

Statement of Paul Smith

1 May 2015

1. Introduction

- 1.1. I was the Managing Partner of Ernst & Young (EY Ireland) until my retirement in 2009.
- 1.2. Ernst & Young is an international leader in assurance, tax, transaction and advisory services with 190,000 employees and partners worldwide. EY Ireland now operates under the "EY" brand and through a group of partnerships (Ernst & Young Chartered Accountants, Ernst & Young Business Advisors and Ernst & Young Business Advisory Services) and is a member firm of Ernst & Young Global Limited, a UK company limited by guarantee (EYG).
- 1.3. EY Ireland serves a variety of clients ranging from the public and private sectors including some of Ireland's progressive entrepreneurial 'start-ups' and largest corporate bodies, and some of the world's largest and most iconic businesses. EY Ireland employs over 1,375 people in Dublin, Cork, Waterford and Limerick.
- 1.4. Although as a firm EY Ireland offers expertise in a range of areas, individual professionals generally specialise in their chosen field and operate in the area of their individual expertise – taxation in my case.
- 1.5. I joined the firm in 1973, specialising in taxation and became a partner in 1982. I was based in Ernst & Young's New York office, working on the Irish tax desk between 1994 and 1996, before returning to Ireland. In 2000 I became Managing Partner until my retirement in 2009.
- 1.6. I confirm that EY Ireland was the statutory auditor of the Financial Statements of two of the seven covered institutions. We audited the Financial Statements of Anglo Irish Bank and EBS for the financial years ending 30 September 2008 and 31 December 2008 respectively (and for earlier years). In accordance with the Committee's direction, I will make no further reference to Anglo Irish Bank.
- 1.7. The Committee has invited Mr Dargan FitzGerald of EY Ireland to appear on 20 May along with me. Mr FitzGerald is an Audit Partner specialising in the audit of financial institutions and is EY Ireland's Audit Compliance Principal. He was the audit partner for EBS for the years ending 31 December 2007 and 2008. Accordingly, he is better placed to assist the Committee on any questions about our perspective or role as auditors of EBS. I have read and agree with Mr FitzGerald's statement. However, I do not claim his knowledge or expertise in respect of the accounting and auditing standards nor do I have his familiarity with the audit work in respect of EBS in the financial years ending 31 December 2007 and 2008 respectively. Likewise, because I have been retired for six years and because I was never an audit specialist, my statement necessarily reflects and draws upon the corporate knowledge and experience of my former colleagues in EY Ireland to the extent that I am unable to address matters from my own personal knowledge and recollection.

2. The Global Recession - Why was the Irish economy and banking system so vulnerable?

- 2.1. For the avoidance of doubt, I should make clear that when I refer to "banks" in this statement, I am including building societies such as EBS.
- 2.2. While I do not claim particular economic expertise, I believe that the reasons for the impact of the recession have been explored in the reports before the Committee. Those reports suggest, and I agree, that while the global recession was an international crisis, Ireland was particularly hard hit. The open, export driven nature of the Irish economy – an advantage in a positive international environment – rendered Ireland more vulnerable in a downturn, but I agree that this does not fully explain the Irish experience in the global recession. As appears from those reports (admittedly with the clarity of hindsight), there is now a widespread recognition that leveraging by Irish banks and borrowers, and lending practices followed by banks, combined with low capital requirements set by international

regulations and norms, created a major exposure in the event of a reduction in liquidity in the international markets or a fall in the international property markets. Both of these scenarios ultimately occurred.

- 2.3. In the final years of the "Celtic Tiger", banks clearly played a key part in Irish economic expansion. The *Honohan Report* observed:

"... the four last years of the boom, from late 2003 onwards, were clearly bank-led."

- 2.4. The availability of low cost, short term liquidity offered an opportunity for Irish banks – and their overseas counterparts – to expand. As *Nyberg* notes:

"Entry into the euro area markedly reduced Irish interest rates. Banks had increased access to market funding, where cheap and abundant credit was already available owing to monetary policies in major countries ..."

- 2.5. I agree with the conclusion in the various reports that prior to the emergence of sub-prime issues and the global "credit crunch" there was a widespread view in Ireland and internationally, that the favourable economic conditions would continue. Nor, as was acknowledged in the *Honohan*, *Nyberg* and the *Regling and Watson Reports*, was a cataclysmic fall in the property markets (or its impact on banks in Ireland and elsewhere) generally seen as a likely scenario during the years of growth. There was a widespread expectation that borrowers and lenders would continue to benefit from the economic environment.

- 2.6. I also note that commentators have expressed the concern, again with hindsight, that the State itself benefitted from the property boom, arguably creating a political disincentive to actions which might restrain the banks and the property markets, and increasing the State's vulnerability in a downturn. *Regling and Watson* note:

"The main reason for the sharp increase in the fiscal deficit in 2008-09 was the collapse in tax revenue. This was possible because the structure of tax revenue had changed dramatically from the 1990s to 2006-07. The composition of tax revenue had shifted gradually from stable sources of taxation, like personal income tax and VAT/excise taxes, to cyclical taxes, such as corporation tax, stamp duty and capital gains tax. The share of these cyclical taxes reached 30 percent of tax revenue in 2006; in the late 1980s it had amounted to only 8 per cent."

- 2.7. *Nyberg*, again with the benefit of hindsight, described the development of "a national speculative mania in Ireland during the period, centred on the property market". I do not disagree with the conclusions of the reports that, at the time, the general consensus welcomed the growth of the economy and underestimated the risk or magnitude of a downturn. Official analyses were generally to similar effect. As the *Honohan Report* noted:

"The major tool of overall financial stability policy was envisaged to be the Financial Stability Report (FSR). The language of successive FSRs was too reassuring throughout, even as late as November 2007, and did little to induce the banks - or the public and policy makers - to adjust their behaviour to avoid the threats that lay ahead."

3. The beginning of the "Credit Crunch" and the development of the Global Recession

- 3.1. Starting with the sub-prime issues in the US and the "credit crunch", a succession of negative events with seismic consequences in many jurisdictions led to the global recession. These included the collapse of **Bear Stearns** (22 June 2007) followed by **Northern Rock** (22 February 2008), the "**St Patrick's Day Massacre**" (17 March 2008); and the collapse of **Fannie Mae** and **Freddie Mac** in the US (6 September 2008). These events changed the international landscape in terms of liquidity. They culminated in the collapse of **Lehman Brothers** (15 September, 2008) triggering an international banking crisis which led to government interventions in many jurisdictions, including Ireland.

3.2. I agree with Nyberg's summary:

"...as bank funding dried up, the credit-driven property development sector started to experience liquidity problems. From then on, the link between property prices and funding accelerated the downturn and reduced banks' perceived creditworthiness..."

3.3. While the Government Guarantee was intended to address the liquidity requirements of the "covered institutions", the continued macro-economic deterioration in the following months, the loss of market confidence, and the collapse of property values further exposed Irish banks (and banks in other jurisdictions) and led to further Government interventions, including NAMA.

4. Responsibility for the Irish Banks' Exposure

4.1. Banks around the world were catastrophically affected by the global recession. Irish banks were also affected. The explanations advanced by the reports before the Committee include an overreliance on short term liquidity, poor lending decisions and an over exposure to property markets. Accordingly, questions arise as to responsibility for such exposures and as to how to prevent a recurrence. To answer those questions, it is necessary to consider the roles and responsibilities of various parties.

Responsibility of the State and of Regulators

4.2. Leaving aside political responsibility for macro-economic policy and regulation (including the role and responsibility of Government and of the Department of Finance in particular), when considering the management and regulation of individual banks, and of Irish banks generally, it is necessary to consider the roles and responsibilities of the Central Bank and the Financial Regulator along with the responsibilities of the Board and management of individual banks (and their auditors) and the rules and standards under which they were required to operate.

4.3. I understand that prudential regulators have the prime responsibility for anticipating and preventing systemic crises.

4.4. I believe that responsibility for the regulation of financial institutions rested with the Financial Regulator and the Central Bank. I understand that the Financial Regulator was an institution within the Central Bank at the time and that the Financial Regulator and the Central Bank enjoyed extensive rights of access to information and enforcement and regulatory powers.

4.5. I understand that the Central Bank's responsibilities included the overview of the banking system, and analysis of the macro and micro prudential health of the financial sector and that the Financial Regulator's responsibilities included the prudential supervision of banks and the provision of advice, information and assistance in relation to the Central Bank's functions to its Board and the Governor.

4.6. I am not in a position to comment in detail on the various regulators' discharge of their duties prior to 2008, issues already explored in reports before the Committee, save to note my belief that, as a result of regular and detailed regulatory returns by individual banks to the Financial Regulator and of information available to the Financial Regulator and the Central Bank from their counterparts throughout the European Union, the Financial Regulator and Central Bank should both have had access to a greater overview of exposures affecting the entire market, offering greater visibility of market conditions and exposures than was available to individual banks or their auditors.

4.7. I am informed by my former colleagues and therefore believe that in carrying out their prudential responsibilities, supervisors could (and now do) make better use of auditors and other external experts through greater dialogue (in both directions) and through targeted risk based reporting.

Responsibility of Directors and Management

- 4.8. The ultimate responsibility for the management and commercial direction of any company rests with its directors. While not professing to be an expert on corporate governance, I understand that Directors' wide-ranging statutory, common law and fiduciary duties include:
- exercising their powers in good faith and in the interests of the company as a whole;
 - carrying out their functions with due care, skill and diligence;
 - disclosing certain personal information; and
 - duties regarding the disclosure of their transactions with the company.
- 4.9. The directors also bear ultimate responsibility for:
- commercial decision-making, commercial strategy and business model;
 - corporate governance;
 - management and controlling business risk;
 - maintaining proper books of account; and
 - the preparation of annual Financial Statements which comply with legislative and accounting requirements.
- 4.10. While responsibility remains with the Board (along with its Committees including the Audit Committee and the Risk Committee), in practice, some of these functions are frequently delegated to management and to internal functions. These typically include the following:
- the Internal Audit Function;
 - the Finance Function; and
 - Individual executives with responsibility for areas such as finance, financial reporting, risk and regulatory compliance.

Responsibility of Auditors

- 4.11. Statutory audits are focused on the historic Financial Statements of individual entities and on the risk that those Financial Statements have been materially misstated.
- 4.12. The statutory auditors' primary function is to carry out a statutory audit of the annual Financial Statements and to express an independent opinion in respect of the company's Financial Statements. The audit opinion must address matters prescribed by law - such as whether the Financial Statements show a true and fair view in accordance with the applicable accounting standards.
- 4.13. Statutory audits are not intended to advise on future business or commercial risk, particularly business risks which are market-wide and not confined to a single entity or geography.
- 4.14. While I do not claim to be an auditing expert or to have reviewed the EBS audit files, I can say that as far as I am aware the EY Ireland audit team properly performed its responsibilities as statutory auditors, including in respect of its audit of the Financial Statements of EBS for the year ending 31 December 2008 (and for previous years).

5. **EY Audit methodology**

- 5.1. Having specialised exclusively in tax before becoming Managing Partner, I was never involved in the day to day execution of individual audit engagements (unless taxation issues arose). As Managing Partner, I was responsible for the strategic direction, management, development and leadership of the firm as a whole and for dealing with issues referred or escalated to me as Managing Partner. As Managing Partner I was also responsible for ensuring that the objectives of the firm (as agreed from time to time) were being adhered to. My duties as Managing Partner also included promoting the interests of the partnership, initiating matters of policy and representing the partnership at meetings with EY Global as necessary.
- 5.2. As Managing Partner I was updated from time to time by the leaders of various divisions in respect of their practice areas, including the then Head of the Financial Services Group. These were high level updates in respect of the Financial Services Group as a whole. Individual audit engagements were rarely raised with me unless an issue arose in the course of our audit work which required my attention for some reason. As far as I can recollect, no such issue ever arose in the course of our audit work in respect of the Financial Statements of EBS for the year ending 31 December 2008 (or for previous years).
- 5.3. I was aware of our firm wide approach to audits over the years. It was (and is) my understanding that EY's Global Audit Methodology (EY GAM) provides a global framework for delivering high-quality audit services in all audit engagements. I understood that the audit approach adopted by the firm was designed to comply with the applicable auditing standards, involving our international expertise in the audit of Financial Statements where appropriate. Based on my experience as Managing Partner, I was (and remain) satisfied as to my colleagues' professionalism and commitment and was confident that they would undertake their audit of the financial statements with the appropriate rigour.
- 5.4. The audit team on the particular engagement could draw on the knowhow and expertise available both in Ireland and internationally, including the firm's Financial Reporting Groups in Dublin and London, which could assist with regard to any technical issues which might arise during the audit of the Financial Statements concerning the interpretation or application of the relevant standards.
- 5.5. An audit partner was responsible for each engagement, supported by a team which varied depending on the size and complexity of the particular engagement. I understood that work was delegated within the audit team subject to review and sign off by more senior members of the audit team, with the Audit Partner ultimately responsible for signing off on the audit of the Financial Statements as a whole based on the work of the audit team.
- 5.6. My role was not to get involved in the planning, execution or completion of individual audit engagements. It would be only if a major issue arose that I might be consulted (such as where we decided to resign as auditors). No such issue arose in respect of EBS.

6. **Specific Issues Raised by the Committee**

- 6.1. My comments above have addressed most of the specific issues which the Committee has asked me to consider. However, for completeness, I briefly summarise the position;

Issue B1:b Integrity of financial reporting

- 6.2. I am not an expert on financial reporting but, based on my discussions with my former colleagues in EY Ireland and my review of publicly available material such as the reports before this Committee, I believe that, far from being caused by issues with regard to the integrity of financial reporting, the global crisis was an economic crisis caused by a series of factors including governance failings, supervisory weaknesses and capital upheaval, made worse in Ireland by the massive losses resulting from the dramatic downturn in the property market over a number of years, in addition to the overall economic downturn in the last quarter of 2008.

6.3. Issue B2: a - Appropriateness of property-related lending strategies and risk appetite

Issue B3: e – Capital Structure and Loss Absorption Capacity

Issue R2: c - Adequacy of the Assessment and Communication of solvency and liquidity risks in the banking institutions and sector and Issue C2: c - the Liquidity versus Solvency debate

Because I was not an auditor, I was never involved in advising EBS or any other financial institutions on these issues. Nor am I aware of the extent to which such matters would have been considered in the course of the annual audit of the previous year's Financial Statements. However, I would have regarded such matters as primarily commercial issues for determination by the boards and executives of the financial institutions' concerned, under the supervision of the Central Bank and the Financial Regulator.


Mr Fitzgerald is better placed than I am to comment on each of these issues, and I note that he has dealt with them in greater detail in his statement to the Committee.

7. **Conclusion**

7.1. Based on my own understanding and the reports already before the Committee I believe that the banking crisis was triggered by the international economic crisis and rapid economic deterioration rather than by any failure by Irish banks to comply with accounting standards in the presentation of their statutory Financial Statements or by any failure in the statutory audit of such Financial Statements.

7.2. While I do not claim to be an expert on banking practice, I agree, based on the reports before the Committee, that the exposure of Irish banks may well have been increased by their lending strategies and practices. However, I would view these as commercial issues and the responsibility of the individual banks, their directors and management. At a prudential supervisory level they were also the responsibility of the Financial Regulator and/or the Central Bank. I note that Mr FitzGerald's statement addresses these issues in greater depth.

8. I look forward to appearing before the Committee and answering any further questions it may have in respect of these issues.



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Paul Smith

1 May 2015