Tithe an Oireachtas
Houses of the Oireachtas

# Joint Committee of Inquiry into the Banking Crisis

## Witness Statement of

## Denis O'Connor

## Session 61

## 09 September 2015 (a.m.)

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>
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[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

Submission to the Banking Inquiry

Denis O'Connor

Opening Submission to the Banking Inquiry

Denis O'Connor

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## *Introduction*

My name is Denis O'Connor. I am a Partner in PricewaterhouseCoopers. I was admitted to partnership in a predecessor firm, Craig Gardner, in 1995. I am a fellow of the Institute of Chartered Accountants in Ireland having qualified in 1986. I graduated from University College Cork in 1982.

In my early years as a Partner I was the Lead Audit Partner on many of the Firm's public company audits in both financial services and non-financial services. In the late 1990's I reduced my time on audit related assignments and moved to the Transaction Services area of PwC where I have been involved in a significant number of the largest transactions involving Irish Companies over the past 15 years. I lead the Transaction Services Group within our Firm and have worked extensively with Irish and International business during my 33 year career with PwC.

I was invited to appear before the Committee as part of a panel with my fellow partner Aidan Walsh in my capacity as co Team Lead for the PwC team working for the Financial Regulator on liquidity and loan quality for the covered Banks.

## *Context of my appearance*

In advance of my appearance, the Committee provided me with a direction to address certain aspects of the remit of the Inquiry. This direction set out the themes which it wishes me to cover. These are

- Role of advisors in analysing the crisis (to include crisis management options)
- Effectiveness of reviews of banks' loan books and capital adequacy.

My evidence on these themes relates to the work performed by PwC resulting from our engagement with the Irish Financial Services Regulatory Authority (" IFSRA") as per our letters of engagement, the first of which is dated 18 September 2008. This work was termed *"Project Atlas"* and was led jointly by my partner Aidan Walsh and myself.

Mr Walsh has prepared his own statement for the Committee.

## *Confidentiality Obligations*

I am obliged to point out to the Committee that at the time of our engagements by the Irish Financial Services Regulatory Authority and the Department of Finance in 2008 and 2009 we were specifically advised that we would be bound by the following statutory provisions:-

- Sections 33 AJ and 33 AK of the Central Bank Act, 1942; and
- Sections 57, 57A and 58 of the Criminal Justice Act, 1994.

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As the Banking Inquiry will be aware Section 33 AK of the Central Bank Act 1942 provides that no party is permitted to disclose confidential information concerning

1. *"the business of any person or body whether corporate or incorporate that has come to the person's knowledge through the person's office or employment with the Bank, or*

2. *Any matter arising in connection with the performance of the functions of the Bank or the exercise of its power."*

The Central Bank has confirmed in writing to the Committee that we are subject to our obligations under Section 33AK of the Central Bank Act (as amended).

This limits the amount of information that I can discuss with the Committee.

## *Role of advisers in analysing the crisis*

At the outset let me set out what work PwC completed during the crisis.

I attended a meeting together with Aidan Walsh, a fellow partner in PwC, and a Senior Manager from PwC, with Mr Neary the Financial Regulator, Ms Burke, Banking Supervisor and Mr Con Horan, Prudential Director of IFSRA at 15.00 on Thursday 18 September 2008. Mr Neary explained to us that he was very concerned about the impact the global financial crisis and the freezing of the interbank funding markets was having on the Irish banking system. .

We agreed the areas that IFSRA wanted us to review, were principally short term liquidity, credit quality and capital and the assumptions made by management in respect of these issues. In respect of credit Mr Neary suggested we focus on the top 20 lending exposures.

Following further discussion with the Financial Regulator we agreed the scope of work outlined below and which forms part of our engagement letter dated 18 September 2008. The scope of our work is set out in Appendix One.

Our work on Project Atlas was based on management accounts of the relevant banks and did not involve any independent verification procedures. Our initial work on this scope focussed on liquidity and a high level review of major lending positions and the level of loan provisions that were booked by the banks. We reported our initial findings on liquidity to the Central Bank and the Dept. of Finance on 28 September 2008. A brief paper on credit provisions was also prepared for the Central Bank and the Dept. of Finance. We were not involved in any meetings or significant correspondence between that date and our next meeting with the Financial Regulator and his staff on Monday 6 October 2008.

Following on from these discrete pieces of information gathering in advance of 30 September 2008 we continued to work on the scope of work noted above. The results of our work were reported to the

Regulator in early October. We were also asked to draw up a list of loans that could be used as collateral.

In addition, I attended meetings in the Dept. of Finance, the Central Bank / Financial Regulators office and the offices of the NTMA at various dates between 18 and 28 September 2008. The attendees at these meetings varied from meeting to meeting but representatives from the Central Bank, the Financial Regulator, the Department of Finance, the NTMA, Merrill Lynch, Arthur Cox, and the Attorney General's office attended all meetings. The late Minister for Finance attended some meetings and the Taoiseach attended one meeting that I was present at.

PWC's role in many of those meetings was to obtain , analyse and summarise information from the Banks (the 6 Banks that were eventually covered by the Guarantee).

The results of this work by PwC is summarised in the various Project Atlas Reports that are with the Committee.

## *Effectiveness of reviews of banks' loan books and capital adequacy*

The next phase of work that PwC were engaged to carry out was **Atlas Phase 2.**

This work was concentrated primarily around reviewing loan books and loan losses concentrating mainly on the large loan relationships. The top 20 borrowers was expanded to top 50 borrowers.

Our work did not include a review of cases outside the large cases included in our loan samples for each of the Banks. Smaller loans may have characteristics and risk factors that may make them higher risk in terms of their potential for impairment. We did not review any of the mortgage books in any of the banks. We did not, in the time available to us, check the adequacy of security, valuation reporting etc. or any of the underlying documentation in any of the 6 Banks.

Where we made comments and observations about possible asset write downs and scenarios, these were for indicative purposes only. We did not seek to "mark to market" property assets in the present economic environment (where the market for property assets is largely illiquid); in that context it is difficult to forecast the outturn of any immediate short term asset sales or asset developments.

The work involved was covered by our letter of engagement dated 9 October 2008 and involved the 6 banks listed in Appendix Two together with the scope of work procedures is outlined in Appendix Three.

The result of our work was reported to the Financial Regulator and the Department of Finance in mid-November 2008.

In addition PwC were requested to include two additional impairment scenarios, Scenario 1 and Scenario 2. As was stated in our reports these scenarios were for illustrative purposes only to show the sensitivity of the Institutions to average losses of the specified quantum. The composition of the impairment scenarios were developed in conjunction with the Dept. of Finance, representatives of the NTMA, the Central Bank and the Financial Regulator in advance of the calculations being run by the various financial institutions.

The PwC scenarios analyses was based on a number of assumptions and other than INBS, had not been reviewed by management in the Institutions. This scenario analysis was not our assessment of likely losses but was to illustrate sensitivity to increased levels of losses. We also noted that as events and circumstances frequently do not occur as expected, there will always be differences between predicted and actual results, and those differences may be material

In carrying out Atlas 2 one had to comply with the underlying accounting standards that the financial statements of the relevant financial institution would be reporting under, in the Irish banks case that was IFRS. The future capital ratios would be calculated based on the underlying future financial statements prepared under IFRS.

The requirement to focus on past transactions and events means that IFRS addresses risk through measurement only. In fact, IFRS prohibits the recognition of future events. By way of example:

1) There is a general rule in IAS39 that losses expected as a result of future events, no matter how likely, are not recognised as impairment on loans and receivables - ***the incurred loss approach***
2) There is a general rule in IAS37 that provisions should not be recognised for future operating losses
3) IAS10 does not allow an entity to recognise the financial impact of events that arise after the balance sheet date concerning conditions that did not exist at the balance sheet date.

***IFRS only recognises past transactions and not future events or risks.***

Once an asset or liability (including an incurred loss in the context of impairment) is recognised, under the rules of IFRS, it needs to be measured. The measurement requirements of IFRS do take account of risk, but risk is measured differently depending on the measurement approach adopted. IFRS has two measurement approaches - fair value and amortised cost. Cost is the primary measurement approach with fair value only being allowed in certain specified circumstances (by way of example, financial instruments held for trading). Most financial assets and liabilities are required to be accounted for at amortised cost including loans and receivables.

If an asset or liability is measured at fair value, this value will take account of the market's assessment of the risk of the expected cash flows at the balance sheet date. The expected cash flows take account of the coupon of the financial instrument and if this coupon adequately compensates the holder for the expected credit losses then a fair value loss will not be booked. Where expected credit losses exceed the amount compensated for in the coupon, then a fair value loss will arise.

Fair value is a point in time assessment and it is important to note that changes in this assessment post balance sheet are not reflected in the balance sheet fair value. By way of example, a major fall in asset prices, as was seen in the crisis, between the balance sheet date and the date the financial statements are signed is not reflected in the balance sheet measurement as this fall does not reflect the market's expectations at the balance sheet date.

In contrast, amortised cost does not reflect the variability in the value of an asset or liability to the same extent as fair value. By way of example, IFRS does not require entities to determine different outcomes and probability weight these scenarios (expected value) in the measurement of incurred losses for impairment. Impairment losses are typically calculated using a best estimate approach (single most likely outcome) which does not take account of the impact of worse case situations. One cannot, under IFRS, provide based on the worse case outcome only.

IFRS set the rules which had to be applied in the financial statements of Irish banks during the financial crisis. The financial crisis tested some of these rules and found them wanting. Changes have been made since but, nonetheless, they were the prevailing rules and notwithstanding one's view of their fitness for purpose, they were required to be applied.

In preparing capital calculations the Financial Institution had to comply with the relevant accounting standards which did not allow the recognition of future events or risks. These events had to have existed at the date of the financial statements. In addition the core Tier 1 ratio in 2008 was 4% and that was what the financial institutions were measured against, in 2009 as the crisis developed this ratio was felt to be too low and a Core Tier 1 ratio of c 10% was more the norm. In order to achieve this new ratio significant additional capital was put into the banks throughout 2009.

## *Atlas 3*

Work on Atlas 3 commenced in late November 2008, and involved both PwC and JLL. The scope of the work to be carried out at each of the 6 banks is outlined in Appendix Four.