified during the audit, and concerns, if any, over the “going concern” of the company. Accordingly, to some extent, it could be expected that where such deficiencies are not flagged, auditors may be taken as indicating to the board and to management that they have not identified any significant risk exposures, including in relation to property, funding and liquidity. However, the deficiencies in question are only those which were identified as a consequence of conducting an audit, rather than ones that might be identified on a more ‘root and branch’-type review of internal controls and risk management. I am not in a position to speak to the detailed processes employed by auditors, but my understanding is that the audit process is not tantamount to such a root and branch review, and accordingly, whether for this reason and/or for other reasons, the audit process did not seem to result effectively in the identification to the board and management of concerns regarding significant risk exposures, or, in the event that there was such identification, to the communication of same.

In accordance with Section 27 of the CBFSAI Act 2004 auditors were required to submit such reports to IFSRA and in the event that no such report was issued, to inform IFSRA accordingly. To the extent that issues were raised in such reports, depending on their significance and/or whether IFSRA had prior knowledge, BSD followed up on issues directly with the credit institutions concerned. My recollection is that insofar as any issues were identified by auditors in reports to the board and/ or IFSRA, nothing was so fundamental as to call into question the viability of institutions in accordance with the “going concern” principle which would have resulted in qualified audit reports.

MARY BURKE

29 APRIL, 2015