HOUSES OF THE OIREACHTAS

Volume 1 **Number 9**

AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉIREACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 25 Feabhra 2015

Wednesday, 25 February 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D'Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O'Keeffe.
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

reason the ECB wanted Ireland into the troika bailout programme. It wanted its support to turn into liquidity support and not become a risky position.

Senator Sean D. Barrett: Regarding the Watergate moment, are the tapes of the capital market desk distinct from the Anglo Irish Bank tapes? How many bankers are recorded on those tapes admitting they were insolvent? How long did it take place before the embellishment document that Professor Connor described?

Professor Gregory Connor: It would be very interesting for the committee to hear more of those tapes. I do not know if the committee can ask for them. I have only heard little bits-----

Chairman: I need to put on the record that these are matters that may be subject to a criminal investigation and cannot be dealt with by this inquiry. I will give the Senator some leverage to ask a different question or else we will move on.

Senator Sean D. Barrett: Esmond Birnie wrote very strongly against entry into the euro. In the Northern Ireland Parliament, three of the five parties accepted the dangers of the euro. There were some in Irish economics and public life who acknowledged there were dangers in entering the euro without reading the small print.

Professor Gregory Connor: Several prominent Irish economists who I will not name were strongly opposed to euro entry. There were more who were sceptical about the Greek entry, not the Irish entry. Many of them found it quite uncomfortable because of the political pushback from expressing that view.

Senator Susan O'Keeffe: In 2008 in a letter Professor Connor co-wrote to *The Irish Times*, he spoke about bank management and shareholders failing in their duties with managers presiding over a loss of wealth unprecedented in the modern economy and shareholders failing in their duty to monitor and control management. He said, "Neither side should get away with this dereliction of duty". Does he believe there needs to be individual penalties for banking officials or fines levied against their institutions? Does he believe officials in the Central Bank or in the Financial Regulator should resign?

Professor Gregory Connor: It is very easy, especially in this Chamber, to talk about punishing the bankers because the only bankers left, except for Bank of Ireland, are the taxpayers. There is no one left to punish. All the shareholders have walked away with zero cash. There is nothing left under limited liability. The shareholders cannot be punished any more than being left with zero cash. As for the bank managers, it is true. It might be through the criminal system and not part of the committee's investigation.

Chairman: I thank Professor Connor for his participation today. It has been a very informative and very valuable meeting which has added to our understanding of the factors leading to the banking crisis.

Professor Gregory Connor: I thank the committee for inviting me to make a presentation to it.

Sitting suspended at 11.25 a.m. and resumed at 11.45 a.m.

Professor Eamonn Walsh

Chairman: I welcome Professor Eamonn Walsh, UCD, to discuss the regulatory and supervisory policies, systems and practices which may have underpinned the banking crisis in Ireland and, in particular, accountancy standards and auditing. Professor Eamonn Walsh is PwC professor of accounting at UCD. He has served as Dean of the Smurfit School of Business and chairman of the accounting department. Prior to joining UCD he held faculty positions at the London School of Economics and New York University. Appointments have included UC Berkeley and Peking University. A consultant to a number of leading European, US and Asian corporations, he has also completed assignments with governmental organisations, the International Monetary Fund and the United Nations. His primary research, teaching and consulting interests are in the areas of financial analysis, equity valuation and US security markets. A co-author of three books, his research has been published in *Accounting Organisations and Society*, the *Journal of Business Finance and Accounting* and the *Journal of Accounting Auditing and Finance*. He was the founding editor of *European Accounting* and served as associate editor of the *Journal of Accounting Auditing and Finance*. He was the inaugural recipient of the Institute of Chartered Accountants Excellence in Education Award and has been a presenter at the World Economic Forum.

I wish to advise the witness that by virtue of section 17(2)(*l*) of the Defamation Act 2009 witnesses are protected by absolute privilege in respect of their evidence to the committee. If witnesses are directed by the Chairman to cease giving evidence on a particular matter and they continue to do so, they are entitled thereafter only to a qualified privilege in respect of their evidence. Witnesses are directed that only evidence connected with the subject matter of these proceedings is to be given and, as the witness has been informed previously, the committee is asking witnesses to refrain from discussing named individuals in this phase of the inquiry. Members are reminded of the longstanding ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the House or an official by name or in such a way as to make him or her identifiable. I now invite Professor Walsh to make his opening statement to the inquiry.

Professor Eamonn Walsh: I thank the Chairman for his introduction and the committee for the opportunity to assist the inquiry. I was asked to consider the role of accounting in bank crises and also external auditors. I have prepared some brief remarks on these two topics which, in the interests of brevity, I have distilled from my published statement. I would be happy to elaborate on any of the points I have raised. I am also happy to discuss other accounting issues of relevance to the banking crisis.

When we think about banking crises, accounting is largely a silent bystander. A bank crisis generally involves rapid loan growth alongside which we get concentrations of risk. Often this rapid expansion is funded from volatile sources. When one is in this expansionary mode, if a regulator or anybody else questions the business model, management will dismiss them because they will be able to point to excellent accounting profits and, as a result, great contributions to capital. This pattern of behaviour was evident prior to 2008 in Ireland. Our banks were among the most profitable in Europe. It was widely believed that in what appeared to be challenging scenarios there were sufficient cushions to withstand risks. Balance sheets and income statements formed the basis for this analysis so accounting was clearly implicated in the misperception of risk. By 2009 it was apparent that the capital cushions available to Irish banks were entirely inadequate. Some financial institutions had liabilities that exceeded their assets; they were insolvent.

Balance sheets and income statements are prepared using accounting rules or accounting standards. In general these are known as international financial reporting standards. They are a large body of rules which indicate how one should measure assets, liabilities and income for an enterprise. However, during banking expansions these accounting standards may be a little unhelpful and they will serve to over-estimate the profits that are reported to external investors and lenders. If we start thinking about bank lending which is going to be the principal asset for banks, and the Irish banks in particular, essentially the big problem is estimating loan impairments. Loan impairments are the amount of the loans that will not be repaid and it is a challenging accounting problem. Impairment may be understood as something not performing as anticipated. If we think about it in American terms, one would speak about someone being visually impaired - it means the eyes are not working as originally anticipated. The notion of impairment means that things are not working as originally anticipated.

With bank lending, if one knew exactly how much the bank was going to lose the accounting would be straightforward. For example, if a bank engaged in very risky lending and we knew in advance just how risky that was and the risks entailed, impairment accounting would be very easy, because we would say we expect to lose all the money we lent to a particular customer, therefore, we should buck a loss and decrease profits and decrease capital. The problem is that this scenario is highly unlikely. If we lent money to a customer and we knew we were going to lose it all immediately we would not lend in the first place. Lending is based upon the proposition that we do not expect to lose our money when we lend money to a particular identified customer. The problem then is that we must engage in some estimates of the defaults that might occur. Given that there are estimates and judgment calls involved in determining these impairments, it is necessary to have additional guidance. The accounting standards as they stand require an entity to assess at the end of each reporting period whether there is any objective evidence that a financial asset or a group of financial assets is impaired. In other words, one is required if one is preparing financial statements for a bank to sit down and ask at the end of an accounting period whether there is objective evidence that an impairment has occurred. The rules go on to state that a financial asset is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset. In other words, one must point to some event that has occurred since we originated the loan that constitutes objective evidence that we have made a loss.

If we believe that a loss has been made it is necessary to estimate the impact of that loss and one is required to produce a reliable estimate of the amount of that loss. The most counter-intuitive part of all of this is that the standard explicitly states that losses expected as a result of future events no matter how likely are not recognised. In other words, if the dogs on the street expect that losses will occur they are ignored by accounting standards. One is required to have objective evidence that the loss has been incurred rather than a belief that events will occur in the future which will endanger these loans. Therefore, it is a very conservative definition of impairment since it requires objective evidence that a loss has been incurred. As a result, impairment accounting is pro-cyclical. What this means is that in a period of expansion as a bank expands its loan book, the bank will appear far more profitable because as it originates the loans it does not expect to lose money, it has not incurred a loss and so the bank will appear incredibly profitable. In turn that means it will have additional capital so it will appear that it has additional cushions against future losses. In a period of contraction the reverse happens.

When the bank expanded it made lots of loans. When there is contraction it becomes apparent that some of these loans are impaired. That immediately means a swing from having excessive loss of profits to excessive losses. That is what we mean by procyclicality.

There are two additional features of accounting policies which lead to even greater procyclicality, one of which is the accrual of interest. It means that if one lends money to a customer and agrees that they do not need to repay interest immediately then instead the interest will be rolled up on the loan. That roll-up of interest will be recognised as a profit even though the cash has not been received from the customer.

The second thing that can juice up the amount of income that is reported during the expansionary phase is the existence of loan arrangement fees - in other words, some agreement whereby the lender will give money to the bank, at the origination of the loan, as compensation for the origination costs of that loan. It does mean that accounting rules give rise to excessive reporting of profits when we are expanding credit and it will also lead to substantial declines later in the cycle. This cycle was quite evident in Ireland. We had exuberant new lending which gave way to no lending at all because we went from having very high profits to almost no profits at all. Nevertheless, it is difficult to conceive an outcome that would have been very different. Even had accounting rules permitted the use of expected losses, as distinct from incurred losses or other alternatives, I believe that profits would have exhibited a similar pattern.

Impairment accounting is largely diversionary for four reasons. First, the rules are well understood by informed users of bank financial statements. In other words, what I have said today is not new and has been known for decades.

Second, individual banks could create additional provisions despite the accounting rules. There is nothing to prevent a bank from saying "We believe, to give a true and fair view of our results, that we should book additional provisions this year."

Third, there is nothing to prevent the Financial Regulator from insisting upon additional provisions or enhanced disclosure. The regulator did exercise such powers.

Fourth, the expected loan losses during the growth phase in Ireland were likely to have been low anyhow. No matter how one tries to cut it, during the period 2004 to 2006, inclusive, it is very difficult to conceive of any type of a mechanism that would have resulted in a large decrease in the reported profits of banks.

While these measurement rules are quite different it is important to realise that banks also make disclosures. This is a key part of financial reporting, and it is not just what is in an income statement and a balance sheet, but also the additional disclosures in the financial statements. Additional disclosures help one to understand exactly what is going on in terms of reported income. In my opinion, the disclosures concerning the increased risks within Irish banks were inadequate during the period.

Through the lens of 2002 balance sheets - which were balance sheets dominated by residential lending - users could have easily concluded that increased profitability was synonymous with increased cushions but a seismic shift occurred during 2002 to 2007. There was a big change in the composition of loan portfolios for Irish banks. Rather than residential mortgages dominating property landing, commercial and development lending became almost 50% of property lending. In other words, the composition of the assets changed very dramatically. There were concentrations of risky lending that displaced less risky home mortgages. The distribution of the shift is also significant. It is clear that these additional risks were not distributed equally across banks in Ireland at the time. Further, a significant proportion of the loans were concentrated among a relatively small number of borrowers.

In summary, I believe that the real challenge for external users of financial statements was understanding the changing nature of the risks on balance sheets before 2007. Had users fully understood the increased exposure to commercial and speculative lending, and that it was concentrated amongst a very small group of borrowers, it would have been far easier to realise that the quality of profits had declined and that capital mattresses, rather than cushions, were required.

The second point I was asked to talk about was bank audits. What do auditors do? Directors are responsible for preparing and approving the financial statements of a company or a bank and then auditors issue an opinion on the financial statements. For example, an audit report will state something like the group's financial statements. It will give a true and fair view, in accordance with international financial reporting standards as adopted by the European Union, of the state of the group's affairs as at 31 December 2015 and of its profits for the year then ended. The first thing auditors do is express an opinion that the financial statements have been produced in conformity with international financial reporting standards.

Bank auditors have some additional responsibilities to a regulator and are required to bring certain matters to the attention of a regulator. That means there are some additional responsibilities between an auditor and a financial regulator.

In addition to these responsibilities, a regulator has the power to request information from an auditor. There is a particular additional set of duties with respect to bank auditors. For example, bank auditors would have been required to perhaps produce reports of any breaches of prudential sector lending limit guidelines. As Nyberg concludes, in the majority of cases the auditors did not report regulatory sector lending limit excesses to the Financial Regulator. Even if all excesses had been reported, it appears unlikely that any action would have been taken by the Financial Regulator who was already aware of, and not concerned about, such excesses. In other words, there were alternative reporting mechanisms between the banks and the Financial Regulator that are quite independent of annual financial reports prepared for shareholders and lenders. While I have not had access to the auditors' communication with the Financial Regulator, Nyberg states that the auditors clearly fulfilled this narrow function according to existing rules and regulations.

The committee might wish to know what else auditors do apart from expressing this opinion. For say loans and receivables, there would be a general expectation that auditors should go along and look at a sample of some of the lending files within a bank. As part of their audit they would do the following: ensure that lending policies are adhered to; review concentration reports and related party loan reports; establish evidence of any collateral assigned to the institution; check the financial condition of co-signatories and guarantors, examine past experience with the enforcement of guarantees, and confirm terms with the guarantor; compare loan amounts with appraisals; and ensure that construction loans are correctly classified as loans rather than real estate investments. For significant construction projects, they would ensure that advances are based on progress and that there are offsite-onsite inspections to verify the collateral and the progress with the construction.

Auditors should also assess management's loan reviews for impairments. Audit procedures should establish that management has looked beyond the collateral to identify potential borrower weaknesses, to identify if collateral appraisals are adequate and that up to date borrower financial information is available.

Auditors are also expected to review performance against the original loan agreement and be alert to any biases, for example, loans to public figures or personalities.

In summary, when published financial statements are prepared in accordance with international financial reporting standards, auditors also play a valuable role in assuring the veracity of the loans and receivables on a bank's balance sheet.

I shall make some concluding observations. Between 2002 and 2007 the aggregate loans in Ireland grew rapidly and exhibited significant concentrations of commercial lending, and speculative commercial lending. However, these concentrations varied across banks and there were also significant individual borrower exposures which gave rise to exponentially greater risks. Contemporaneous knowledge of these loan portfolio risks would have alerted external users to the sources of bank profits and their sustainability. While there was no requirement to report these risks in the published financial statements, especially for financial statements prior to 2007, there were requirements to report capital adequacy, liquidity, impairment, large exposures and sectoral limits to the Financial Regulator. It is an empirical matter as to whether these amounts were correctly reported to the regulator and to the boards of financial institutions.

I thank the committee members for their attention and I would welcome any comments or questions you might have.

Chairman: Thank you Professor Walsh. In order to set the scene, can you outline briefly the types of public reporting the banks engage in as part of their day-to-day work, publicly and internally, such as annual reports?

Professor Eamonn Walsh: International accounting rules are essentially concerned with reporting to shareholders such as public financial reports and reporting performance to investors and other external parties. In general this involves an annual report consisting of a very large document - for a bank this may be 200 pages - which gives much detail about the bank's directors, how governance works, a balance sheet, an income statement and notes to the financial statements. This is not timely information and is produced four or five months after the year end. If the bank is quoted on a stock exchange it will, at a minimum, have a preliminary announcement of its results. This might be a month or two ahead of the publication of its annual financial statements but about two to three months after the end of its financial year. If a bank is listed on a stock exchange it might also produce a half yearly report. If the bank is listed in the United States it might also produce quarterly reports for investors. Investor reporting is generally not very timely. There are time-lags between events occurring and the publication of those financial statements.

Reporting to a financial regulator is the next type of reporting. A regulator is almost omnipotent regarding the information it can demand from a regulated entity. Regulators set up rules which can call for quarterly reporting of large exposures; there will be quarterly reporting of detailed balance sheet information; there will be far more detail than information available to external investors and there might be more frequent reporting concerning matters like liquidity. There are two universes - one is reporting to external users and the other is reporting to regulators, where the regulator sets the ground rules.

Chairman: You mentioned the regulators. In regard to external users, would auditors have obligations concerning risks associated with concentrations of lending limits by banks?

Professor Eamonn Walsh: I am sorry, is this in regard to regulators?

Chairman: Do external auditors have obligations concerning disclosure of risks associated with concentration of lending by the banks? If there is a particular concentration of lending in an area, does the auditor have a requirement to report that to the regulator?

Professor Eamonn Walsh: As I understand it, the banks will report this information quite frequently to a regulator. The auditors' responsibility is to make sure that if they become aware of information which might not have been correctly reported to the regulator, then that would be reported to the regulator.

Chairman: We heard from Professor Connor and from others that there were high lending concentration limits within the banks to the property development sector. From your examination of the practice of accountancy and auditing, was there any reporting by auditors to the Central Bank between 2007 and 2008, the period of high concentrations by banks in that sector?

Professor Eamonn Walsh: I would not know. The communication between an auditor and a financial regulator is not available to external users. I believe the Nyberg report would have had some access to that communication and an opportunity to look at it. A lay member of the public, such as myself, would not have access to that communication.

Senator Marc MacSharry: Good morning Professor and thank you for being here. Not being an accountant, and conscious of the people at home, could you confirm that IAS No. 39 is the standard applied in accounting and auditing in Europe?

Professor Eamonn Walsh: Thank you Senator. International accounting standards have been around for a very long time. They started in the 1970s. A big change occurred in 2005 when the European Union introduced a requirement that if you issue equity to the public you are a listed enterprise and as such you are required to prepare your financial statements in accordance with international financial reporting standards or IFRS. I have a copy here with me and as you can see it is a thick volume of accounting standards. There is one standard within this called international accounting standard No. 39. This IAS No. 39 deals with financial instruments. The principal assets and the principal liabilities a bank is likely to have are its financial instruments. When one speaks about accounting for banks the principal guidance is IAS No. 39. These rules apply to all enterprises. A retailer applies the same rules as a bank or an insurance company. These rules do not have a specific standard which deals with banks, they have a general standard that deals with financial instruments.

Senator Marc MacSharry: What circumstances, if any, would need to have been in place where the standard would have allowed the value of loan assets to be written down, with losses reflected by the banks? It is clear from Professor Walsh's opening statement there were limitations on IAS No. 39 in that regard.

Professor Eamonn Walsh: The rule IAS No. 39 says that one should not book an impairment until one has objective evidence of an actual loss. There is, however, nothing to prevent a financial institution from saying it has losses coming down the road, and in the interests of presenting a true and fair view to its shareholders, it might make an additional allowance for those expected losses. It would not conform with international accounting standards but it could be something a financial institution could do - Anglo Irish Bank did so in 2008. In its annual financial report Anglo Irish Bank put in an additional provision of €0.5 billion. There is nothing to prevent a bank putting in an additional provision, albeit being against the rules. There is a big body of rules and if one goes against the rules people will ask what it is that is being tried here.

Alternatively, one could have a disclosure which says the impairments are low, the profits are high, and loans have been made which could go bad quite quickly. A disclosure could be made to investors which states that loans may get into difficulty despite the fact they are not reflected in the balance sheet or the income statement.

Senator Marc MacSharry: Is this the way to account for an impairment?

Professor Eamonn Walsh: Yes. There is a post-change to these rules, largely as a result of the financial crisis. I believe that from 2017 or 2018 the banks will be required to record impairments using expected credit losses. This will involve making an estimate of expected losses so that greater impairment can be recognised earlier in the cycle. When one makes loans, one does not expect to make huge losses. It is only as the cycle progresses that it becomes apparent that one has some borrowers who cannot or will not repay their loans.

Senator Marc MacSharry: If there had been acceptance of the credit risks that banks were running during the 2002-07 period, was there any scope to report on them in annual reports or periodic statements?

Professor Eamonn Walsh: There was very little in the way of requirements. There was a standard up until 2007 known as IAS 30, which dealt with bank disclosures in a general sense about concentrations, but largely the guidance was so woolly that I do not believe one could find anybody who was not in compliance with the standard. In other words, what some regulators did, for example, in New Zealand, was put in additional interpretations of what they had said banks should be disclosing under IAS 30, but in the absence of such additional guidance, it is fair to say there was no requirement to make extensive disclosures. Nevertheless, there is absolutely nothing to prevent any financial institution from engaging in additional disclosure. As a financial institution is not required not to disclose, a bank could have engaged in significant additional disclosure and a financial regulator could have given guidance to a bank that additional disclosures should be made in the published financial statements.

Senator Marc MacSharry: In Professor Walsh's opening statement - the published statement, as opposed to the briefer one - he referred to the work of the US Federal Deposit Insurance Corporation in documenting the life cycle of a bank failure in 1997. Rather than quote every word, it spoke about rapid loan growth, concentrations emerging, aggressive lending and so on, as it stated and the record would show. In Professor Walsh's view, were such features understood adequately by the Irish authorities, including the Central Bank and the regulator, during the pre-crisis period?

Professor Eamonn Walsh: To be honest, I have no idea. I largely think this is an empirical matter, that is, to ask them whether they knew about these risks. If so, what did they do about them? Did they know about the risks and do nothing or, alternatively and quite possibly, did they not know about them? It is quite possible that, given the way information was being reported and making its way through channels, they were not fully aware of the nature of these risks.

Senator Marc MacSharry: In Professor Walsh's professional opinion, does he feel it is likely, unlikely or impossible to judge?

Professor Eamonn Walsh: It is impossible for me to judge based on the information I have available to me, in my professional opinion.

Senator Marc MacSharry: Professor Walsh could nearly consider another profession with an answer like that one.

Professor Eamonn Walsh: Yikes.

Senator Marc MacSharry: I mean no disrespect. In Professor Walsh's statement he described the growth and the change in the composition of loan portfolios at the aggregate level in the Irish banking system as being the seismic shift that occurred between 2002 and 2007. He also stated: "The risks associated with increased commercial lending are well known and have been well known for many years." Given that such lending had been recognised for some time as an important risk factor in banking crises, was the accumulation of such risk disclosed in periodic reporting by individual banks during the period 2002 to 2007? If so, what is Professor Walsh's assessment of the disclosures?

Professor Eamonn Walsh: Again, I had a very short period of time in which to prepare my statement for today. These financial statements date back to about seven or eight years ago. Unfortunately, it would be quite difficult for me at this stage to recall specific reporting practices. If I were to say in general, one of the difficulties is that, in the absence of disclosure, it means that one just reports a number like that for loans and receivables. We have loans and receivables of €50 billion and that is all of the information one receives in the annual report. It would clearly be very helpful if one said, "We have €50 billion of loans and receivables, €48 billion of which is speculative development lending." To an investor, if he or she were to receive that information, he or she would immediately know that this was quite a risky loan book and chances were that the income might not persist in the future for this particular financial institution.

Post-2007, disclosures were made. One of the problems with international financial reporting standards more generally is that they are designed for general purpose use. It means that the requirements for credit disclosures are not very well specified or articulated; the Senator can imagine, therefore, how disclosure could be quite difficult. Let us consider examples. Suppose a bank lends money to a retailer and that retailer is going to use the proceeds of the loan to purchase some development land, seeks rezoning of that land and then extends the retail store onto that land if the rezoning is successful. The question is: is that a loan to a retailer or is it a loan for speculative property development? One of the difficulties with the disclosures is that it is possible that somebody might look at this in the cold light of day and make a determination that this was a loan to a retailer rather than a loan for speculative property development. One of the difficulties with disclosure is that the absence of specific guidance means that it is possible that in that situation, there would be some judgment involved in determining whether it was a retail loan or a speculative development loan.

Senator Marc MacSharry: If I were a bank or if there was a bank that decided to make a very large investment in an institution or a pension fund, would this be reflected in any way such that an auditor would see it? If that were the case, would there be any reporting obligation on auditors to regulators if, for example, an investment was seen to be particularly large, on the one hand, or, on the other, for a particularly short period of time?

Professor Eamonn Walsh: Could the Senator give me an example in order that I could answer his question?

Senator Marc MacSharry: I do not want to be specific. I will not give the example, but if I were a bank and wanted to invest €10 million in Deputy Murphy's bank for one week and he gave it back to me the following week, would there be anything in auditing that would ring an alarm bell or would there be any obligation within the system or standards that would suggest to Professor Walsh that one would need to report this to the regulator or say to the regulator that

Senator MacSharry and Deputy Murphy were investing in each other's companies for unusually short periods of time?

Professor Eamonn Walsh: One of the difficulties - it is a sort of twist in international accounting standards - is that one could actually maintain that the proper accounting for this would be to recognise an asset, namely, an investment, and recognise a corresponding liability, namely, an obligation to repay that investment later. The accounting rules - they are very specific rules - are called offset rules. In other words, one could construct a transaction whereby offset rules under international accounting standards would forbid one from offsetting these two amounts.

Chairman: Time, Senator.

Senator Marc MacSharry: I am nearly there. In terms of lessons, if any, what can be learned about how banks disclose information on their lending practices, investments and financial performance to help to mitigate future banking crises? To what extent are new rules and practices being considered and applied? Are they sufficient?

Professor Eamonn Walsh: From what we have seen, I think the Central Bank of Ireland does deserve some praise. It has actually issued additional guidance to banks in terms of their disclosures on their loan books, in particular disclosures on impairments. If we were to look at the financial statements of the larger banks in Ireland today, we would find that there were much more copious disclosures of impairments, of loans past due and so on and it would be much easier for an informed user to make a sensible judgment on what was going on with a loan book at a point in time. I think that, largely, the difficulty is that international accounting standards are aimed at all enterprises. One needs some sort of regulatory overlay, or some other overlay, which requires them to disclose more information, in a sensible manner, to investors.

Deputy Eoghan Murphy: I want to go through the Nyberg report with Professor Walsh, if I may. I presume the professor has read that report.

Professor Eamonn Walsh: Yes but it was some time ago.

Deputy Eoghan Murphy: In the written statement provided to the committee, Professor Walsh references the argument that "international accounting standards had prevented more prudent provisioning for possible future losses during the growth phase of the cycle" but says he believes that this conclusion may be too strong.

Professor Eamonn Walsh: Yes. I referred earlier to the idea that the focus on loan impairment accounting may be a bit of a diversion. What has happened, and this frequently happens after a crisis, is that people are looking for somebody or something to blame and loan impairment accounting has been identified as something that was wrong. There has been a huge effort by international accounting standards setters, since 2008, to devise a new set of loan impairment rules. Everybody then thinks that if we solve the impairment rules, we will prevent bad things happening in the future but I am not convinced by that argument.

Deputy Eoghan Murphy: When the professor says a diversion, does he mean in terms of apportioning blame for how the risks were missed?

Professor Eamonn Walsh: One could end up spending a lot of time thinking about the right way to account for impaired loans but largely the result will not be that different in the growth phase of a credit boom. Generally, one will have quite low loan reserves. For example, the Nyberg report makes mention of the Spanish authorities which required a particular form of provisioning. They said that they were not interested in the international financial reporting standards but wanted their banks to provide for loans in a particular way.

Deputy Eoghan Murphy: That implies then that the banks understand the risks of this procyclical impairment accounting.

Professor Eamonn Walsh: Yes, absolutely. In 2006 the loan to value ratios for domestic mortgages were changed by the Financial Regulator, with an additional capital penalty for lenders if they issued a mortgage that had a loan to value ratio in excess of 80%. In the regulator's report on this, one of the reasons given for doing it was international financial reporting standards. In other words, because it knows that impairments were not being recorded in a timely way, it puts in an additional capital requirement for these particular riskier residential mortgages.

Deputy Eoghan Murphy: Professor Walsh spoke about inadequate disclosures concerning the increased risks faced by the banks. If there is nothing preventing the banks from disclosing, why do they not do so?

Professor Eamonn Walsh: That is a very good question. Let us take a hypothetical bank that is really bad. There is no way it would want to tell everybody that it had a really bad loan book. There are no incentives for a bank with a bad or risky loan book to disclose that fact. If anything, the incentives that operate are such that it might try to convey the impression that the loan book is a lot less risky than it really is because that will lower the cost of funds and make the bank more profitable. In that sense, an intervention is required which demands additional disclosure.

Deputy Eoghan Murphy: So, the auditor comes in, on an annual basis, to the banks. Nyberg also says that the new standards that we have referred to meant that external auditors could not insist on earlier loan-loss provisioning. Does the professor agree?

Professor Eamonn Walsh: The auditors are basically determining whether the financial statements and the impairment accounting comply with international financial reporting standards. The auditor cannot insist, in that context; the bank can insist, but not the auditor.

Deputy Eoghan Murphy: When one talks about "external users", are the auditors in that category? Do they understand the accounts in the same way the banks would? Do they understand the risks in the same way as those preparing the accounts for the auditors would?

Professor Eamonn Walsh: The auditors are not like vanilla external users. Auditors auditing a bank would generally have had considerable training in how banks operate, how best to audit a bank and so forth. We would expect them to have a very high level of knowledge of how to audit a bank.

Deputy Eoghan Murphy: Is it fair to say that they would have understood the risks on the bank balance sheets being presented to them?

Professor Eamonn Walsh: One would imagine they were familiar with the business models that had been adopted by the banks and the risks associated with those business models.

Deputy Eoghan Murphy: Nyberg also states that the combination of growing property and funding exposures, combined with material governance failings, should have raised questions for the auditors about the sustainability of a bank's business if they were exercising the necessary "professional scepticism". What does Professor Walsh understand from that?

Professor Eamonn Walsh: To be honest I would need to revisit the report and read the paragraphs preceding and following on from that comment, rather than make a statement ---

Deputy Eoghan Murphy: I am trying to get a sense of the obligations on the auditors if they understand risks on a balance sheet but are performing their duties in accordance with the accounting standards. Are there obligations on them to ring a warning bell if that were required?

Professor Eamonn Walsh: Again, we must distinguish between ringing a warning bell for external users or internal users. The former would happen, largely, at a very late stage. It is probably fair to say that in terms of audits for external users, any signals from the auditor's report published by a bank is going to come late in the day. That occurred for the British banks, the Irish banks and indeed, right across the banking sector. The audit report is something that comes late in the day and it is really only when the ship is sinking and has probably hit the bottom of the seabed that it suddenly becomes apparent that the audit report is flagging something.

Deputy Eoghan Murphy: In terms of breaches in prudential sector lending-limit guidelines, four of the covered banks breached those limits for property and construction lending between 2002 and 2008 but in a majority of cases the auditors did not report these excesses to the Financial Regulator. Is that unusual?

Professor Eamonn Walsh: Again, I am not a bank auditor so I cannot say whether it is unusual or not. My reading from Nyberg was very much that quarterly statements were going to the regulator, so the regulator was receiving this information anyhow. The auditors were probably assuming that the regulator was receiving this information. They would have seen the reports that were issued by the bank to the regulator - one would imagine - and would assume that it was largely known that these limits had been breached. The Nyberg report is very helpful in this regard with its diagram illustrating how much of the lending was taking place outside of these limits versus how much was within the limits. That diagram is very useful in showing the extent to which there seemed to be an absence of control with respect to those limits.

Deputy Eoghan Murphy: In terms of information flowing directly from the banks to the regulator - in the context of how an external user would understand them - would the risks that were being built up on the balance sheets of the banks have been obvious to the regulator?

Professor Eamonn Walsh: It is difficult for me to know exactly what was reported to the regulator. We can imagine how the process might work, but we are speculating here. It might be the case that there is some sort of standardised Excel spreadsheet issued to every bank to be filled in and returned to the regulator. The main challenge with the design of such a spreadsheet is the captions that are used, for example, whether something is a retail loan or a speculative development loan. The captions used will colour the information that goes through.

The second issue is sectoral lending exposures or large exposures to individual lenders. One would anticipate that this would be reported up through the system. What could happen that would mean that it was not reported up? First, the guidance issued for filling in the spreadsheet might not be sufficiently detailed to make clear what must go into every box in the spreadsheet. Alternatively, the spreadsheet might not have had enough places to put in extremely risky lending.

There is a final consideration. I am not suggesting this occurred in Irish banking but we know from other jurisdictions, that one might structure information in such a way that it comes out in a certain way in reports. In other words, let us consider a big loan as a big chunk of salami and find a way to slice the salami so that it might not be apparent when looking at aggregate reports. Equally, one can think further back the food chain and if I was someone borrowing money from a bank, I might seek to structure a large loan in a way that might make it easier for the bank to slice salami later on. I am not suggesting that has occurred in an Irish setting but there are other cases, like BCCI, that are very informative if one looks at the auditing processes that went on in banks. It is an awful example of how information was making its way through the system.

Deputy Eoghan Murphy: If the regulator becomes concerned, he has the power to request more information.

Professor Eamonn Walsh: I am not a bank regulator and I am not an expert on bank law but my understanding is that a regulator is basically able to go in and demand whatever information he wants. A regulator can insist on an on-site inspection and can seek whatever information is required.

Deputy Eoghan Murphy: Is it unusual, as happened in 2008, for the regulator to instruct auditing firms to report concerns with liquidity or solvency they might have had from the 2007 audits? Is that an unusual thing?

Professor Eamonn Walsh: I cannot speak to whether it is unusual.

Senator Sean D. Barrett: I welcome Professor Walsh. When Professor Ed Kane was before the committee, he said in his presentation that regulatory officials and industry lobbyists resist transparent performance accounting. How does Professor Walsh respond to that?

Professor Eamonn Walsh: Things are a little different in the United States. There is a different regulatory environment and a different financial reporting environment. Comparisons between the US and Europe are difficult to make given our different environments. It is difficult to establish what might be transparent reporting and what the bank should be reporting. One would like to see good disclosure about the risks financial institutions have. The international Financial Stability Board has issued extensive guidance on the types of disclosures banks should make. This considers credit risk and involves extensive disclosure.

The second issue is the roll-up of interest. This is not apparent under international accounting standards. Under US accounting rules, there are various regulatory overlays to help us to establish how much cash interest a financial institution is receiving. Australia, which uses the international financial reporting standards, requires banks in Australia to tell the amount of cash interest they have received. It is quite possible to take international accounting rules and use it to basically insist the rules are applied in a particular way that involves disclosure of cash interest received. That would be very helpful in dealing with the interest roll-up issue. It gives users an immediate indication of what is being rolled up and the risky loans in it.

Outside of international accounting standards, one area where this is quite transparent is in Russian banking. The Russian banking regulator has a requirement that people say what is the amount of cash interest being received. I see that as being key.

Senator Sean D. Barrett: What should be in a stress test?

Professor Eamonn Walsh: The trick with a stress test is to understand what are the risks.

If one were to look back and think that the risks were primarily the residential mortgage book then we would specify stress tests that say that if residential property prices change by a certain amount, we can ask what will happen to bank profitability. However, if it turns out that, instead of being primarily a residential property book, it is also a significant commercial book with significant speculative lending and significant concentration to individual borrowers, the way we would conduct stress tests and the kinds of stresses we would like to impose on the model would be entirely different. The perception of risk is important in terms of determining how we ultimately conduct the stress test.

Senator Sean D. Barrett: The point is raised in Professor Walsh's evidence that even if auditors had been willing to be whistleblowers, the regulator was not listening so it would not make any difference if they had blown the whistle. What should be the relationship between the auditors and the regulator?

Professor Eamonn Walsh: I quoted from the Nyberg report because I do not have any direct evidence of these matters. It is not important to think about what the relationship should be because the Financial Regulator largely gets to dictate the relationship. It is largely a case of what one believes to be good regulatory practice. The regulator should dictate to the auditor the information required in the reports.

Senator Sean D. Barrett: Should Ireland not have dumped the Generally Accepted Accounting Practice, GAAP, for International Accounting Standards, IAS, 39? Is there substance in that, as opposed to a technical accounting matter, that we can explain to the people at home? Was it a serious change?

Professor Eamonn Walsh: We were using UK accounting standards prior to 2005. My sense is that the differences are not that great and if one wished to research the topic further, when the bank switched they were required to do a reconciliation for old GAAP to new GAAP. I had a look at two of the largest banks at the time and the differences are not that great in terms of moving from local Irish GAAP to the application of IAS. There were largely similar views of the world.

Deputy Michael McGrath: Professor Walsh is very welcome. Given that we are talking so much about disclosure, I will ask him a question about his position that jumped out at me. He is described as the PwC professor of accounting in UCD. What is the role of PwC in his title?

Professor Eamonn Walsh: PwC kindly made a donation to UCD about 15 years ago for the creation of a chair in accounting. Subsequent to the donation by PwC, UCD advertised the position and I was appointed in an open competition. Subsequent to that, I had no obligation to PwC, nor is there any continuing financial involvement or anything of that nature that should be brought to the attention of the committee.

Deputy Michael McGrath: Is the amount donated on the record and public?

Professor Eamonn Walsh: It predated my appointment to UCD so I have no idea.

Deputy Michael McGrath: Is the right to have the position named the PwC professor indefinite as a result of the donation 15 years ago?

Professor Eamonn Walsh: Yes, to the best of my knowledge. I have not been informed that the title of my position has changed. It is fair to say that business schools generally, in order to get new posts in a university sector that is quite stressed, seek donations to create new positions in new areas of study and to appoint people to the positions.

Deputy Michael McGrath: I am not suggesting anything improper but just want to have all the facts out in the open given that Professor Walsh is giving evidence to this inquiry. Did the auditors of the banks in Ireland, during the years 2004 to 2006, inclusive, form the view, and during the course of their work, that the banks were following an unsustainable model? Did they think there were huge concentrations of risk being built up in terms of lending to one sector, for example? Did they feel the banks complied with the accounting standards and other legal requirements? What options were open to auditors to raise their concerns? What duties and rights had they to insist on disclosure, for example, of those risks?

Professor Eamonn Walsh: It is probably fair to say that they do not have much power to mandate that particular disclosures should be made. If international accounting standards do not require those disclosures then I would imagine it is very difficult for an auditor to say, "Look, we expect you to make additional disclosures over and above the ones that are currently required by accounting rules".

Deputy Michael McGrath: Would a disclosure of that nature have been entirely voluntary?

Professor Eamonn Walsh: I believe it would.

Deputy Michael McGrath: Did the auditors have any duty, under accounting standards or law, to report concerns about the overall sustainability of the model being pursued and the concentration of risk to the regulator or the Central Bank?

Professor Eamonn Walsh: I would probably need to go carefully through this. In terms of duties, my written statement fully discloses my relationship and the nature of my appointment as well. In my written statement I made particular reference to the auditing rules and the rules in terms of communication between an auditor and a financial regulator.

Deputy Michael McGrath: Has Professor Walsh formed a view as to whether the auditors of the main banks in Ireland, during the 2003 to 2007 period, fully met their legal obligations? Has he formed any view on that matter?

Professor Eamonn Walsh: It would be very difficult for me, as an external observer, to form such a view.

Deputy Michael McGrath: Of course.

Professor Eamonn Walsh: What I did was quote the Nyberg report. Certainly, the Nyberg report, in its introductory section, seemed to say that auditors had fulfilled their obligations. Clearly the Nyberg report had access to those communications but I would not.

Deputy Michael McGrath: In regard to impairment provisions, clearly on a bank's balance sheet the liabilities are clear in terms of the accuracy of the figures but the real issue is the value of the assets. Does the professor agree that is where the variability and risk might lie?

Professor Eamonn Walsh: In terms of accounting for the assets involved, when we lend money to a customer we record basically the amount that was lent as an asset. The accounting is then done in such a way that we must wait for an impairment to occur which means it is not reflected on the balance sheet.

There are other disclosures. For example, the fair value of the loans. Currently, banks have a footnote where they disclose the fair value of those loans, namely, the price they believe that an unrelated third party would pay for those assets in an arm's length transaction.

Deputy Michael McGrath: Are impairment provisions for loans related to specific loans? The professor did not speak about impairment provisions but that at the level of the individual loan, one must make a judgment as to whether an impairment should be booked against that loan. Is that how it works or it is more general?

Professor Eamonn Walsh: There are a couple of aspects to that question. I have glossed over a lot of the technical detail with respect to these impairments but I would be delighted to go through that technical detail.

Basically, impairment assessment could occur in a number of ways. First, there is the level of individual loans. Second, one might look at groups of loans. That would be the case if one considered something like a mortgage book where it would probably be very challenging to go through each and every mortgage and assess it individually for impairment. One would be essentially engaged in a group assessment of impairment for those loans. One can view it that we could look at loans in groups and then individual assessments of loans. There are detailed rules with respect to how one conducts that assessment.

Chairman: To conclude this session, would Professor Walsh outline the concept of true and fair in the context of opinions of auditors and annual financial statements. What does true and fair mean?

Professor Eamonn Walsh: If I could answer that question I would be very happy with myself. When I hear the term "true and fair" I think of the City of London in 1750 where everybody knows everybody else, my word is my bond and we engage in true and fair reporting. As I would understand it now, largely the term "true and fair" has become synonymous with reflecting international financial reporting standards. It is a legacy term that is used in Britain and Ireland, the idea of a true and a fair view, but it has largely been superseded by detailed accounting standards, which we did not have 50 years ago. The notion that somehow, there is a principle of the true and fair view that would guide one on the right way to account for a particular transaction becomes largely redundant when there are many rules governing guidance, as there are today. If the Chairman is interested, there is a legal opinion that was prepared about a year ago which explains how a true and fair view should be interpreted under UK law.

Chairman: I ask Professor Walsh to revisit the matter as we conclude.

Deputy John Paul Phelan: The Chairman has stolen my true and fair question. In light of that question, I wish to ask a general one. Does Professor Walsh think that in the run-up to the crisis, the audits of the banks in Ireland served the true and fair purpose for which they were intended? What purpose did they serve?

Professor Eamonn Walsh: The first thing they did was to say that financial statements should be prepared in accordance with this set of rules. That is probably not such a bad thing. In the absence of such a set of rules, and in the absence of somebody making sure that a financial institution had applied those rules correctly, one would have very little confidence in the reported financial information of a bank. It is a third party assurance that the financial statements have been prepared in accordance with a set of rules.

Let me outline the second aspect. I guess people are quite down on auditors and take the view that companies spend a fortune on audits but do not seem to get anything in return. One has to consider the counter-factual. If there were no audits then one would create a Wild West situation. That means one could create an asset on one's books and there would be no external attempt to verify that the asset existed.

Deputy John Paul Phelan: I understand what Professor Walsh has said. Other witnesses have used the term "Wild West" a lot to describe the banking sector in the run-up to the collapse. A lot of commentators have made the point that the audit process did not reveal, satisfactorily at least, the difficulties that existed in the balance sheets of Irish banks. Did a Wild West situation exist? I do not want to ask a leading question or I shall be accused of doing so. Even with external auditing, and I do not suggest that there should not be external auditing, did a Wild West situation not exist in the run-up to the crisis?

Professor Eamonn Walsh: I shall turn the question on its head. It is easy for people to have expectations in terms of what they believe an audit should deliver. It would be true to say, and it is not just in Ireland but across the world, that audits are quite limited in their scope. Audits indicate first, that financial statements have been prepared in accordance with rules and, second, that there is evidence these loans exist and so on. It is important to have a relatively low expectation of what an audit is meant to be delivering and then to look for other mechanisms that would blow the whistle on things such as a financial regulator.

Deputy John Paul Phelan: I have a question on the relationship between auditors and the financial institutions being audited. Is there not a contradiction at the heart of the traditional appointment of auditors by financial institutions as well as other companies? I do not want to ask a leading question. Is there not a contradiction in the sense that if one is a commercial bank and choosing one's own external auditors, does that not, potentially at least, lead to a contradiction in what the audit hopes to achieve, and in terms of the true and fair test that we mentioned?

Professor Eamonn Walsh: The best way to view it is in terms of the long-standing literature, regulations and ethical rules in place for auditors and so on. The latter reflect the possibility that there could be a conflict. I refer to circumstances where one is getting, on inspection, a clean bill of health but one is paying the cheque for that clean bill of health. The question is whether the auditor can be truly independent if one is paying for the clean bill of health rather than perhaps a third party doing so. The same could be said of credit rating organisations as well. It then comes down to the individual rules relating to ethical conduct by auditors and so on which kick in to ensure auditor independence.

Deputy John Paul Phelan: Does Professor Walsh believe, as some others have suggested, that financial institutions should choose their own auditors or should an external third party such as the regulator have responsibility in this regard? Is he of the view that it might be necessary that the auditors of financial institutions should change regularly and that the same firm should not be responsible for auditing a particular institution's books for a protracted period?

Professor Eamonn Walsh: Again, there is a long history in this regard. Auditor rotation is an issue the EU is addressing at present. There is a notion that it might be unhealthy for a company to have the same auditor for 120 years and that perhaps some rotation might be in order. The more subtle point is whether there is partner rotation. In other words, we are basically down to four audit firms that are capable of conducting an audit of a large bank. I am not really being fair in this regard because there are a number of other mid-sized firms which could assist with or carry out such a process. Ultimately, investors looking at a large bank that is not audited by a big four firm would be concerned about the audit.

Deputy John Paul Phelan: Should a bank or financial institution be allowed to choose its own audit firm?

Professor Eamonn Walsh: I may be too old and cynical but I really think there are probably enough checks and balances in place to ensure that something sensible happens. Outsiders say these conflicts exist but I have never seen them in practice.

Chairman: Will Professor Walsh outline the extent to which an auditing firm can be exposed to one financial institution in terms of its business book? Can a firm have 50%, 60% 80% or 100% of its business with one client?

Professor Eamonn Walsh: Again, I am not quite sure what the ethical rules are in this regard. Clearly, however, one would like to ensure that an individual audit firm was not entirely dependent on a single client. This again brings us back to the big four. Outside investors or lenders to a bank would generally expect a big four audit, simply because that danger of having a smaller audit firm dependent on a single customer would clearly be incredibly unhealthy.

Chairman: Is it 80%?

Professor Eamonn Walsh: I honestly do not know.

Senator Michael D'Arcy: I welcome Professor Walsh. Will he outline his view in respect of some of the really important audits that occurred during the banking crisis? I specifically refer to the PwC report presented to the Minister for Finance prior to the introduction of the bank guarantee which indicated that the potential liability to the State in respect of Anglo and INBS was €5 billion. What is Professor Walsh's opinion on that?

Professor Eamonn Walsh: I have only seen bits of the PwC report. If I understand it correctly, PwC was commissioned by the Financial Regulator to examine individual banks during September 2008. Is that correct?

Senator Michael D'Arcy: Yes.

Professor Eamonn Walsh: It is just one of those things but when I received my invite from the committee some weeks ago, I immediately thought "I have to take a look at this again". That was because I had not looked at it in a long time. Unfortunately, I was not able to find it on the Internet but late yesterday evening I did obtain a copy of a small part of it that deals with Anglo. As I understand it, there were three phases to PwC's analysis, namely, a phase that was undertaken in mid-September 2008 - a report relating to which was submitted later that month - a second phase in November and a third in December. Is that correct?

Senator Michael D'Arcy: Yes.

Professor Eamonn Walsh: Now that I know what I am meant to be looking at, what-----

Senator Michael D'Arcy: I will amend the question a little. Professor Walsh is a university lecturer. If he was grading PwC's analysis of the institutions involved, what grade would he award?

Professor Eamonn Walsh: In terms of tying up with what I said earlier, what I find interesting about this report is that as one reads about the phases of the project undertaken by PwC - it should be borne in mind that I have only seen the final report and I have not seen the intermediary outputs, of which there could have been many, that might have been produced for the regulator - one discovers that these concentrations of risk are becoming more and more apparent as the project progresses. One gets a certain sense about the concentration of risk when one reads the first one. With the next one, it is a case of "Oh my goodness, there are 20 large borrowers and there seems to be quite a bit of exposure to development lending in very concentrated areas of north and south Dublin". With the third phase, it was "We'll have a look at the next 50 borrowers and guess what? It seems they also borrowed money in much the same areas of north and south Dublin". As I read through the report, I felt that in September these concentrations did not appear quite as bad as when we get to phase 3 of the report. That is how I read it.

The other thing that jumped out at me relates to the sort of concentrations outlined. PwC lists the 20 largest concentrations in the UK, the US and Ireland in its report. As I looked at it, the question I would have felt remained unanswered relates to whether there was an overlap between all of those concentrations. In other words, that there was a super-concentration involved.

Senator Michael D'Arcy: What is Professor Walsh's view on the PwC report that was commissioned after the guarantee had been introduced in order to evaluate its impact on the banks?

Professor Eamonn Walsh: This relates to the estimates of what sort of capital requirements there might be. I stand open to correction but I am of the view that there was a change between phase 1 to phase 2. Paragraphs 4.8.4 and 4.8.8 of the Nyberg report deal quite well with this matter. Paragraph 4.8.4 states:

> The outcome of the initial PwC assessment was generally viewed by the Authorities as reasonably benign. In early November a joint letter was sent by the CB and the FR to the Minister for Finance which included assurances as to the solvency of the covered institutions on the date of the Guarantee as well as their future solvency through to 2011.

While paragraph 4.8.8 states:

> Notwithstanding the benign view generally taken by the Authorities of the PwC initial assessment it has been argued – correctly, in the Commission's view – that the nature, scale and concentration of the exposures now listed should have aroused more heightened and widespread concerns that institutions were likely to face solvency difficulties.

Deputy Joe Higgins: In Professor Walsh's written submission to the committee he says, "Prior to the Irish banking crisis in 2008 it was widely believed that Irish banks were highly profitable and that they had sufficient cushions to withstand a variety of challenging scenarios." He says also, "The belief was based upon accounting reports, particularly income statements and balance sheets." Let us leave that quote hanging there for a moment. Just above that Professor Walsh quotes the United States Federal Deposit Insurance Corporation which documents the life cycle of a bank failure. It says:

> In the first stage there is rapid loan growth, loan concentrations emerge and lending is aggressive, internal controls in the growth areas are weak and underwriting standards are lenient. Management usually points to the excellent earnings and contributions to capital that the growth has provided.

If the Federal Deposit Insurance Corporation in the United States in 1997 can outline the life cycle of a bank failure, if Professor Black and other witnesses come in here and rehearse more or less the same scenario, and if those features were manifestly present in Ireland prior to the crash, how can accounting reports in Ireland imply that there was no problem, as indicated by what Professor Walsh has said, that the belief was based upon accounting reports, particularly income statements and balance sheets?

Professor Eamonn Walsh: The basic problem is with the accounting rules. The accounting rules say a bank goes out and lends money to a customer and it earns interest from that customer. In Ireland between 2002 and 2007 banks expanded their loan books very dramatically. In the early years of issuing a loan to somebody, in general one would expect that nothing is likely to go wrong with that loan, so early in the boom when everything is going up there is very little objective evidence that anything might be going wrong with these loans.

Deputy Joe Higgins: Can Professor Walsh show the committee that impressive tome that he displayed; it looks like The Bible and The Koran rolled into one. How many pages are in that?

Professor Eamonn Walsh: I thank the Deputy for the question. That is why I brought it with me. The index ends on page 2,719.

Deputy Joe Higgins: That must be nearly 500,000 words.

Professor Eamonn Walsh: It is quite a small font.

Deputy Joe Higgins: Professor Walsh says on page 3, "Unfortunately, accounting standards were especially unhelpful and served to obscure the underlying nature of both profits and loan portfolios." Given what Professor Walsh has just shown us, the obscuring was certainly not due to a shortage of space, so might that as well be a mystery novel, or were accounting standards framed in such a way as to deliberately obscure the real situation?

Professor Eamonn Walsh: Part of the difficulty is that these accounting standards are written for all enterprises. They have the same set of accounting standards for a retailer, a bank or a manufacturer. The challenge is that banking is a different business to retailing or manufacturing. There is not a specific standard that deals with accounting for banks. As a result we get these unusual settings and the one I would worry most about is accrual of interest. A bank can make a loan to somebody and it can agree with that person that he or she does not need to pay any interest for five years. During the life of that loan, for five years, the bank can book interest every month as if it had received cash from the customer. It will then be able to say that the loan is continuing to perform because cash is being received from the customer.

Chairman: The Deputy has time for a final question.

Deputy Joe Higgins: Given the extent of the rules and given the huge financialisation of the world financial markets over the last 20 years, by common consent, should these rules not have been advanced considerably to avoid the type of situation that developed, whereby apparently, if I have interpreted what Professor Walsh has said correctly, there was no real reporting of the huge risks that were included in the banking, the speculation and the loans that were going on at the time?

Professor Eamonn Walsh: The Deputy's question is a great one. The way I would have addressed it would have been to emphasise the notion of an informed user of bank financial statements. An informed user of bank financial statements would understand that these rules exist and therefore would know that during the up cycle the amount of profits is overstated and during the down cycle the amount of profits may be understated. I think the most helpful way

I can respond is to say that there is this bundle of rules there and as a result of this bundle of rules, to simply say that profit went up 10% is probably not such a good idea. Instead one has to understand why profits went up by 10% and to what extent the increase was driven by particular twists in these rules with respect to accounting measurement.

Deputy Pearse Doherty: Professor Walsh said earlier in response to Senator MacSharry that to go against the rules is not that wise. Would it be reasonable or not to say that accountancy rules are powerful tools for framing what passes as normal behaviour?

Professor Eamonn Walsh: I beg the Deputy's pardon.

Deputy Pearse Doherty: Professor Walsh has written about this in a paper he co-authored entitled From Moral Evaluation to Rationalisation where it says that, "Creating visibilities of payment behaviour, accounting numbers became powerful disciplinary tools in constructing the norm and punishing the deviant." Would it be reasonable to say that accountancy rules are powerful tools in framing what passes as normal behaviour?

Professor Eamonn Walsh: Largely, it does normalise. In that way accounting does have a normalising role; accounting rules and accounting definitions of things become institutionalised. Our understanding of what profit might be, what income might be, what an asset might be, and what solvency might be, are driven by these conventions.

Deputy Pearse Doherty: Would it be fair to say that the accounting rules are informed by that tension between what would be regarded as normal behaviour and what would be regarded as deviant behaviour?

Professor Eamonn Walsh: I would need to think about that. It is a great question but I would need to think more carefully about the answer to it.

Deputy Pearse Doherty: I will move on, but Professor Walsh has said, "accounting numbers became powerful disciplinary tools in constructing the norm and punishing the deviant". How are accounting numbers a powerful tool in constructing the norm? Do they set the agenda of what is normal or not? Would Professor Walsh like more time?

Professor Eamonn Walsh: The Deputy's question is quite a deep one about accounting rather than specifically dealing with the banks.

Deputy Pearse Doherty: If today's accountancy standards were applied to the 2008 Anglo Irish Bank balance sheet, would an audit still find on 30 September 2008 that the bank would make a profit just shy of €500 million after tax?

Professor Eamonn Walsh: Yes, it would. While there are changes coming down the road in about three years' time, there has been no change in the standards since the financial crisis. One would reach much the same conclusion today as one would have reached back in 2008.

Deputy Pearse Doherty: Would an auditor have knowledge of the fact there was inadequate loan documentation for some loans? The chief executive of NAMA, the National Asset Management Agency, Mr. Brendan McDonagh, said in 2010:

> [NAMA's] our own detailed due diligence on a loan by loan examination has revealed a troubling picture of poor loan documentation, of assets not properly legally secured and of inadequate stress-testing of borrowers and loans - all born of a mindless scramble to funnel lending into one sector at considerable pace and of a reckless abandonment of basic prin-

ciples of credit risk and prudent lending.

The Minister for Finance informed me in reply to a parliamentary question that, as a result of this poor loan documentation, NAMA paid €477 million less on the €32 billion it paid. Would an auditor be expected to pick up on some of these issues and report them?

Professor Eamonn Walsh: That is an excellent question that goes to the heart of what might be going on here. In my written statement, I listed what one would be expected under US audit guidance to establish with respect to looking at a loan book. The interesting question is to take some examples that NAMA has referred to and step back to see what happened to these particular loans and their documentation in the process. Were they subject to audit?

Deputy Pearse Doherty: The questions are specific. We know NAMA paid just shy of €32 billion for these loans. We know €477 million of a write-down was given to NAMA, a large portion of €32 billion, as a result of poor documentation. Is this something an auditor is supposed to pick up? Should an auditor have picked up that €1 out of every €60 of the loans transferred to NAMA had poor loan documentation and their security was not enforceable? Alternatively, is it the case, as Professor Walsh said, that an auditor is guided by the provisions and if they did not expect them to do this, then they did not have to do it?

Professor Eamonn Walsh: It is difficult without seeing what documentation was available and what work was conducted by the auditors at the time. I agree with the Deputy that there appears to be a disconnect between what was being reported as the amount of loans a bank had and what we know subsequently happened with NAMA where it would appear security was not perfected on these loans and, perhaps, there was a belief there were guarantees but they were inadequate. It is also possible that unanticipated events occurred. This is an excellent line of inquiry. In shedding light on what occurred, it would be a far more interesting line of inquiry than worrying about impairment accounting.

Deputy Kieran O'Donnell: Is it fair to say the true and fair concept is the auditors' opinion of a company's actual financial position?

Professor Eamonn Walsh: True and fair is a term that is used but how it is interpreted is the question. Is it in line with accounting standards?

Deputy Kieran O'Donnell: In his written statement, Professor Walsh stated:

> By 2009, it was apparent that the capital 'cushions' available to Irish banks were entirely inadequate. Some financial institutions had liabilities that exceeded their assets (i.e. they were insolvent or had negative capital).

In terms of the audit reports that were issued between 2003 and 2007, were there any qualified opinions in any audit of the banks?

Professor Eamonn Walsh: I do not believe so.

Chairman: Will Deputy O'Donnell explain what a qualified opinion means?

Deputy Kieran O'Donnell: An auditor must provide an opinion on a company's financial statements. The auditor has to give an actual report based on whether the accounts show a true and fair view. If an auditor gives a clean audit report, that means they show a true and fair view. If the auditor gives a qualified opinion, it can go from a spectrum of not reflecting the true and fair view-----

Chairman: Okay. Does Deputy O'Donnell want to-----

Deputy Kieran O'Donnell: Will the Chairman give me some liberty? With due respect, you asked me to explain it.

Chairman: I am holding the clock. I will bring the Deputy back into the time. There is no need for him to be like that.

Deputy Kieran O'Donnell: Thank you.

Some banks had liabilities that exceeded their assets. They were essentially insolvent. Is it fair to say that clean audit reports, where they were not qualified, did not reflect the true and fair view of the financial position of the banks?

Professor Eamonn Walsh: In terms of the legal definition of true and fair, they did.

Deputy Kieran O'Donnell: With due respect, there is a judgment call on the part of the auditor. Looking at the reports that were issued, did they reflect the financial positions of the banks at that time?

Professor Eamonn Walsh: Unless there was fraud or something like that of which we are not aware, it is probably fair to say that there was a true and fair view as is understood by accountants. Is it true and fair for the public? Probably not. People have asked how one can possibly say last year this was a going concern but this year it is not.

Deputy Kieran O'Donnell: Did the auditors' reports reflect the true and fair view to the shareholders of the banks?

Professor Eamonn Walsh: In so far as ticking the boxes and complying with their responsibilities as auditors, it is fair to say they were a true and fair view. If I were an individual investor in these banks, it would have been very helpful had there been additional information to me as an investor to understand the actual risks these banks were undertaking.

Deputy Kieran O'Donnell: Were they required under Stock Exchange rules to provide additional reporting requirements such as emphasis on matters or additional work on the audit report where it would not be qualified? Is it fair to say that underlining a true and fair view is a going concern? When one looks at a set of financial statements, apart from the tomes of standards Professor Walsh referred to, surely the underlying criteria is going concern.

Professor Eamonn Walsh: That is correct.

Deputy Kieran O'Donnell: The point I am making is that Professor Walsh stated some financial institutions were insolvent. One can speak all one wants about the bible of accounting standards. However, it is underlined by basic accounting principles such as prudence, accruals and, ultimately, going concern. Going concern should have been a fundamental criterion in any audit of a bank at the time. This, in turn, would have given rise to a qualification in the audit report.

Professor Eamonn Walsh: This is a matter that has been extensively studied by the UK Government. The same question was expressed there. How could there have been a bank with a clean audit opinion one day and then, a day later, be in public ownership? There has been a certain amount of thoughtful work by the UK Government on the issue of going concern. My recollection of its conclusions is that it said the definition of going concern used by auditors and within the accountancy profession and in case law is probably too restrictive to reflect what the man in the Clapham omnibus would consider to be going concern, namely, if the bank closes down today after getting a clean audit opinion yesterday, there is something wrong with the audit opinion.

Deputy Kieran O'Donnell: Is Professor Walsh saying he believes the accounting and auditing principles in place are flawed?

Professor Eamonn Walsh: No, I am saying there is a mismatch between the expectations of a lay member of the public and what is actually done in respect of definition of going concern.

Senator Susan O'Keeffe: As a general rule, are auditors and accountants allowed to be directors of companies for which they work?

Professor Eamonn Walsh: Off the top of my head, absolutely not.

Senator Susan O'Keeffe: Has it ever happened? Has that ever been reported?

Professor Eamonn Walsh: I would imagine that when a person joins an audit firm there is a prohibition on being a director of a firm that person is auditing, and probably restrictions on being a director of other companies.

Senator Susan O'Keeffe: As regards the large book, the international accounting standards we have been discussing, there have been criticisms over the years by the European Parliament, the Securities and Exchange Commission, SEC, and other people. Who decides to change them? Obviously, it is a long and complex process but are corporations or large financial institutions allowed to lobby and keep things or change them?

Professor Eamonn Walsh: In general, the approach is probably reasonably good. The International Accounting Standards Board is a stand-alone not-for-profit foundation. It issues rules and goes through due process. For example, with respect to loan impairments, it issued a proposal in 2008 I believe it was, and would have issued another proposal having obtained feedback from the banking community. All the feedback is on the public record. It then sought to work with the US authorities to change the rules. It goes through extensive due process but it is a largely independent body and lobbying would not work. That is not part of its cashflow, so to speak.

Senator Susan O'Keeffe: Is it not made up of representative accounting organisations in different countries?

Professor Eamonn Walsh: The International Accounting Standards Board is a stand-alone foundation with a chief executive officer, and board members are appointed. It would not be described as being under the thumb of any particular interest. There would be a perception among some in the United States that perhaps it is a little too dependent on getting EU endorsement for things it does, that it has responded to EU political concerns at various times. I am not saying I hold this opinion. Some in America have argued that this perhaps is not such a good thing.

Senator Susan O'Keeffe: Can Professor Walsh explain his comment on page 3 of his written statement, "In periods of expansion, as a bank expands its loan book, the bank will appear far more profitable since profit measures exclude expected loan losses."?

Professor Eamonn Walsh: Suppose we are in the boom days of 2004, we go out and grant an additional 5,000 mortgages. That essentially means that now we have interest coming in on those mortgages. Our interest goes up. We will pay some money out from funds we have managed to get to support those mortgages, which hopefully we receive quite cheaply. Our overheads are probably much the same as they would otherwise be, which means our profit shoots up as a result of expanding the loan book. However, we all know that some of those mortgages will not turn out as anticipated. It is only later in the cycle that will be reflected in the financial statements. As a result, profits will inevitably be high because in the early years a loan generally performs.

Senator Susan O'Keeffe: That will always be in the cycle of banks.

In respect of the banks that reduced their loan loss provision themselves, and Professor Walsh refers to this when he says provision for loan losses declined from 0.7% of loans to 0.5% of loans, would the banks know they were doing that, or did it happen accidentally? Would they be obliged to tell the Central Bank they had done that or would the Central Bank have discovered it from their accounts?

Professor Eamonn Walsh: This refers to the change from Irish accounting rule, the Irish GAAP, to international accounting standards in 2005. The old rules had something for expected provisions for losses, the new rules did not. There was a small change for the large banks, probably approximately €100 million in the provisions as a result of this. This would have been entirely transparent to the users of financial statements. It would also have been entirely transparent to the Financial Regulator and the Financial Regulator adjusted capital requirements for loan to value, for home mortgages and stated part of its reason for doing so was these new rules. The whole process was completely transparent.

Senator Marc MacSharry: Considering everything that has gone on, does Professor Walsh feel there are any reforms required to ensure the independence of the appointment of auditors? The perception, and I am sure that is all it is, is that he who pays the piper calls the tune.

Professor Eamonn Walsh: Some people believe there should be greater auditor rotation, greater switching between firms. Some countries have used proposals such as having two audit firms perform an audit and having checks such as that. There are many proposals that go around. I have not seen any evidence that these proposed measures result in better outcomes. It would strike me that people feel good because they pushed through a reform but I have yet to see evidence that it changes anything dramatically. I may be in a minority of one.

Chairman: Is Professor Walsh familiar with the Central Bank's winter quarterly bulletin 1995 where very clear and specific recommendations were made to external auditors with regard to concentration limits? This was referred to in the Honohan and the Nyberg reports.

Professor Eamonn Walsh: I am not familiar with it. I saw it referred to in the reports and had difficulty trying to get it. I could be wrong. I do not know if it was available as soft copy.

Chairman: I will not be drawing Professor Walsh on its specifics. I want to get his view of several aspects of it. There is a chapter heading for external auditors, section 3.4, Auditing Irish Banks. It covers sectoral concentration limits, prudential sector lending limits of 20% of a bank's own funds for one sector, and 250% of a sector, subject to a common predominant risk factor. The Honohan report states:

> Rules of this kind were actually in effect, but not enforced. Specifically, there was a long-standing ceiling (200 per cent of own funds) which was supposed to be applied to

loans to any one economic sector (various classes of property loan were treated as different sectors, so the overall property ceiling was higher). This requirement seems to have become a bit of a dead letter, [Professor Honohan mentioned that in his engagement with us.] with violations being noted but not acted upon. Albeit old-fashioned, this kind of rule would, if enforced, have been quite effective in slowing the bubble.

These were rules for auditors going into banks to see how the sectoral concentration limits were operated.

How was it that the external auditors were not applying the recommendation or guideline indicated to them quite specifically in the Central Bank bulletin in 1995?

Professor Eamonn Walsh: I think this goes back to the quote I had from the Nyberg report. Certainly how I would understand it is that largely it appeared that there were these limits in place but they were being ignored by the regulator. In other words, the quarterly reports that would go to the regulator or whatever would make it clear that there had been breaches of these limits, that auditors were basically seeing what was going to the regulator and Nyberg concludes that even if they had reported these things to the regulator, the regulator would not have done very much about it. My feeling is largely that the difficulty is not an audit one *per se*, given the audit communications with the regulator and the regulator potentially knew, rather it is more a case that these prudential limits would have made tremendous sense, had they been adhered to we would be in much better shape today than we are and the question is why those limits were not adhered to by the regulator.

Chairman: What is Professor Walsh's view on Professor Patrick Honohan's comment that this guideline or rule was a dead letter? Does Professor Walsh have a view on that?

Professor Eamonn Walsh: From my reading of the reports that have been prepared, it would strike me that the conclusion is entirely correct, that the sectoral limits might have existed but nobody seems to have paid any attention to them. I would say the same if we move over to disclosures of individual exposures where clearly there were large individual exposures. When we look at the PwC report referred to, this becomes a super concentration of risk among individuals and with particular types of real estate lending.

Chairman: In chapter 7.18 of his report he concludes the paragraph by saying: "It is fair to acknowledge, however, that experience shows that quantitative credit limits can be circumvented fairly easily". What does Professor Walsh think he means by that?

Professor Eamonn Walsh: This is again, a fascinating issue. It would be very easy to slice up something or characterise a transaction in a particular way to navigate around such specific rules. For example, we could take something that the man on the 44A agrees is speculative property lending and redesignate this as lending to a retailer.

Chairman: Does that mean in regard to the book Professor Walsh brought in to us today, to use Deputy Higgins's theological term, that one can either have biblical or subjective interpretation of Canon Law or religious law? In regard to Professor Patrick Honohan's final comments about being circumvented fairly easily, are the rules in that book subjective or are they determined?

Professor Eamonn Walsh: There is an amount of guidance in here. This book is called *Principles Based Accounting*. The equivalent US rules would be about five times the size of this book. The US rules are much more specific and would have much more detailed requirements about disclosures of concentrations of credit risk in published financial statements and much more detailed disclosure about what listed entities should do. International accounting standards do not have that level of detailed requirement and then the opportunities for creating particular impressions for being able to slice up a transaction in particular ways, for example, to say that part of it was a UK exposure and part of it was an Irish exposure and, particularly, given Northern Ireland it would allow one to represent things as if concentrations were a lot less than it appeared.

Chairman: I thank Professor Walsh. Is there anything else he wishes to add?

Professor Eamonn Walsh: No.

Chairman: I thank Professor Walsh for his participation in the inquiry. It has been a very informative and valuable meeting which has added to our understanding of the factors leading to the banking crisis in Ireland.

The joint committee adjourned at 1.45 p.m. until 9 a.m. on Thursday, 26 February 2015.