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Provision of Evidence for the Sharman Inquiry - Going Concern and Liquidity Risk Assessment for Financial Services Entities

This requested evidence is provided on an individual basis, the primary perspective being the inquiries (by the Commission of Investigation into the Banking Sector in Ireland, report at www.bankinginquiry.gov.ie) into i.a. comments by the external auditors of the Irish covered banks on the main causes of the problems that emerged. This perspective also, to a substantial extent, corresponds to that of an advisor during the Finnish banking crisis in the early 1990's. The comments below refer to the draft questions presented in the document "Transparency of going concern and liquidity risk assessment for financial services entities". The numbers refer to the order in which the questions are posed in that document.

1. Transparency requirements for financial services entities ("banks") must take into account the special importance of continued market confidence for a bank's daily operations. Audit opinions, when qualified, pose an immediate threat to the continued financing and operation of the bank. Disclosures that indicate serious problems with, for instance, the bank's balance sheet or prudential routines may have a similar effect, particularly in times of financial market stress.

   This has two major implications for auditors. First, due to directly and indirectly interdependent financial relationships, it may prove quite difficult to assess an individual bank's solvency and liquidity position in isolation from that of other banks. Second, any auditor doubts and views need to be communicated directly, in confidence, to the client bank at as early a stage as possible, before there is a need to issue a qualified audit opinion. This could ideally happen early enough to make unnecessary formal contacts with the authorities, something that would need to be considered once problems have prevailed and worsened for some time. However, even early reporting to the authorities should not pose any insurmountable problems if such reporting is agreed in the engagement letter with the client.

   It appears likely that such a developed role for auditors would require developing their schooling and skills appropriately, as well as to accept that active professional skepticism and experience may be as important as adherence to formalized rules and practices. Such measures, like solutions in general, should ideally be global in scope given the present strong concentration to a few global audit service providers for major banks.

2. If auditor engagement with their client bank could be developed in this way, present disclosure rules could possibly remain essentially unchanged. If auditor warnings on emerging problems, weaknesses and risks were to be given early enough to clients, they would not necessarily yet be relevant for assessing the present value of the bank since problems could/would have time to be rectified.

   It would not seem useful to specify public financial support that must not be publicly disclosed. First, public bank support relates to its objective rather than its form and it could prove difficult to formulate rules that cannot, when necessary, be circumvented. Second, provided other sources of funding are subject to transparency, major public support is unlikely to remain undetected by market observers if they are vigilant enough. Third, lack of disclosure may lead to increased uncertainty in the market with effects also on banks not subject to public support but to unfounded rumors.

3. Publishing stress test results and recovery plans would appear to be useful if they sufficiently accurately reflect the bank's primary risks and the likely state of the real and financial markets in cases where the bank has encountered difficulties. Given the partly unexpected developments during

the ongoing financial crisis, such accuracy is unlikely to be achieved, making it possible for such publication to provide imaginary rather than real comfort.

Even if not published, sufficiently stringent stress scenarios may help banks and auditors assess the sensitivity of asset values to historically relevant disturbances. Together with professionally prudent assessment of the relevant financial market situation, this could help in establishing reasonable asset valuations. For instance, a prudent evaluation of the congested situation in the Irish property market together with the freely available knowledge of similar previous situations in other countries could have provided Irish external auditors with a more realistic view of fair real estate credit values.

To be sure, stress test results applying to numbers of banks and using similar crisis scenarios could usefully be published in order to enable bank comparisons.

4. For banks it appears that governance issues, including lending expertise, experience and practices, would be important additional areas of auditor attention, confidential communication and eventual disclosure. A regular assessment of non-executive directors' level of expertise, skepticism and oversight activity could prove useful.

   When assessing the bank's ability to finance and develop its business model auditors should take appropriate account of market conditions; in Ireland, part of banks' problems arose from the fact that a number of them, in fact, lent generously to the same limited market. Concentrating primarily on existing capital could otherwise, once more, seriously understate banks' sensitivity to the solvency and liquidity of their customers.

5. Measurement of uncertainty in valuing assets and liabilities requires that there are robust valuation models; such models would need to rely on quite long time series in order to also incorporate several periods of serious financial stress. The present crisis has indicated serious deficiencies in a number of such models and it is unclear how any revised models will perform over the medium and long term. Unless there is strong reason for renewed confidence, it could prove more useful to evaluate the need to radically reduce allowed leverage and risk concentration in banks' balance sheets.

   Disclosing a bank's exposure to market risk similarly requires this risk to be robustly evaluated, making such disclosure subject to the same doubts as already expressed above. Unless such risks can be confidently assessed – which arguably seems to have been disproven by the present ongoing crisis – financial stability requires that bank overall leverage and risks are sufficiently reduced. This, of course, is not the responsibility of auditors though they well could have a role to play in assessing the primary risks taken on and handled by individual banks.

   Useful disclosure of a bank's business model and risk profile requires i.a. that primary and important markets and risks are distinguished from the others. Long listings and descriptions of all the various markets and risks are, in practice, likely not to be very useful to all but the most sophisticated investors and observers. For banks, governance and lending issues as already mentioned above could prove important also from a disclosure point of view, at least when possible problems are or have been adequately addressed. Accurate but prioritized reporting of business model and risk profile issues appears not to always be available, variously depending on conceptual, classification and governance problems within banks. It does not seem as if such issues generally have been fully captured by external bank auditors at present.

6. Present evidence indicates that external auditors do adequately fulfill only a narrow and formal role in banks. While this causes few noticeable problems during good times, both past and recent evidence also indicates that it will not prevent banks and their external auditors from accepting practices that lead to serious financial problems when times are less good. These practices have included grossly deficient internal procedures, imprudent lending and reporting practices as well as historically excessive growth in both lending and funding. Remarkably, concrete experience in

various countries from a number of such cases in recent decades does not appear to have markedly influenced the operations of major global audit service providers.

It could reasonably be argued that an assessment of going concern, particularly in the financial sector due to reasons touched upon in answer 1, requires external auditors to have a very solid, complete and professionally skeptic view of the business model and prudential practices of their client bank. It is not obvious that present auditor rules and practices require this. More frequent rotation of auditors could help avoid auditory “capture”, as could the establishment of possibly confidential reviews by independent examinators.

The special nature of bank audits has already been noted above. It is possible that the narrow and formal focus of present bank audits reflect the difficulty and stability dangers of disclosing existing and emergent problems in client banks. If so, reference has already been made to a possible system where auditors would be expected to confidentially engage bank management and boards at an early stage when problems are and should be noticed. This, of course, would require auditors to mobilize a substantially greater amount and depth of market and business understanding than necessary at present. However, this would also tend to make external auditors more relevant without requiring them to provide formal non-audit consulting services to their clients.

Respectfully

Peter Nyberg