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THE EUROZONE BANKING CRISIS

DID THE ECB AND THE BANKS

COLLUDE TO HIDE LOSSES,

THUS DISTORTING

THEIR OWN BALANCE SHEETS?

By

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and

ED HEAPHY

Commissioned by Luke Ming Flanagan MEP

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2 FOREWORD by Luke Ming Flanagan MEP

2.1 New currency launched – already holed below the water-line

The banking crisis that originated through the greed and ignorance of bankers, traders and (possibly greatest contributor of all) ratings agencies in Wall Street, almost destroyed the American economy.

It then crossed the Atlantic, hit Europe in 2008, with equally devastating consequences.

The EU was particularly vulnerable to what had become, in banking at least, almost **The Perfect Storm.**

A new currency had recently been launched, was then less than a decade old, but it was **seriously flawed from birth**, flaws that weren't immediately obvious in the boom that was then happening, but flaws that were foreseen by top economists such as Paul de Grauwe in the London School of Economics, who in an article in the Financial Times in 1998, predicted almost to the letter the catastrophe that was about to unfold in countries such as Ireland, Greece, Spain, Portugal and Italy.

With the introduction of the new currency and the accompanying huge fall in borrowing rates, hundreds of billions of euro flooded into those five countries. The effects varied from country to country but in Ireland and in Spain especially, this tsunami of cheap money led directly to the inflation of a massive property bubble.

Most of the major banks in Europe – inside and outside the Eurozone – got in the act, and – as had been the case in Wall Street – among the biggest gambler/investors were the German banks.

When the bubble burst the major inherent structural weaknesses in the fledgling currency were exposed and the eurozone Member States were helpless; bereft of the normal monetary tools for dealing with a crisis situation in their banking system, they were unable to defend themselves.

Those weaknesses are now being addressed, after the fact, arguably still too little for a complete currency, but certainly all too late for the devastated peoples of those five countries.

2.2 The ECB

The ECB was the Central Bank established in conjunction with the new currency. Nominally it is totally independent of all political influence but in reality, serious questions can and have been asked of its role during the entire crisis, in Greece particularly following the election of Syriza there, but also in Ireland.

After the crash, and in tandem with the European Commission and the IMF, the ECB moved into the crisis-hit countries – the Troika was born. It's mission, however, wasn't to save the people; it's mission was to save the banks, not just the banks inside those countries but the lender banks, the giants of Germany and France etc who were massively exposed after their collective reckless gambling spree, in danger of collapse if the borrower banks were to go under. Something had to be done, and fast, something *was* done, and fast.

But was it legal???

2.3 Heaphy and Butler – posing pertinent questions

This Report focuses on the role of the ECB during that period, focuses in particular in the reporting by banks of its assets and liabilities after the crash and poses a most relevant and pertinent question –

did the banks give a true and fair picture of their actual position, as required by law, or did they, in collusion with the ECB, conspire to hide their losses?

This is a fundamental question, goes to the very heart of banking. The conclusion reached by Ed and Cormac suggests that yes, the ECB DOES have questions to answer, serious questions.

Read, and decide for yourselves.

2.4 EXTRACT FROM PAUL DE GRAUWE FINANCIAL TIMES ARTICLE – 20/02/1998:

'Suppose a country, which we arbitrarily call Spain, experiences a boom which is stronger than in the rest of the euro-area. As a result of the boom, output and prices grow faster in Spain than in the other euro-countries. This also leads to a real estate boom and a general asset inflation in Spain. Since the ECB looks at euro-wide data, it cannot do anything to restrain the booming conditions in Spain. In fact the existence of a monetary union is likely to intensify the asset inflation in Spain. Unhindered by exchange risk vast amounts of capital are attracted from the rest of the euro-area. Spanish banks that still dominate the Spanish markets, are pulled into the game and increase their lending. They are driven by the high rates of return produced by ever increasing Spanish asset prices, and by the fact that in a monetary union, they can borrow funds at the same interest rate as banks in Germany, France etc. After the boom comes the bust. Asset prices collapse, creating a crisis in the Spanish banking system.

Too far-fetched to be realistic? The US monetary union provides many examples of such local booms and busts followed by financial crises that lead to large scale bail-out operations. Scenarios of local booms and bust, as the one just described, will almost certainly happen in the future euro-area. The essential ingredient triggering such crises is the existence of regional differences in rates of return on assets coupled with the fact that in a monetary union banks can borrow at the same interest rates.'

For more on Luke's work:

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3 BIOGRAPHIES

3.1 *Cormac Butler*

Cormac Butler is an equity and options trader and a former consultant with Lombard Risk Systems London and has also worked with KPMG and PricewaterhouseCoopers.

He has considerable international experience as a trainer in insurance, derivative accounting, corporate finance and derivative mathematics, working with major banks including BNP Paribas, and has advised insurance companies on the implementation of Solvency 2, Embedded Value and Basel 3.

He also specialises in the accounting frameworks particularly insurance (IFRS 4) and financial instrument accounting (IFRS 9). He has conducted in-house courses for Morgan Stanley, PricewaterhouseCoopers (Holland), Investec (South Africa) and ABB Switzerland and Asian Development Bank.

In addition, he has worked for IIR and Euromoney in Singapore, Hong Kong, Thailand, America and Saudi Arabia. Cormac graduated from the University of Limerick, Ireland with a degree in finance. He has published two books, Mastering Value at Risk (Financial Times Pitman) and Accounting for Financial Instruments by Wiley.

3.2 Ed Heaphy

Ed Heaphy is a former banker presently working as a research consultant with expertise in assessing commercial borrowings. He has advised legal teams in Ireland, Scotland, England, the US, Spain, Portugal and Liechtenstein.

Having served at management level in two Irish banks, he has spent most of the past decade researching pre- and post-crash practices in European lending institutions.

He collaborated with the US-based control fraud expert William K Black with regards to cases involving NAMA, Ireland's bad bank, and has considerable experience examining regulatory requirements, bank balance sheets, derivatives, securitizations, covered bonds, as well as details surrounding the collateral provided by banks.

In addition to evaluating and assessing the terms and conditions of commercial loans, he has significant experience advising on courtroom strategy and has provided expert reports and evidenced-based affidavits for a number of cases involving Irish lending institutions.

4 EXECUTIVE SUMMARY

1. **On September 30th 2008 the Irish government unveiled a guarantee arrangement to safeguard the deposits and debts of six financial institutions in response to severe worries that the Irish banking system was about to collapse.** The guarantee was given on the premise that on 30th September 2008 all of the Irish banks were solvent, i.e. that they had sufficient assets to meet their liabilities. Both the ECB and the major accounting firms gave an implicit assurance that the banks were solvent. It follows that **the guarantee given was designed to cover the inability of banks to borrow money and was not intended to cover losses that Irish banks may have hidden.**

2. Normally, a guarantee of this nature would imply that the government protected *only* the losses that banks might suffer from future lending decisions. The ECB, however, took the incorrect view that the guarantee extended to losses that the banks had already suffered but not disclosed. **In a letter exchange between the then Minister for Finance and Jean Claude Trichet who was head of the ECB, it was made clear to the Irish government that it must take responsibility for all losses that the Irish banks suffered and not just future losses. It was not only illegal for the ECB to act in this manner, there is also the question as to whether Ireland has the legal capacity to repay money it borrowed from the ECB to cover hidden losses.**

3. The consequences of the ECB pressure was that Ireland was forced into a bank bailout that eventually cost over €69.7billion (excluding interest) with devastating consequences to the economy, devastating particularly for the most vulnerable members of that economy who played no part in the destructive practices of the Irish banking system.

4. This report examines the following questions:

   i. Did the ECB play a part in helping banks to conceal losses so that it could discretely subsidise the banking system which in turn found its way to bankers' bonuses?

   ii. Did the ECB break the law by helping banks to conceal their true financial position?

   iii. In subsidising banks that were in fact insolvent, thus keeping them afloat, did the ECB also subsidise the reckless speculation that resulted from those loans, as the banks then loaned out vast sums to favoured influential friends and developers, who were then able to use non-recourse loans to buy property, knowing that if the property fell in value, the banks would have to suffer the losses?

   iv. Does Ireland have the legal authority to repay borrowings from the ECB that were used to plug the hole created by hidden losses?

5. There were also several other questions examined, such as:

   i Were bank shareholders misled?

   ii After the mass bailout of Irish banks, who owned the collateral?

   iii Was NAMA forced into a fire-sale of assets by the ECB, at a cost of billions to the Irish people?

6. The **ECB official policy towards commercial bank lending may be summarised as follows**:

   i. All commercial banks and governments are entitled to equal treatment, and

   ii. where the ECB lends money to commercial banks, the collateral used is eligible only if it is sufficient to recover all losses that the ECB may suffer in the event of default.

7. This report shows that the ECB has fallen short of this ideal, with devastating consequences. Indeed the ECB's non-transparent policy towards the banking sector contributed to the severe banking crisis of 2008. This report will expose that the ECB:

   i. Is not transparent in its Target Two policy of offering liquidity in respect of collateral posted by Europe's commercial banks;

   ii. Does not take adequate safeguards to ensure that the collateral offered is sufficient to recover losses, with the result that when losses occur, the ECB passes them on to vulnerable governments;

   iii. Has actively and publicly endorsed flawed accounting rules which allows influential commercial banks to obtain concealed subsidies by using overvalued collateral;

   iv. Has forced certain healthy and profitable financial institutions to enter into the quick-fire sale of assets which resulted in heavy losses for those institutions concerned and in turn has resulted in substantial profits for vulture funds and hedge funds.

4.1 IAS 39 makes its appearance

8. There is evidence that in 2001 the ECB was aware of plans by the accounting profession to introduce the controversial accounting standard known as IAS 39. At the time, the architects behind this standard stated that banks would be allowed to hide losses and overvalue certain loans. The International Accounting Standards Board (IASB) made a

very frank admission in 2015[1] about hiding losses, a practice that it had used for over ten years. The ECB itself said of the proposed rules “potential credit losses remain hidden until signs of deterioration are evident”[2].

9. Despite being aware of this flaw, three years later, in 2004, the ECB wrote to the International Accounting Standards Board[3] supporting the IASB’s intention to roll out IAS 39. This new standard allowed banks to hide losses which in turn, because those losses were now concealed, enabled the ECB to give loans on favourable terms to those banks on the basis of their now overvalued collateral. Critical to note here though is that this was a standard, not a law. Through the flawed rules, the ECB could thus disguise that it was lending to insolvent banks, even though this is clearly contrary to Monetary Financing rules (these rules essentially prohibit the ECB from giving hidden subsidies to banks). The same IASB rules allow banks to overstate profits, enhance bonuses and award loans on preferential terms to favoured customers.

10. Through IAS 39 the ECB felt it was empowered to subsidise commercial banks and even lend to banks that were unable to repay loans borrowed. As a result of what the ECB was doing, these banks were able to conceal their insolvency.

11. The International Monetary Fund has repeatedly expressed its concerns about the ECB approach, the European banking system and its impact on the wider economy. In 2014 for instance, it estimated non-performing loans in Europe at over €800bn[4] and this was before the current Italian banking crisis erupted[5]. According to the IMF, “Europe's largest and most powerful banks receive up to $400bn in subsidies. This compares to just $70bn in the US where banks have been able to re-access market funding to a much greater extent.”

4.2 Cause and Consequence

12. **If the ECB encourages banks to overvalue assets, then using those overvalued assets as collateral it (the ECB) is in a position to lend excess cash to these banks. If the assets**

[1] http://www.ifrs.org/-/media/project/financial-instruments/features/article-by-sue-lloyd-big-changes-ahead-march-2015.pdf

[2] https://www.ecb.europa.eu/pub/pdf/other/notefairvalueacc011108en.pdf?f569946e5cb4b13adaf9cb70e935ffb1

[3] https://www.ecb.europa.eu/pub/pdf/other/378_04_09_06_letter_iasb_signeden.pdf?82bf960e6094744f4eb759f1d7425348

4 http://www.irishtimes.com/business/economy/taxpayers-paying-dearly-as-banks-conceal-loan-losses-1.1770367

5 http://www.irishtimes.com/business/financial-services/italian-banks-dig-deeper-into-trouble-with-zombie-lending-1.2762013

are overvalued the ECB will end up lending more money than the assets are worth, which means it will suffer huge losses if the bank gets into difficulty.

13. The evidence which follows shows that banks **did** overvalue their collateral, putting the ECB into a very vulnerable position.

14. A second major consequence is that **banks overvaluing collateral also deceive shareholders**. **Shareholders think that the bank is making profits and presumably approve bonuses on that basis, when in reality the bank may be making huge losses but covering them up.** This report will reveal that the ECB was aware as far back as 2001 that banks were going to hide losses. It had the authority to stop this but didn't do so. The ECB ended up amassing huge losses but, based on evidence from the 'Trichet letters', put illegal pressure on the Irish government to assume these losses. **The ECB would also have been aware that its stance on accounting allowed banks to deceive shareholders, a group which suffered heavily during the banking crisis of 2008.**

15. **There is also the collateral question**. If banks had been allowed to wind down without artificial and illegal support from Ireland, the ECB would have suffered a substantial proportion of the total losses but would also have ended up becoming owners of the loans within the banks it should have bailed out. This raises **the legal question as to who currently owns the collateral on the loans that the Irish banks have transferred to NAMA**.

16. Through pressure from the ECB Ireland has bailed out banks to a total of over €69 billion. It is no coincidence that the loans (at excessive interest rates) that Ireland got from the Troika under the 2010 Memorandum of Understanding is almost exactly that same amount. The country effectively borrowed €45 billion from the ECB plus a further €22.5 billion from the IMF, a total of €67.5billion. This is presented as a bailout for Ireland, when in fact it was a bailout ***by*** Ireland and its citizens of not just Irish banks, but banks from right across the EU and beyond. **The legal 'ability' and obligation to repay this money to the Troika is questionable at least, given the legitimate questions over the ECB's policy of imposing losses of its own creation onto Ireland and other governments of equally vulnerable countries.**

17. The consequences of the ECB's actions are far-reaching. Today, the factors that gave rise to the worst financial crisis that Europe has ever experienced, remain in place. There are hundreds of court cases alleging misconduct by some of Europe's biggest banks. The authors of this report believe that a legal case could be made to restrain authorities like the ECB from their potentially illegal conduct and that urgent action is necessary.

5 CHAPTER ONE- BACKGROUND

5.1 PRUDENCE, IAS 37 & IAS 39

18. Before proceeding further it is necessary to take a brief diversion into the world of auditing, where we will meet the concept of 'prudence', IAS 37 and – most crucially – IAS 39.

5.1.1 The Concept of Prudence

19. Prior to 2003 the definition of prudence was well understood, having been incorporated into European case law and also Article 31 of Directive 78/660. In simple English, **the concept of prudence** prevents entities from estimating profits in its annual report. Those **profits must have been 'made 'or realised'** i.e. the asset giving rise to the profit must have been sold **before the profit is recognised**. **For losses, the treatment is different.** Clearly fearful of directors overpaying for assets and therefore putting creditors at risk **the prudence concept requires *the immediate recognition of losses***.

    Please note those words, 'the immediate recognition of losses'. The world of banking and investment can be deep, murky and dangerous, risky by definition. In its accounting, however, there is meant to be clarity, and the concept of prudence is a cornerstone of auditing. Before they take the plunge, investors need to know that the entity in which they're investing is sound, solvent, that any and all losses that can be accounted for – as in, for example, property collateral that may have suffered a collapse – are in fact accounted for.

    Keep this in mind for later…

20. A more formal definition of prudence was given in the case Lloyd Cheyham & Co Ltd v Littlejohn & Co (1985):

    Concept of prudence*: revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty;* ***provision is made for all known liabilities (expenses and losses) whether the amount of these is known with certainty or is a best estimate in the light of the information available.***

21. The recognition of 'realised' profits and all losses does not of course guarantee that assets are shown at a value that the market is willing to pay, **but it did introduce an important safeguard by ensuring that an entity always had sufficient assets to meet its liabilities. In cases where they did not, the company had a legal duty to warn creditors and shareholders.**

22. On July 25th 1978 the **EU '4th Directive[6]'** was signed into law and while not mentioning 'prudence' specifically, it did confirm that 'shareholders and creditors must be protected' and **introduced strict rules stating that 'entities must reveal all losses (whether actual or estimated) when preparing annual reports for distribution to shareholders'. For example Article 20 of the Fourth Directive requires "**Provisions for liabilities and charges are intended to cover losses or debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount".

5.1.2 IAS 37 (More elaborately explored in Appendix One)

23. In September 1998 the Accounting Standards Board had concerns with the reporting of liabilities, with some companies reporting 'excessive liabilities' by providing not only for losses suffered but also for potential losses that the entity might suffer in the future[7]:
In the absence of an accounting standard on provisions the practice has grown up of aggregating liabilities with expected liabilities of future years, and sometimes even with expected expenditures related to ongoing operations, in one large provision, often reported as an exceptional item. The effect of such 'big bath' provisions has been not only to report excessive liabilities at the outset but also to boost profitability during the subsequent years, when the liabilities are in fact being incurred.

24. The problem was rectified in accounting standard IAS 37. In the explanatory memorandum that introduced Article 1(9) to Directive 2003/51 the purpose of the amendment was clearly stated:

    In the 4th Directive, Article 31 sets out certain basic rules as to the liabilities which must be taken into account in preparing the annual accounts and Article 20 expands on these principles, giving specific rules for provisions.

    The provisions recorded under IAS are more specific than those under the 4th Directive. In particular, IAS restricts the amounts recorded to those obligations which exist at the balance sheet date. In addition to such amounts, the 4th Directive envisages also the provision of liabilities which are 'foreseeable'. The proposal resolves this inconsistency in the case of companies applying IAS without necessarily changing the status quo for annual accounts and unlisted companies. This has been achieved by amending Article 31 to require the recognition of amounts consistent with IAS ***whilst allowing Member States to continue to permit or require those additional amounts currently envisaged by the Directive.***

[6] http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:31978L0660&from=EN

[7] http://frc.org.uk/Our-Work/Publications/ASB/FRS-12-Provisions,-Contingent-Liabilities-and-Cont-File.pdf

25. It's important to note here that IAS 37 was introduced to address a specific problem, the **over-reporting of liabilities**, where **entities** were **reporting losses they hadn't yet incurred;** this should not be confused with **under-reporting of liabilities**, where **entities are aware that assets/collateral they are holding *have* gone down in value, yet do not report that loss**.

5.1.3 IAS 39 (More elaborately explored in Appendix Two)

26. In November 2001 the ECB confirmed it was aware of attempts by the International Accounting Standards Board (IASB) to introduce rules that would allow banks to hide losses in Europe[8].

27. In a publication titled 'Fair Value Accounting In The Banking Sector', the ECB referenced the new International Accounting Standards Board (IASB) and its strategy to introduce a comprehensive Fair Value Accounting (FVA) framework for the recognition and measurement of financial instruments. Citing the issue of ***prudence***, the ECB stated:

> *'The use of FVA in the banking book would entail that potential profits and losses would be treated in the same way, by being recognised as soon as they emerge. This goes against* ***the principle of prudence according to which losses stemming from the banking book should be recognised as soon as they are known, even if only potential, whereas profits should be recognised only if they are actually realised.*** *Potential profits should be recognised only for marketable instruments. Therefore,* ***there is the possibility that the application of FVA to the banking book might induce banks to adopt an imprudent behaviour. This is a crucial aspect also from the viewpoint of the banking supervisory function****.'*

In conclusion, and as a possible way forward, it suggested:

> *'In light of the critical aspects mentioned above, the ECB has a negative stance towards the possibility of applying an FVA regime to the banking book of banks. Against this background, the following developments could be considered in order to make a constructive use of the valid arguments that lie behind FVA.* ***A first development*** *would entail that, whereas* ***FVA would not be recognised as an accounting standard for the banking book of banks****, supervisory authorities might* ***use it as a supplementary instrument*** *to complement their assessment of the situation of individual credit institutions.* ***A second development*** *involves the adoption by banks of the* ***so-called "dynamic provisioning". This entails recognising that a proportion of the loan portfolio can deteriorate in the future and that this proportion can be measured ex ante on the basis of a specific statistical analysis.*** *It would also involve the disclosure by banks of the results of stress-test analyses conducted on the interest rate sensitivity of the banking book. This approach would allow two criticisms associated with the current accounting standards to be overcome, notably that potential credit losses remain hidden*

[8] https://www.ecb.europa.eu/pub/pdf/other/notefairvalueacc011108en.pdf?f569946e5cb4b13adaf9cb70e935ffb1

until signs of deterioration are evident and that market participants have insufficient information about the interest rate risk profile of banks.'

28. Also in 2001, August 23rd to be precise, the Chairman of the IASB, David Tweedie, received a letter from the Basel Committee on Banking Supervision that was very critical of his approach. The letter contained two criticisms[9].

    Firstly, there was concern about plans to hide losses:

    "Dr Schilder has drawn my attention to ***the topic of accounting for impairment of financial assets*** *(question 112-3), an area of obvious importance to the Basel Committee. Specifically, as discussed more fully in the note,* ***the suggested approach may cause a delay in loss recognition, resulting in an overstatement of assets and a reduction in the relevance of the accounting measure****; as well as being contrary to a measurement methodology already accepted in major countries."*

    Secondly, the authority to hide losses was not contained in the standard itself but in guidance notes to the standard. The letter stated:

    "The suggested answer does not promote good accounting. To account for impairment on an individually significant loan only when it can be measured in relation to that specific asset could well result in delayed loss recognition, overstated asset values and reduced relevance in the resulting accounting measure. Losses that are probable in the portfolio as a whole, but not identifiable in individual loans, would not be considered in the measurement. In effect, the guidance prescribes a measurement methodology that may well violate the measurement objective of the standard: to measure impaired loans and groups of loans at their recoverable amount. *In contrast, the accounting regimes in major countries require or permit an additional group assessment for significant loans that have been individually evaluated but are determined not to be impaired."*

29. In **2002 the French Banking Federation attempted to warn regulators of the damage that the 'Fair Value' rules as envisaged above would impose on all European banks.** Their document titled '*Loss of confidence in the financial markets and International Accounting Standards'* said:

    "Accounting principles in various countries throughout Europe, while different from country to country, are robust and well known by the users of financial statements (notably analysts and relevant authorities). Up to now, they have not led to the accounting manipulations seen in the United States. ***It is essential that the Accounting Regulatory Committee of the European Union postpone endorsing any particular IAS/IFRS standard, in particular lAS 39, until they are satisfied that the deficiencies highlighted in this memorandum are corrected".***[10]

30. **19th July 2002: EU Regulation 1606 of 2002 signed into law. This Regulation states that International Accounting Standards must only be adopted for use in Europe if they comply with the principles of the EU '4th Directive', and therefore continued the**

[9] https://www.bis.org/bcbs/commentletters/iasb06.pdf

[10] http://www.fbf.fr/fr/files/87JBNH/Memo_FBF_revision_projet_normes_IAS_2002_EN.pd

practice of forcing entities to reveal all losses. It introduced safeguards against attempts by the IASB to over-extend its power. The safeguard is contained in Regulation 1606 of 2002. It states:

> ***The international accounting standards can only be adopted if: — they are not contrary to the principle set out in Article 2(3) of Directive 78/660/EEC which requires entities to show a True and Fair view. In essence, the entity must show the financial position correctly and is therefore prevented from hiding losses (see Paragraph 48 of the Martin Moore QC Opinion in 2008[11].***

31. The IASB now faced a dilemma. On the one hand it was under pressure from certain influential bankers, who in turn were supported by the ECB, to circumvent the concept of prudence and allow banks to hide losses (the ECB saw the accounting standards as an opportunity to hide the subsidies they wished to offer banks). On the other, the IASB wanted their rules to be incorporated into EU law even though that law required the immediate recognition of losses. The IASB took an unusual approach:

i) It developed an accounting standard that was vague enough to encourage different interpretations. This standard became known as IAS 39

ii) It issued guidance to shareholders and regulators reassuring them that if entities followed IAS 39 they would be forced to reveal all losses and would therefore be in compliance with EU Directives[12].

iii) It issued very different guidance to the accounting profession, advising that under IAS 39 banks were forced to hide losses (see paragraph 8 above).

32. It's certain that the ECB was exposed to severe lobbying pressure from those such as major investment banks/the big four accounting firms/hedge funds, all of whom had vested interests. On this very same subject (the booking of loan losses) but in the US, in 1992 Walter P Schuetze, chief accountant with the Securities and Exchange Committee, was arguing for 'mark-to-market' reporting. In a document titled 'Relevance and Credibility in Financial Accounting and Reporting', he provided evidence of lobbying attempts by the banks dating from as early as 1977[13]:

> *"The profession, **in response to its bank clients**, asked the FASB [the American accounting Standards board] to issue **FASB Statement 15** more or less as the FASB did back in 1977. That document **allows for restructured loans to be reported at 100 cents on the dollar even though that dollar will earn no interest and will not be collected until many years in the future. FASB Statement 15 has plunged an entire generation of accountants into darkness**."*

[11] https://www.frc.org.uk/FRC-Documents/FRC/True-and-Fair-Opinion,-Moore,-21-April-2008.pdf

[12] http://www.ryanalm.com/Portals/5/newsletters/Empire_Club_speech.pdf

[13] https://www.sec.gov/news/speech/1992/081292schuetze.pdf

5.1.4 2004 - ECB ADOPTS IAS 39

33. 18th June 2003: EU Directive 51 of 2003 signed into law. The Irish government relied on this to justify its stance on hiding losses (see paragraph 56 below).

34. In 2004 the ECB wrote to the International Accounting Standards Board[14] supporting the IASB's intention to roll out that controversial accounting standard, IAS 39. At the time, the architects behind this standard stated that banks would be allowed to hide losses and overvalue certain loans.

35. In 2006 the IASB took a formal decision to drop prudence. It said:

    Financial information needs to be neutral - free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty15

36. In 2006 also the ECB confirmed its awareness that under IAS 39 banks can hide losses 'until a fairly late stage'.

    In the case of a broad interpretation of the respective provisions of IAS 39 (Financial Instruments: Recognition and Measurement), the IFRS approach can be implemented in very different ways, but the most immediate one would be to refer to the "incurred loss" pattern and therefore not to recognise credit risks through provisions until a fairly late stage.[16]

37. **To get around the restrictions imposed by the Regulation 1606 of 2002, the IASB not only wrote IAS 39 in a very confusing manner but it gave two wildly contradictory interpretations of the same standard, (as discussed in paragraph 31). Under one version, banks were hiding losses while under a second, banks were obliged to reveal all losses.** It warned people not to read the standard as it was too confusing and instead encouraged people to rely on its own interpretation of the standard. **Its head Sir David Tweedie said "If you understand 39, you haven't read it properly[17]."** But how can a standard that is difficult to understand add to transparency, particularly if those behind the standard give it two interpretations? Tweedie himself said of IAS 39:

    No entity is ever allowed to disclose assets valued at more than their recoverable amount in its financial statements".

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[14]

[15] http://www.ifrs.org/Meetings/MeetingDocs/IASB/Archive/Conceptual-Framework/Previous%20Work/CF-0505b07.pdf

[16]

https://www.ecb.europa.eu/pub/pdf/other/assessmentaccountingstandards2006en.pdf?a1415598edf084566 9bc3b33248da0d3

[17] https://www.accountancyage.com/aa/feature/1781591/profile-sir-david-tweedie-setting-standards

38. In February 2004 the ECB 'endorsed' IAS 39. Now, with banks using IAS 39 to conceal losses and overvalue loans, the ECB was able to give subsidies to commercial banks – it was lending against overvalued collateral. Through the flawed rules the ECB could also disguise this fact (loans that in many cases could never be repaid by those banks). This is explicitly contrary to Monetary Financing rules, which prohibit the ECB from giving hidden subsidies to banks. Those banks were thus facilitated in hiding their own insolvency, as was very much the case with Anglo Irish Bank and INBS through use of the infamous government Promissory Notes, for example..
39. 1st January 2005: Irish banks first use IAS 39.
40. **In facilitating and encouraging all this, the ECB was also putting itself at risk, and by extension putting all eurozone Member States and indeed the entire EU at risk.**

5.2 IRELAND'S BLANKET BANK GUARANTEE – SEPTEMBER 2008

41. In 2008, just prior to the blanket bank guarantee, the government commissioned a report from PriceWaterhouseCoopers (PwC), Project Atlas, on the health of the banks. It was quite clear that the report was issued to ascertain the capital position, and therefore the solvency of Anglo. In other words the report was to establish if Anglo had sufficient assets to cover its liabilities. According to PwC themselves: "The PwC Reports were prepared to assist IFSRA in its review of the financial and capital position of Anglo and for no other purpose."

    It is quite clear that to measure the financial position PwC would need to identify those loans where repayment was in doubt and then estimate how much the bank would recover. The expected recovery would then be used to determine if there was sufficient cash to cover the liabilities. ***PwC however, like the ECB, was aware that Anglo was both in difficulty and was hiding losses and therefore exploited the supposed loophole in IAS 39.*** The firm nevertheless concluded that "The Bank's profitability has developed strongly over the last 8 years, driven by lending advances growth and a low cost to income ratio". During the Irish banking inquiry PwC confirmed its view that many Irish banks were insolvent though this did not feature in their Project Atlas report.

    Deputy Kieran O'Donnell[18]

    And, if you'd been asked on that meeting of 25 September whether Anglo or Irish Nationwide were solvent, what response would you have given?

    Mr. Denis O'Connor

    That's the answer I would have given. Unless some plan was put in place, a contingency plan put in place, to get the cash on 30 September, it wouldn't have been solvent. They had to put some plan in place to get the money.

    Clearly, PwC should have mentioned the loophole that both it and the ECB were aware of, but PwC in essence had taken the same view as the ECB, namely that when banks are borrowing money or seeking guarantees over their liabilities (which is the equivalent to borrowing money), under IAS 39 it is perfectly acceptable to misrepresent the financial position by overstating the value of the assets used as collateral and concealing the fact that those assets have fallen in value because of huge losses.

42. **On September 30th 2008, in response to severe worries that the Irish banking system was about to collapse, the Irish government unveiled a guarantee arrangement to safeguard the deposits and debts of six financial institutions. The guarantee was given on the premise that on 30th September 2008 all of the Irish banks were solvent**, i.e..,

[18] https://inquiries.oireachtas.ie/banking/hearings/aidan-walsh-partner-advisory-services-pwc/

that they had sufficient assets to meet their liabilities. Both the major accounting firms and the ECB gave an implicit assurance that the banks were solvent. It follows that the guarantee given was designed to cover liquidity problems, the inability of banks to borrow money and was not intended to cover losses that Irish banks had hidden.

5.3 THE TROIKA COME TO TOWN – NOVEMBER 2010

43. On November 27th 2010, following quickly on an unprecedented intervention by its own Central Bank Governor Patrick Honahan, the Irish Government formally applied to enter the Troika Programme (the Governor made a phone-call to a national early-morning radio show in which he contradicted the assertion by the Government that it would NOT need a 'bailout'. Mr Honahan made the call from Frankfurt, where he was attending a meeting of the ECB governing council…).

    This very quickly became known as the 'bailout for Ireland' when in fact it was Ireland doing the bailout, not just of its own banks but of the entire eurozone banking system, which was on the brink of collapse – the victors again writing the narrative.

44. The ECB official policy towards commercial bank lending may be summarised as follows:
    - all commercial banks and governments are entitled to equal treatment, and
    - **where the ECB lends money to commercial banks, the collateral used is eligible *only* if it is sufficient to recover all losses that the ECB may suffer in the event of default.** Unfortunately for Ireland and for several other eurozone countries that were also in trouble, this didn't happen.

45. By late 2009/early 2010 it became obvious that Irish banks along with other European banks were in deep difficulty. In the absence of even a semblance of a eurozone Banking Resolution Mechanism (one of the many glaring euro design flaws – this mechanism is now in place but too late for the likes of Ireland), individual Member States were forced into injecting vast amounts of money into their troubled banks.

    Ironically, a large portion of this injection was borrowed from the ECB, which a) knew that most of those banks were actually insolvent and thus shouldn't have allowed that injection of billions, and b) even it *did* want to prevent collapse, it should itself – as the European CENTRAL Bank – have been the entity bailing out those banks.

    Even more ironically, the ECB charged those Member States excessive interest rates on those loans, loans we are STILL repaying to that same ECB.

46. Over the following few years, through pressure from the ECB, Ireland bailed out all its banks, to an eventual total of over €69billion. It is no coincidence that the loans (at excessive interest rates) that Ireland got from the Troika under the 2010 Memorandum of Understanding is almost exactly that same amount. The country effectively borrowed €45billion from the ECB plus a further €22.5billion from the IMF, a total of €67.5billion. This is presented as a bailout for Ireland, when in fact it was a bailout ***by*** Ireland and its citizens of not just Irish banks, but banks from right across the EU and beyond. **The legal 'ability' and obligation to repay this money to the Troika is questionable at least, given**

the legitimate questions over the ECB's policy of imposing losses of its own creation onto Ireland and other governments of equally vulnerable countries.

47. The consequences of this **bank bailout cost in Ireland – over €15,000 for every man, woman and child –** were devastating for the economy in general, but particularly so for the most vulnerable members of that economy, who played no part in the destructive practices of the Irish banking system and yet who were subsequently forced to bear the brunt of the austerity measures that followed.

5.4 THE CONSEQUENCES

48. The consequences of the ECB's actions are manifold:

- If the ECB lends to an insolvent institution, the ECB should suffer the losses; instead, individual EU member states such as Ireland, Greece, Spain, Portugal, Italy, Cyprus etc. were made to bear the cost;
- The second consequence is that **banks overvaluing collateral also deceive shareholders.** Shareholders think that the bank is making profits and presumably approves bonuses on that basis when in reality the bank may be making huge losses but covering them up.
- Thirdly, **if collateral is used by an insolvent bank to borrow money, there is a question over who is the proper legal owner of the collateral**. If the asset belongs to the ECB and not the commercial banks, then the ability of the commercial banks to sell assets to Ireland's bad bank, the National Asset Management Agency (NAMA), is called into question.
- There is also **the risk that the ECB's policies are encouraging criminal acts such as deliberately misrepresenting the financial position of a commercial bank**.

49. When it emerged that the banking crisis – and all its consequences – wasn't in fact a result of liquidity problems, but was actually a solvency crisis, with banks (as explained) overvaluing assets and disguising the losses they suffered, a practice facilitated by the ECB, it put the ECB, the banks and the auditing firms on the back foot. Not alone did they now have to admit that they were hiding losses, they also had to justify why they were hiding them.

6 CHAPTER TWO – ANALYSIS

6.1 DID IAS 39 HAVE LEGAL STANDING?

6.1.1 LEGAL OPINION – THE UK

50. The accounting profession argued that it had a legal obligation to comply with accounting standards and since those accounting standards were incorporated into EU regulation it had no alternative but to comply, even if it led to a misleading or deceptive financial position. The situation was summarised by the Irish Chartered Accountants Regulatory Board (CARB) as follows:

    "CARB believes it unfortunate that compliance with an accounting standard is deemed of itself to result in a true and fair view of a company's financial position. Accordingly, CARB believes that in the future the first principle that should apply is true and fair; followed then by adherence to the individual standards."

51. The CARB view is based on a legal opinion commissioned by the UK's Financial Reporting Council (FRC) from Martin Moore QC and issued in 2008. According to the FRC:

    The introduction of [IASB rules] in the UK did not change the fundamental requirement for accounts to give a true and fair view. Indeed, for the avoidance of doubt, the FRC obtained an Opinion from Martin Moore QC in 2008 which confirmed that the true and fair concept remains paramount in the presentation of UK company financial statements, even though the routes by which that requirement is embedded may differ slightly. The Opinion also confirms that fair presentation under [IASB rules is] equivalent to a true and fair view

52. However this is an oversimplification. It attempts to suggest that blind compliance with an accounting standard will get bankers off the hook if they provide misleading information to the markets, yet later in that same opinion Moore comes out strongly ***against*** blind compliance. Moore warned that if an entity complies with an accounting standard and that accounting standard is misleading, then the entity must override it, i.e. ignore the accounting standard, but must of course disclose why it has taken this course of action. He said ***"It does not follow from that observation that the preparation of financial statements can now be reduced to a mechanistic process of following the relevant standards without the application of objective professional judgment applied to ensure that those statements give a true and fair view, or achieve a fair presentation".***

53. A legal opinion from George Bompas QC in 2013, in which he mentions the Moore opinion, confirms that it is illegal to ignore **prudence** (an accounting and company law concept that prevents entities from hiding losses). He also issued a legal opinion claiming that if the accounting standards forced banks to hide losses, directors of those banks would be forced to commit a criminal offence. He said:

The practical importance of this debate is that if a company director whose company is preparing IAS accounts as its statutory accounts and who believes that the accounts so prepared fail to give a true and fair view may not be able to rely on Mr Moore's Opinion, or the statement of the Minister in the debate on CA06 s.393, to permit departure from particular requirements of an international accounting standard which may have been incompatible with the production of accounts giving a true and fair view. The director would be faced with a dilemma. On the one hand his obligation would be to have his company produce its statutory accounts to be laid before the company, and to do this applying international accounting standards where that was the applicable accounting framework; and he would commit a criminal offence if he approved them not believing that they complied with international accounting standards (CA06 s.414). On the other hand he would be faced with the s.393 statutory prohibition against approving accounts which he did not believe to give a true and fair view.

54. Although Moore disagreed with Bompas in many areas, both agreed on the importance of 'prudence'. Bompas stated that an accounting standard which attempted to undermine prudence by forcing or even allowing banks to hide losses would be illegal. Mr Moore stated in paragraph 76a of his 2013 Opinion that prudence was a legal requirement:

Before developing this analysis, I should explain that I do not share Mr Bompas's concerns at the absence of any reference to 'prudence' in the Conceptual Framework for two reasons:

First, because the version of IAS1 adopted by the EU refers to the 2001 Framework, and that version has not been amended to refer to the Conceptual Framework. As a result, there can be no debate as to whether 'prudence' has been, and remains now, a component of a true and fair view (or fair presentation) for the purpose of determining the application of the override in IAS1, paragraph 19. . .

55. Both Mr Moore and Mr Bompas agree then that 'prudence' is an essential ingredient of company law and that accounting standards which ignore, or even compel the dropping of, prudence are automatically illegal. It follows from this that there should be no doubt as to whether the hiding of losses, which is imprudent, is illegal. If the concept of prudence requires the immediate recognition of losses, then, any accounting standard which promotes or encourages the hiding of losses is potentially aiding and abetting a criminal offence. These legal arguments are more fully explored in Appendix Three.

6.1.2 LEGAL SITUATION IN IRELAND – PARLIAMENTARY QUESTION

56. In February 2017 the Minister for Jobs, Enterprise and Innovation in Ireland, Mary Mitchell O'Connor, replied to a Parliamentary Question from Catherine Murphy TD (MP). It appears that accounting profession relied on EU Directive 51 of 2003 to justify its view that the concept of prudence was changed by law to accommodate the hiding of losses.

Parliamentary Question
Catherine Murphy (Kildare North, Social Democrats)

286. To ask the Minister for Jobs, Enterprise and Innovation further to Parliamentary Question No. 187 of 7 February 2017, if she will provide the date that Article 3(2) of Regulation 1606 of 2002 was first amended to allow for the adoption of international accounting standards that delay the recognition of loan losses in view of the fact that the concept of prudence, as defined in Article 31 (c) of Directive 78/660 requires the immediate recognition of losses; and if she will make a statement on the matter. [7465/17]

Mary Mitchell O'Connor (Dún Laoghaire, Fine Gael)

Regulation (EC) No 1606/2002 was adopted on 19 July 2002. Article 3(2) has not been amended since then.

Article 1(9) of Directive 2003/51/EC of 18 June 2003 amended Article 31 of Directive 1978/660/EEC of 25 July 1978 by replacing the existing text of paragraph (1)(c)(bb) and by inserting a new paragraph (1a). The new text of paragraph (1)(c)(bb) made no reference to losses. The provisions of paragraphs (1)(c)(bb), as amended, and (1a) of Article 31 of the repealed Directive 1978/660/EEC are now reflected in paragraphs (1)(c)(ii) and (5) of Article 6 of Directive 2013/34/EU of 26 June 2013.

57. The essence of the Minister's argument is that the concept of prudence was changed to bring it into line with the accounting standards and since the IASB wanted to hide losses, the law was changed to accommodate the IASB. The Minister's argument is flawed for a variety of reasons:

i. Prior to Directive 2003/51/EC the EU explicitly prohibited the hiding of losses through Article 3(2) of Regulation 1606 of 2002. The correct way to change this Regulation is to alter the Regulation itself, ***not*** by use of an EU Directive to alter an EU Regulation;

ii. In an explanatory memorandum on Directive 2003/51/EC, it is clear that the purpose of the amendment is to incorporate accounting standard IAS 37, ***not*** IAS 39. Unlike IAS 39, the standard IAS 37 is only concerned with excessive provisioning. i.e. making it illegal to provide for losses that a bank has not yet suffered. That standard does not allow banks to hide losses that it has already suffered, and the difference, while subtle, is critical – **where property values have collapsed, banks holding property collateral have already suffered losses**.

iii. Notwithstanding the above, the 'authority' to hide losses does not come from IAS 39. Instead it comes from an explanatory memorandum produced by the IASB which gives instructions on how to apply IAS 39. These instructions were not approved by the EU and therefore do not have any legal standing.

iv. Finally, even if IAS 39 ***did*** allow banks to hide losses, the failure of bankers and their auditors to state this explicitly in their accounting policies makes the act of hiding losses a criminal offence.

58. The Minister claims that the removal of the words *'or losses'* from Article 31(1)(c)(bb) of Directive 1978/660 enables banks to delay or conceal losses on troubled loans. If an entity is required to recognise 'all liabilities' then it must recognise all losses associated with those liabilities. It follows that although the words 'or losses' were dropped, the revised paragraph still requires the recognition of all liabilities and (through basic double entry bookkeeping) all losses associated with those liabilities. Although Article 1(9) made no reference to losses, they must still be recognised as discussed in paragraph 56 above.

59. Article 31(1)(c)(bb) before the amendment, contained one specific example of prudence which is not relevant to the way banks calculate loan loss provisions. It required entities to recognise all liabilities and where those liabilities were associated with losses, those losses must also be recognised. This particular example was not designed to deal with the way banks accounted for loans advanced. In the case of banks, the advancement of loans appears as an asset on its balance sheet not as a liability. George Bompas QC[19] has argued that modifying an example of prudence by removing redundant words does not alter the concept of prudence (see paragraph 26). Although Martin Moore QC has attempted to dismiss Bompas, Moore did not disagree with Bompas on this matter. In any event, the IASB has confirmed that its interpretation of prudence does not allow for the overstatement of assets and the hiding of losses. It said[20]:***

> Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that **assets or income are not overstated** and liabilities or expenses are not understated.

60. Since IAS 37 does ***not*** allow banks to hide losses, it follows from this that the Minister is incorrect to claim that Article 1(9) of Directive 2003/51 allows banks to develop accounting standards that hide losses. The concept of prudence has not changed as a result of Article 1(9) of Directive 2003/51.

61. The difference between an EU Regulation and an EU Directive:

> **Regulations** have binding legal force throughout every Member State and enter into force on a set date in all the Member States.
> **Directives** lay down certain results that must be achieved but each Member State is free to decide how to transpose **directives** into national laws.

62. From the EU Joint Practical Guide, which is used by persons responsible for drafting EU legislation: "In general, it is preferable for the amending act to be of the same type as the amended act. In particular, it is not recommended to amend a regulation by means of a directive."

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[19] http://democracy.wirral.gov.uk/documents/s50012690/Opinion%208%20April%2013.pdf

[20] http://ec.europa.eu/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf

63. A second argument which weakens the Minister's argument is an assurance given by the EU Legislature that in the case of International Accounting it would not use a later EU Directive to update an earlier EU Regulation.

    Accordingly, ***there is no direct interaction between a Directive and a Regulation as only one is directly applicable to companies.*** *Accordingly, the issue properly concerns the interaction of national law and the IAS Regulation.*

    The issue of interaction is only relevant to the extent that national law deals with the same subject matter as the IAS Regulation. *Some aspects of national law transposed from the Accounting Directives deal with matters outside the scope of the IAS Regulation and will continue to apply, for example the annual report (Fourth Directive, Article 46). In this instance,* ***the IAS Regulation deals solely with 'consolidated accounts' (together with certain options in respect of annual accounts)****. It follows that the additional information in or accompanying the annual (and consolidated annual) report falls outside the scope of the IAS Regulation.*

    To the extent that the scope is the same (i.e. with respect to the consolidated or annual accounts themselves), the interaction is as follows:

    No transposed provision of the Accounting Directives may restrict or hinder a company's compliance with (or choice under) adopted IASs, further to the IAS Regulation. *In other words, a company applies endorsed IASs irrespective of any contrary, conflicting or restricting requirements in national law. As such, Member States are not able to restrict explicit choices contained in IASs.*

    Although the paragraph appears confusing, it is making a very simple point, namely that a regulation cannot be hindered or restricted by a later directive. It follows that despite the wishes of the IASB, the EU law does not allow the adoption of accounting standards that hide losses.

6.2 WERE THE IRISH BANKS SOLVENT IN SEPTEMBER 2008?

6.2.1 EVIDENCE FROM THE BANKING INQUIRY

64. During the Irish Banking Inquiry of 2015 former Central Bank governors, Patrick Honahan and John Hurley were asked if the Irish banks were solvent on the night of the guarantee in September 2008. Both relied on a PwC report, known as Project Atlas but could provide no further evidence of solvency. It should have been obvious to both individuals, however, that if banks are hiding losses to the extent that Irish banks were doing so, this alone makes them insolvent since no-one would be prepared to lend to a bank if it is misleading creditors as to its financial position.

65. Given that PwC gave evidence to the same inquiry, under oath, that they allowed their banking clients to hide losses (see paragraph 41), particularly Bank of Ireland, it was

obviously a mistake for the Irish Central Bank to rely on PwC, and a mistake with catastrophic consequences. At the Oireachtas Banking Inquiry, former governor John Hurley stated:

"I formed a judgment that night that nationalising Anglo would have really complicated the situation and not eased it. But there were other factors at play. Anglo was illiquid, it wasn't insolvent."

66. This view however is contradicted by National Asset Management Agency chief executive Brendan McDonagh who at the same Banking Inquiry claimed that all the banks were insolvent in September 2008:

Mr. Brendan McDonagh:

I think the evidence has been that, from what's in the public domain … is that, there was a view they had a, the banks had a liquidity problem when in fact they had a solvency problem. So I think the market made its own assessment subsequently that the banks weren't solvent.

Michael D'Arcy:

And what was your view? ***What is your view?***

Mr. Brendan McDonagh:

I think based on the information that's in the public domain that everyone has seen, ***I don't think they were solvent****.*

67. It is clear that John Hurley relied on PwC's flawed report to justify his conclusion that Anglo *was* solvent.

Mr. John Hurley:

In my view … well, PriceWaterhouse reported within a number of months.

Deputy Kieran O'Donnell:

And looking back everything that we know now in hindsight, do you still believe that it was solvent on the night of the guarantee?

Mr. John Hurley:

On the basis of the information we had, yes, but I can't say when it became insolvent, and … PriceWaterhouse examined the books of Anglo Irish Bank some months later and didn't come to that view.

68. **Of the two views, Brendan McDonagh's seems to be more accurate.** Mr McDonagh regularly advised the government that the value of the loans NAMA took over was well below what the banks were stating publicly and in one controversial appearance before an Oireachtas committee, suggested that banks were misleading the markets – a potentially very serious offence.

69. **Extracts from a public accounts committee in January 2011 reveal why Mr McDonagh came to the opposite conclusion to that of the Irish Central Bank. In essence, the commercial banks deliberately misled Mr McDonagh:**

Deputy Michael McGrath:

> *It has been clear since the beginning of this banking crisis in 2008 that the banks have sought at every opportunity to conceal from the authorities and, indeed, from the markets, the full extent of their loan losses. I believe the truth is that if NAMA had accepted in good faith the original information given to it by the banks and applied a discount of 30%, then it would have overpaid for the loan portfolio to the tune of in excess of €20 billion.*

Mr. Brendan McDonagh:

> ***The point I made on 18 November****, which I make here today, which Deputy McGrath certainly picked up on* ***and which I regard as kernel piece of information, was the original loan-to-value ratios. Each of the institutions exchanged correspondence with me in which they set out their loan-to-value ratios. In the outcome of the valuation process, it does not appear to me that those loan-to-value ratios could have been what they were.***

In other words, the banks were concealing the true value of their loan-book.

70. **Appearing before the same Inquiry, former Central Bank Governor Mr Patrick Honahan** attempted to argue that although the banks were measuring insolvency incorrectly, they were complying with the law. He said:

> *– that, oh, you know, do we really have the power. What … an example of one thing that we don't have the power to do, it seems, according to all the lawyers, that we might want to do, which is close to the area of dividends, is* ***we don't have the power to oblige the banks to change their loan loss provisioning, because that's a matter for their judgment and the approval of their auditors. I think we probably have that implicit power but the lawyers say "No you don't have that power."*** *Now, that's very close to that territory of saying, "Okay, if you're saying that you can't pay dividends, why can we not pay dividends?" "You can't pay dividends 'cause you don't have enough capital." "We do have enough capital, we're showing 15% capital" or whatever number they were … they were showing. "You shouldn't be showing 15% capital because you haven't made enough loan loss provisions." "****Loan loss provisions are a matter for us, not a matter for you, the regulator****." So, I believe they did have the power but I suppose there would be some lawyers who say you don't*[21]

71. **Mr Honahan is making two important points here. Firstly**, if a commercial bank decides to hide losses and misrepresent its financial position so that it can show artificial profits and pay dividends, he says **the Central Bank does not have the power to ask the bank to correct the flawed loan loss provisioning policy; secondly, Mr Honahan claims that he received legal advice confirming effectively that he did not have the power to assess the banks financial position.** If he was correct on both statements then in essence he can lend money to banks that he suspects (or even knows) may well be insolvent, i.e. they didn't

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21 http://oireachtasdebates.oireachtas.ie/debates%20authoring/debateswebpack.nsf/committeetakes/BIJ2015062500002

have sufficient assets to repay the money originally borrowed. Lending money to such a bank in this manner is contrary to the law.

72. It is extremely unlikely that lawyers would give flawed advice which suggested that if commercial banks want to borrow money from the Central Bank they are free to mislead their financial position because the accounting standards permit such deception.

In August 2015, the Irish Central Bank was asked to make public the legal advice that Mr Honahan referred to above. The Bank refused, claiming that because '*The CBI noted that advice had been internal and composite representing the views as outlined… there was no need for any such clarification.'*

73. Nevertheless, in an article produced in the **UK's Daily Telegraph** (Appendix Six) **it would appear that Mr Honahan was well aware that banks were hiding losses. In that article he is quoted as saying:**

> ***I find it unsatisfactory that expected losses in many parts of the portfolio are clearly higher than the provisions already taken because I fear that this evident and in some cases explicit discrepancy may awaken doubts in the minds of investors as to the relevance of other aspects of the reported accounts.***

74. During the Inquiry, former Allied Irish Banks CEO Eugene Sheehy was reluctant to state that on the night of the guarantee (30 September 2008), the banking system was solvent. He said:

> *There were also issues in the Government's draft which we were uneasy about relating to the attestations by the FR that the system was solvent and that all banks were solvent. We felt there was clearly a risk in this statement if market participants purchased shares in companies once the guarantee was issued and it subsequently transpired that these companies were not as strong as contended.*

75. A more serious allegation was made against the Irish Central Bank at that Banking Inquiry. Mr Alan Merriman, a former finance director of the Educational Building Society, an entity that suffered huge losses and therefore required Irish government support stated, under oath, that the Central Bank forced him to hide losses.

Deputy Eoghan Murphy:

> *– and there was no difference of opinion between yourself and E and Y with your provisioning but the Central Bank and the regulator did have a problem, though, "that the provisioning might cause wider difficulties for the other banks and we were cautioned at the highest of levels to be very sure that what we provided was really needed". So there's a difference of interpretation there in terms of the presentation of the numbers?*

Mr. Alan Merriman:

> *No, I think they're two different matters and, again, let me explain my understanding of what was going on with the regulator and with the Central Bank. So, EBS come down and we share … we're going to have our accounts, these are our provisioning levels and we're sharing with the market, not only these provisioning levels,* ***but we're sharing with the market our expectations that there's going to be greater loan losses to come****. We*

can't put them in our accounts but we're telling the market that we believe the loan losses will be higher—– Okay.

Mr. Alan Merriman:

But we were being very appropriate in sharing, not only what we were providing, but letting everybody know we expected bigger losses to come that we couldn't provide for. The Central Bank, as I interpret it, their perspective …. and remember, I was only having to deal with EBS. The Central Bank has a much wider responsibility. ***So there's the Central Bank say, "Okay, here's little EBS coming along" and they're saying, "God, look, all these problems in development finance. Shit, what's the market going to read into that?*** *Will they read across from that into the other banks? The other banks haven't being telling us that they got this extent of a problem.* ***This could actually be another escalation in the Irish crisis.*** *Now, Alan, and I'm just being clear, Alan, just be very sure you need those provisions because this could cause wider difficulty." That's the context.*

76. The Chartered Accountancy Regulatory Board also suggested that banks were providing misleading information about loan losses. It stated, in a report dated 18th September 2015[22]:

    "It may also be the case that auditors and accountants should have been more alert to weaknesses in the banks' lending and financial position."

77. It is obvious, then, that not alone were the Irish banks insolvent on the night of the blanket bank guarantee, they were known to be insolvent by those in the sector, and (at least) strongly suspected to be insolvent by the subsequent Central Bank Governor, Mr Patrick Honahan who believed that the banks were in trouble and also measuring solvency incorrectly.

6.3 DID THE ECB KNOW THE IRISH BANKS WERE INSOLVENT?

78. **There is very clear evidence** – outlined above – **that the ECB was aware of the IASB's intention to hide losses under IAS 39**. In 2001, the ECB said of the IAS 39 standard "potential credit losses remain hidden until signs of deterioration are evident"[23]

79. **There is also very clear evidence that the ECB attempted not only to regulate banks but to lend to banks *knowing* that those banks were representing their financial position incorrectly.** The ECB was not only aware that banks where hiding substantial losses but was also aware of perverse incentive schemes. Banks were actually recording artificial profits and therefore paying inappropriate bonuses on reckless lending. This may well explain why, during the period 2003 to 2008 the growth of reckless lending by supposedly profitable banks increased significantly. **Even if a legal opinion declared that the hiding**

22

http://www.carb.ie/annual_reports/The%20Report%20on%20the%20Review%20of%20the%20Audit%20of%20Provisions%20for%20Impairments%20for%20the%20Irish%2

23

https://www.ecb.europa.eu/pub/pdf/other/notefairvalueacc011108en.pdf?0dc2bc127555052d30ff34c86b8e45da

of losses and the undermining of company law was legal (which is doubtful), the ECB would still be guilty of gross negligence, in allowing banks to measure and report their insolvency position incorrectly.

80. Mr Honahan's version of the law and his decision not to examine banks which were hiding losses, as outlined previously, is shared by the ECB. **Rather than being a victim of the banking crisis the ECB in fact orchestrated the rules that allowed banks to hide losses.** As outlined earlier in this report, it was aware as far back as 2001 that banks were going to introduce accounting rules that enabled them to misrepresent, deliberately, their financial position. **The head of the ECB Jean Claude Trichet** even **wrote to the much criticised and discredited International Accounting Standards Board, on controversial standard IAS 39 when it proposed amending this standard so that banks could hide losses**:

    I am writing with regard to the Exposure Draft of proposed amendments to International Accounting Standard (IAS) 39 on the fair value option, published on 21 April 2004. In its letter dated 19 February 2004, the Governing Council of the European Central Bank (ECB) expressed its appreciation that ***the proposed amendments broadly addressed the concerns set forth by the ECB and were in accordance with what had been agreed between the ECB and the IASB at the meeting held on 4 February 2004****.*[24]

81. **Clearly, if an organisation like the ECB claims that it is not illegal to hide losses, this would encourage both bankers and their auditors to take a cavalier attitude towards legislation.** The actions of Jean Claude Trichet pose two questions. Firstly, why would a regulator encourage banks to hide losses? Secondly, was the ECB acting outside its remit when it forced Irish banks to absorb the losses that the ECB suffered when it knowingly and possibly fraudulently loaned money to the commercial banks while they were insolvent?

82. While the ECB was very anxious to blame Ireland for losses that its banking system clocked up, **it was the ECB not Ireland, that loaned money to the Irish banking system when it knew that the banks, while heavily borrowed, were misleading creditors about their financial position**.

83. **Ireland's two year bank guarantee was supposed to cost nothing.** Although the liabilities of the various banks at the time was around €400 billion, the banks supposedly had assets worth more than that which in effect was supposed to mean that the banks, given time, would be able to pay all their liabilities as they fell due. From an Irish government perspective then, **the guarantee was** necessary **only to prevent banks from being forced to sell assets on a quick-fire sale basis.**

84. The Irish government invited former president, Jean-Claude Trichet to attend its Banking Inquiry. He declined but as a compromise contrived a meeting in Kilmainham on April 30th 2015. Unlike other witnesses to the inquiry, Mr Trichet saw the questions in advance and ending up giving pre-scripted replies which in essence failed to reveal why the ECB simultaneously encouraged banks to hide losses, loaned to those banks while insolvent

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24 https://www.ecb.europa.eu/pub/pdf/other/378_04_09_06_letter_iasb_signeden.pdf?6dda197927919d47f2b648262e61658c

and then used its considerable influence to impose those losses onto the Irish government.

6.4 LOCUS STANDII – WHO OWNS THE COLLATERAL?

85. The banking crisis of 2008 exposed a very important anomaly. If an individual provides his house as collateral for a mortgage and subsequently defaults on that mortgage, the bank has the 'locus standii' (legal standing) to sue for possession of the property and appoint a receiver where necessary. Are the same rights available to the European Central Bank if the commercial bank uses the individual's mortgage as collateral to borrow money from the ECB? The answer, based on legal contracts that the commercial bank signs with the ECB, is yes. It follows that the legal capacity to sue or even to sell any mortgage used as collateral, automatically transfers from the commercial bank to the central bank when the commercial bank becomes insolvent.

86. It must follow from this that the insolvent commercial bank loses both control and beneficial interest in an asset which is transferred to the Central Bank as collateral. An insolvent commercial bank is not in a position to appoint a receiver or even sell assets. The process by which Irish banks repossess certain loans or even sell those loans to the National Asset Management agency is therefore questionable.

87. Recently in Irish courts, commercial banks which should have declared their insolvency attempted to repossess family homes on the grounds that they had the Locus Standii (a legal term that recognises which parties have right to take court action) to do so. Case law would suggest however that if banks have lost control over their collateral due to their being insolvent but disguise that insolvency, the party with the Locus Standii is the Irish Central Bank and not the commercial banks.

88. If banks had been allowed to wind down without artificial and illegal support from Ireland, the ECB would have suffered a substantial proportion of the total losses but would also have ended up becoming owners of the loans within the banks it should have bailed out. This raises **the legal question as to who currently owns the collateral on the loans that the Irish banks have transferred to NAMA**.

89. The Central Bank is prohibited from lending money to an insolvent institution, even if those funds are provided for Emergency Lending Assistance (ELA) purposes. In a confidential document issued by the Department of Finance on 24th January 2008 titled 'Financial Stability Issues – Scoping Paper', it is stated: "*It is very important to note that the CBFSAI is prohibited from providing ELA [Exceptional Liquidity Assistance] to an insolvent institution. Therefore if there is any concern that a financial institution seeking ELA is insolvent, the CBFSAI would not be in a position to provide liquidity support without the question of some guarantee arising from the Exchequer*".

90. **Both the ECB and the Irish Central Bank have dismissed concerns and complaints on this area on the grounds of confidentially and 'constructive ambiguity'.** This is what the Irish Central Bank said on the matter:

In addition, the Bank as a matter of policy, refrains from publicly discussing [Emergency Lending Assistance] in detail to preserve a degree of ***constructive ambiguity*** *about the circumstances and the manner in which it might offer this facility*[25].

91. The ECB said something similar:

These legal provisions provide for a ***professional secrecy regime*** *under which the disclosure of confidential information related to the supervision of individual credit institutions by a competent authority is only permitted in the cases expressly mentioned in the Capital Requirements Directive* [26].

92. There is evidence also that international hedge funds took advantage of the confusion over whether Irish banks were solvent or not. Attempts by the Irish government to force hedge funds to take some of the losses that Bank of Ireland suffered for instance were unsuccessful. The hedge funds argued that the Irish banks were not insolvent, and therefore demanded full payment of their debt.[27]

93. Bank of Ireland may have exposed itself to a charge of insider trading, and/or of oppressing minority shareholders. With the assistance of the ECB, Bank of Ireland exploited accounting standard IAS 39 by withholding its true financial position from the markets but through due diligence and other means influential allowed hedge funds and preferred investors to gain access to records which revealed the true financial position – access which was denied to retail shareholders (See Appendix Four for more details).

[25] https://www.centralbank.ie/docs/default-source/tns/about---tns/freedom-of-information/correspondence/mr-sean-fleming-td-re-allegations-against-credit-institutions-10-03.pdf?sfvrsn=4

[26] https://www.ecb.europa.eu/pub/pdf/other/378_04_09_06_letter_iasb_signeden.pdf?6dda197927919d47f2b648262e61658c

27 *https://NAMAwinelake.files.wordpress.com/2011/06/boi_hf_particulars_of_claim-1.doc*

7 CHAPTER THREE – CONCLUSIONS

7.1 SUMMARY

94. **It is difficult to see why the ECB, as regulator**, promoting the safety of the European banking system, **encourages banks to hide losses; worse, it is even more difficult to understand why the ECB would then use its financial muscle to subsidise those same banks, subsidies given in the form of cheap loans where the interest charged did not reflect the high risk that the loans would never be repaid.** By encouraging banks to overvalue collateral and hide losses, the ECB can transfer subsidies to the banks without the banks having to declare to the public that they receive such subsidies. The method is explained more succinctly by the International Monetary Fund as follows:

    [Systemically Important Banks] then may take advantage of the lower funding costs to increase their leverage and engage in riskier activities. Banks may also seek to grow faster and larger than justified by economies of scale and scope to reap the benefits of the implicit funding subsidy granted to [To Important to Fail] institutions.

    Banks are in a unique position. They can borrow quite cheaply and invest in risky assets where the return is quite high. This facility is not available to everyone, only to banks with lobbying power. Essentially, the commercial banks received the rewards of speculation but passed on the losses to the ECB.

    The ECB uses the term 'constructive ambiguity' to conceal the fact that only it can choose which banks avail of the subsidy.

95. In an Irish government debate on 10th June 2016, Independent TD (MP) Mick Wallace said:

    Mr. Michael Buckley, a former chief executive of AIB, told the Banking Inquiry that 99% of bankers knew that the practice of hiding losses would cause difficulty. Mr. Buckley is not alone in this view. ***Bank of Ireland*** *also knew that the rules were a disaster. Its* ***former group chief financial officer, John O'Donovan, stated:***

    Once the EU adopted IFRS and by extension IAS 39, Bank of Ireland had no choice, as a listed entity, but to apply the new standard. Bank of Ireland understood the pro-cyclical nature of loan loss provisioning under IAS 39, was not entirely comfortable with its outcomes but there was nothing the Regulator/Central Bank or indeed the Court or management of Bank of Ireland could do to change what had been adopted by the EU.

    Extraordinarily, although the ECB knew that Irish commercial banks were hiding losses, many of the Irish regulators within the Irish Central Bank were not so aware. In 2008 for instance the head of the IASB gave a possibly incorrect assurance that banks were not hiding losses, and though he may have been incorrect or possibly deliberately misleading, the fact that he was able to make such a statement without being challenged suggests that many people believed him and were therefore unaware that banks were hiding losses. The statement made by the IASB was [28] "No entity is ever

[28] http://www.ryanalm.com/Portals/5/newsletters/Empire_Club_speech.pdf

allowed to disclose assets valued at more than their recoverable amount in its financial statements. The Irish Central Bank made the following statement in 2010:

"As with other Regulators worldwide, the Central bank uses the audited financial statements as a primary tool in its supervision of regulated firms. As a result, ***it is a concern to the Central Bank that similar to the experience in other jurisdictions Irish firms, specifically Irish credit institutions, were receiving "clean" audited reports in the years leading up to the banking crisis even though these institutions were running significant funding mismatches, were not perfecting their security when providing loans, had significant weaknesses in their corporate governance structures and were under-providing for impairments."***

Just one example of those 'clean' reports: Using IAS 39, Anglo Irish Bank declared in 2008 that it was continuing to make profits[29] and had enough capital to meet regulatory requirements. Clearly, it was in severe difficulty when it claimed this.

The acceptance of poor quality collateral allowed the ECB to subsidise 'too big to fail' influential banks. Through flaws in the accounting standards, these subsidies were classified as profits in the annual report of the recipient banks, allowing for the inappropriate payment of bonuses and in some cases dividends.

96. To conceal the subsidies, the ECB facilitated banks in adopting those flawed accounting standards, standards which have been the subject of much criticism in various bank inquiries. Those flawed standards also facilitated reckless lending and allowed commercial banks to lend on very favourable terms to influential customers. As just one example: In the Dáil (Irish National Parliament), Social Democrat TD (MP) Catherine Murphy has alleged that through one particular bank, Anglo Irish Bank, influential customers obtained loans on very favourable terms; in this context she has mentioned in particular one of Ireland's richest and most powerful individuals, Denis O'Brien, and his company Siteserv. KPMG however, as liquidators, claim that unless it is required to reveal the loss it is under no obligation to reveal any benefits conferred upon wealthy individuals through troubled loans. Specifically, KPMG said:

> *The Special Liquidators of IBRC have provided to the Commission an explanation of their interpretation of the term "capital loss", and the Commission has responded to that explanation. The Special Liquidators have interpreted the term "capital loss" as meaning "amounts comprising either capital or capital plus interest [that] were written off IBRC's books (excluding loan provisions where no amounts in excess of €10,000,000 have actually been written off IBRC's books.)". The Commission's response has been to accept the Special Liquidators' interpretation for the moment, whilst reserving the Commission's right to revisit the definition of the term as matters progress.*

[29] https://www.scribd.com/document/188901750/Anglo-Preliminary-Results-2008

97. The International Monetary Fund has repeatedly expressed its concerns about the ECB approach, the European banking system and its impact on the wider economy. In 2014 for instance, it estimated non-performing loans in Europe at over €800bn[30] and this was before the current Italian banking crisis erupted[31]. According to the IMF, "Europe's largest and most powerful banks receive up to $400bn in subsidies. This compares to just $70bn in the US where banks have been able to re-access market funding to a much greater extent."

7.2 DOES IRELAND HAVE A DEBT OBLIGATION TO THE ECB?

98. Banks are not allowed to trade while insolvent. If the IASB rules mask that insolvency, those rules must be overridden and the true situation – by law – must be reported.

99. It is simply not possible for entities like the Central Bank to regulate banks when these banks are encouraged to hide losses and therefore make it difficult to distinguish solvent from insolvent banks.

100. Irish banks were hiding losses from 2005 onwards (and possibly earlier).

101. Irish banks failed to inform all investors until the Banking Inquiry of 2015 that they had implemented a policy of hiding losses.

102. We know that the ECB, through its adoption of IAS 39, facilitated commercial banks in hiding losses; this then raises the question as to whether Ireland has the legal 'capacity' to repay loans drawn down from the ECB which were used to cover losses that the ECB, major hedge funds and other creditors suffered. To summarise:

   i. *In 2001 the ECB was aware that banks were going to hide losses;*

   ii. *Between 2003 and 2008 the ECB loaned vast sums to the banking system despite knowing that these loans could never be repaid by many of the banks involved;*

   iii. *In September 2008 the Irish government, under the misconception that Irish banks were solvent and also under the misconception that it – the Irish government – was responsible for losses of its own banks, gave a guarantee that it would cover all liabilities;*

   iv. *In 2010 the ECB forced Ireland to borrow money from both the ECB and IMF and use that money to cover the losses that the ECB and other creditors had suffered;*

   v. *Letters[32] were released in 2014 from Jean Claude Trichet to the then Irish Finance Minister Brian Lenihan, which confirmed that the ECB applied pressure for Ireland to cover losses that the ECB suffered;*

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30 http://www.irishtimes.com/business/economy/taxpayers-paying-dearly-as-banks-conceal-loan-losses-1.1770367

31 http://www.irishtimes.com/business/financial-services/italian-banks-dig-deeper-into-trouble-with-zombie-lending-1.2762013

32 http://www.irishtimes.com/news/ireland/irish-news/the-trichet-lenihan-letters-the-full-text-1.1991574

103. The ECB suffered its losses on the date that it advanced the loans to the Irish commercial banks, not after the 30th September 2008 guarantee; prior to 2010, there was no EU Regulation in existence that allowed banks to hide losses. Various attempts were made since 2010 to change the law so as to accommodate the hiding of losses, however many legal experts believe that the hiding of losses remains illegal until IAS Regulation 1606 of 2002 is changed (see for instance the comments of George Bompas QC)[33].

104. Because banks were hiding losses and were insolvent on the night of Ireland's blanket bank guarantee, the ECB would not have a valid claim on the Irish government for losses it had already suffered. Those losses would have arisen because of the ECB's gross negligence or criminal acts. The question of whether the ECB is correct in claiming that banks are allowed by law to hide losses – while important – is nevertheless academic. The ECB, however, has resisted (and continues to resist) all attempts to examine its conduct, principally on the grounds of confidentiality.

105. The conclusion from the above evidence is that the ECB were grossly negligent in allowing banks to draw down ECB funds for short term financing, given that the banks drawing down the funds were either insolvent or not measuring solvency correctly.

106. Various attempts to hold the ECB to account were stonewalled by a confidentiality clause. The ECB has quoted Article 52 of EU Directive 2013/36 to justify its secrecy. However, as the extract below shows, it cannot use secrecy laws to justify dismissing a potential criminal investigation. According to Directive 2013/36:

> *Confidential information which such persons, auditors or experts receive in the course of their duties may be disclosed only in summary or aggregate form, such that individual credit institutions cannot be identified, without prejudice to cases covered by criminal law.*

While the ECB is of course allowed to rely on this, the clause cannot be used to conceal criminal acts.

7.3 SHAREHOLDERS

107. **Directors who run limited companies, incorporated by law, whether public or private, enjoy the privilege of limited liability**. This in essence means that even if they incur substantial losses, the maximum that creditors can claim is based on the value of the net assets in the firm. **However** – and this is pertinent – **courts generally have the power to remove the 'veil of incorporation' if there is evidence that directors are exploiting the concept of limited liability** by clocking up huge losses knowing that the creditors are not able to pursue the directors. There are safeguards in place to prevent such company law abuses.

[33] http://democracy.wirral.gov.uk/documents/s50012690/Opinion%208%20April%2013.pdf

108. When **banks overvalue collateral, they also deceive shareholders.** Shareholders think that the bank is making profits and presumably approves bonuses on that basis when in reality the bank may be making huge losses but covering them up. This report will reveal that the ECB was aware as far back as 2001 that banks were going to hide losses. It had the authority to stop this but refused to do so. The ECB ended up amassing huge losses, and based on evidence from the 'Trichet letters', put illegal pressure on the Irish government to assume these losses, which amounted to over €69.7 billion. The ECB would also have been aware that its stance on accounting allowed banks to deceive shareholders, a group which suffered heavily during the banking crisis of 2008.

109. From the above, it would appear that all bank shareholders who lost their investments during the bank crisis have a reasonable and legitimate claim against the ECB (See also Appendix Four for more on this).

7.4 WHO HAS LOCUS STANDII?

110. **An event of default under the ECB's Target 2 loan facility is defined as *"any impending or existing event the occurrence of which may threaten the performance by the Counterparty of its obligations...".*** The clause then goes on to give a number of examples, two of which are important:

(a) where the participant is, or is deemed by the Bank (central bank) to be insolvent or unable to pay its debts;

and

(b) where any material representation or pre-contractual statement made by the participant or which is implied to have been made by the participant under the applicable law is incorrect or untrue.

111. There can be no doubt that up to the night of the guarantee in September 2008, the covered Irish banks, which include Anglo, Allied Irish Bank and Bank of Ireland, were in severe difficulty not only from a liquidity point of view but also from a solvency perspective. **It is reasonable to assume** also **that the banks were not able to pay their debts, and further, that those banks that complied with the flawed version of accounting standard IAS 39 would *not* have complied with subsection (b) above.** In those circumstances the Irish Central Bank has the power to convert a floating charge to a fixed charge, even without court approval.

112. **Commercial banks which draw down funds from the Central bank also sign away any rights conferred in Section 20 of the Irish Conveyancing Act of 1881. This section contains certain restrictions that prevent a lender from controlling assets used as collateral for a loan.** Additional requirements upon the borrower, apart from those contained in Section 19 of the same Act, makes it clear that in the event of default (as

described above), the lender, which in this case is **the Central Bank, takes full control over any collateral used by an Irish bank which is insolvent**[34].

113. It would appear then the Locus Standii for all the collateral that had been held by the bailed-out Irish banks now rests with the Central Bank and by extension, ultimately with the ECB.

7.5 NAMA AND THE ECB EFFECT

114. On November 22th 2009 the government set up the National Asset Management Agency (NAMA) as its 'bad bank', to take possession of all loans of over €10million from all the troubled Irish banks (because many of those loans were actually performing, not in trouble, this in itself is a matter that merits investigation, but not in this Report).

115. Had NAMA been allowed do its job without interference, sell those assets at the most opportune time – when the markets had recovered – that would have been making the best of a bad situation. However, the ECB was not about to let that happen. Instead, and even as it was still subsidising other Irish banks, it forced NAMA into a fire-sale, a tactic that has allowed foreign hedge funds to profit at the expense of the Irish government.

116. In 2017 the Irish Public Accounts Committee attempted to establish if NAMA had sold assets in Northern Ireland on favourable terms to hedge funds. Amongst the defences NAMA put forward was that it was forced to overvalue assets to comply with accounting standard IAS 39 and therefore the sale of the assets would automatically give rise to a loss. A number of NAMA witnesses not only repeated this incorrect assertion but claimed that the C&AG (Comptroller & Auditor General) approved it.

117. On 6th October 2015 Minister Noonan appeared before the Public Accounts Committee to examine whether foreign hedge funds benefitted at the expense of the Irish public on the 'Project Eagle' sale of assets. Noonan claimed that the ECB put pressure on both him and NAMA to sell the assets in a quick-fire sale. In evidence he said "The European Central Bank, ECB, was constantly urging NAMA to sell assets so that it could redeem the bonds to take pressure off the Irish banks."[35] According to the Irish Examiner:

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[34] This requirement is contained in virtually all standard documents that banks must sign when they require Target 2 funding. It prevents 'Monetary Financing'

[35] https://www.kildarestreet.com/committees/?id=2016-10-06a.21

"Mr Noonan outlined the position during a five-hour meeting in which he blamed the ECB for any pressure to sell and said it was not within his powers to scrap the sale when he learned a NAMA adviser stood to benefit"[36]

118. In relation to the ECB Mr Noonan said:

"I was disappointed that PIMCO had withdrawn because I had been briefed on the basis that things were going well and there could be a sale of the portfolio. I explained the reasons to the Deputy earlier. We were after coming out of the bailout at the very end of 2013 - this was March 2014 - and a lot of advice I got from eminent people was that we needed a precautionary programme to ensure access to the market. The rating agencies had told NAMA, together with others present at the meeting, that the contingent liability of NAMA was a drag on our ratings and we would not get investment grade. The European Central Bank, ECB, was constantly urging NAMA to sell assets so that it could redeem the bonds to take pressure off the Irish banks."[37]

119. It's clear that NAMA, the organisation which sold the assets, could have benefited if it had held onto them. The rental roll from the assets sold was approximately £100 million per annum. The interest cost on loans that NAMA used to buy the assets were a small fraction of the rent roll, so that as a result of the sale Ireland lost heavily. It later emerged that Mr Noonan put pressure on NAMA to accelerate its asset disposal. According to the Sunday Times (16th April 2017):

Michael Noonan, the finance minister, asked NAMA to accelerate its asset disposals to help the government sell its bank shares just as the agency put its Project Eagle portfolio for sale. NAMA previously withheld the memo from a freedom of information response but it was released to The Sunday Times last week. It was deemed that the note is no longer commercially sensitive.

120. On the question of 'Locus Standii' as outlined above, because of a clause in the lending agreement with the Irish Central Bank, control of the bailed-out Irish banks' collateral automatically passes from them to the Central Bank. It follows therefore that only the Central Bank and *not* the commercial banks are free to sell those assets to NAMA and enforce the collateral in the courts. The ECB confusion has created a situation where NAMA, having bought the assets from the commercial banks who were *not* the legal

[36] http://www.irishexaminer.com/ireland/michael-noonan-denies-he-told-NAMA-to-sell-loans-424625.html

[37] http://oireachtasdebates.oireachtas.ie/Debates%20Authoring/DebatesWebPack.nsf/committeetakes/ACC2016100600002?opendocument#W00100

owners, may not have the legal authority to sell them, therefore putting portfolio sales such as Project Eagle in jeopardy.

121. All of this adds up to a situation whereby in addition to the billions lost when Ireland was forced into bailing out its banks, these losses were compounded when the ECB then forced Ireland into a fire-sale of the assets that had been supposedly stored in its bad bank, NAMA, to be sold only when the markets had recovered.

8 RECOMMENDATIONS

8.1 ACTIONS

122. The authors of this report make the following recommendations:

123. The Irish government should immediately begin negotiations with one or all of the ECB, the European Commission and the European Council on the €69.7billion that Ireland poured into its troubled banks;

124. The Irish government should likewise immediately begin negotiations with one or all of the ECB, the European Commission and the European Council on the billions lost through the forced fire-sale of assets by NAMA;

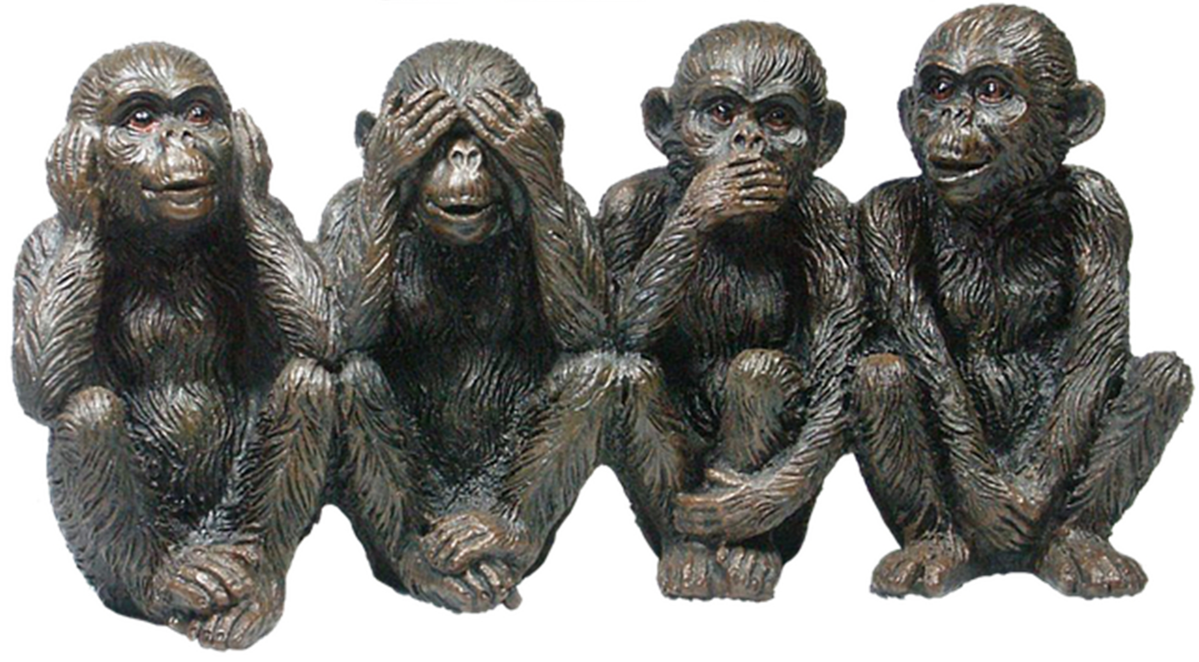
125. The shareholders in the Irish banks who lost their investments because of the ECB practices that led to the banking collapse, and to the practices within those banks themselves, should pursue through the courts all those responsible for those failures;

126. The Irish government should form an alliance with all those eurozone Member States whose citizens, because of the design failures of the euro and because of the subsequent actions of the ECB which went far beyond its own remit, have been forced to bail out their own banks; this alliance should then ensure that just as the ECB has been printing billions of euro to support Europe's banks, should equally now find a means to make good on the losses suffered by all those Member States.

8.2 PROJECTION

127. Will this produce any result, never mind the required result? One thing we know for certain, from bitter experience to date – doing nothing will achieve nothing.

DARWIN



9 APPENDIX ONE – IAS 37

128. In September 1998 the Accounting Standards Board expressed its concerns about the misinterpretation of Article 31(1)(c)(bb). Some entities were reporting 'excessive liabilities' by providing not only for losses suffered but also for potential losses that the entity might suffer in the future[38]:

In the absence of an accounting standard on provisions the practice has grown up of aggregating liabilities with expected liabilities of future years, and sometimes even with expected expenditures related to ongoing operations, in one large provision, often reported as an exceptional item. The effect of such 'big bath' provisions has been not only to report excessive liabilities at the outset but also to boost profitability during the subsequent years, when the liabilities are in fact being incurred.

The Financial Reporting Standard (FRS) addresses these concerns, first by requiring that provisions should be recognised only where a liability exists at the period-end (based on the definition of a liability in FRS 5 'Reporting the Substance of Transactions' and in the Board's draft Statement of Principles for Financial Reporting) and secondly by showing in examples how this principle should apply to a number of commonly occurring circumstances. The FRS deals with recognition, measurement and disclosure for provisions. Because contingent liabilities and contingent assets are closely linked to provisions, the FRS also covers their treatment.*

129. The problem was rectified in accounting standard IAS 37 where the term 'liability' along with other terms were defined:

A provision *is a liability of uncertain timing or amount.*

A liability *is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.*

An obligating event *is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.*

130. In the explanatory memorandum that introduced Article 1(9) of Directive 2003/51 the purpose of the amendment was clearly stated:

Paragraphs 4, 5, 7, 9 and 11 – IAS 37 Provisions, contingent liabilities and contingent assets sets out specific requirements as to which amounts should be recorded as provisions for liabilities. In the 4th Directive, Article 31 sets out certain basic rules as to the liabilities which must be taken into account in preparing the annual accounts and Article 20 expands on these principles, giving specific rules for provisions.

[38] http://frc.org.uk/Our-Work/Publications/ASB/FRS-12-Provisions,-Contingent-Liabilities-and-Cont-File.pdf

The provisions recorded under IAS are more specific than those under the 4th Directive. In particular, IAS restricts the amounts recorded to those obligations which exist at the balance sheet date. In addition to such amounts, the 4th Directive envisages also the provision of liabilities which are 'foreseeable'. The proposal resolves this inconsistency in the case of companies applying IAS without necessarily changing the status quo for annual accounts and unlisted companies. This has been achieved by amending Article 31 to require the recognition of amounts consistent with IAS whilst allowing Member States to continue to permit or require those additional amounts currently envisaged by the Directive. In addition, certain minor changes to terminology and references have been proposed to facilitate the application of IAS 37.

131. In 2001 there was another small change. Directive 65 of 2001 provided for a situation where banks could recognise a profit on certain financial instruments, particularly derivatives even if those derivatives were not yet sold. This change permitted banks to depart from the strict concept of prudence which essentially does not permit banks to recognise profits until the underlying asset is sold. However, it is not relevant to Irish banks which hide losses on loans, since the change in Directive 65 of 2001 does not apply to 'loans and receivables'.

10 APPENDIX TWO – IAS 39

132. In 2002 the IASB faced a dilemma. On the one hand it was under pressure from certain influential bankers, who in turn were supported by the ECB, to hide losses (the ECB saw the accounting standards as an opportunity to hide the subsidies they wished to offer banks). On the other, the IASB wanted their rules to be incorporated into EU law even though that law required the immediate recognition of losses. The IASB took an unusual approach:

i. It developed an accounting standard that was vague enough to encourage different interpretations. This standard became known as IAS 39

ii. It issued guidance to shareholders and regulators reassuring them that if entities followed IAS 39 they would be forced to reveal all losses and would therefore be in compliance with EU Directives.

iii. It issued very different guidance to the accounting profession, advising that under IAS 39 banks were forced to hide losses (see paragraph 31).

133. Unsuccessful attempts were made to change the EU legislation so that it would fall into line with requirements of influential bankers and lobby groups who wished to hide losses.

134. Initially, members of the accounting profession assumed that they had the legal authority to remove prudence and therefore were not under any constraints about hiding or delaying the recognition of losses. For instance, in a letter dated 3 May 2006 to the IASB, the Basel Committee on Bank stated:

"We are concerned with the discussion of neutrality as put forth by the discussion paper. We consider that greater emphasis should be given to the fact that overly optimistic outlooks on the price to be received and the costs necessary are inconsistent with the concept of neutrality. Given that, notably, the concept of prudence has been removed...".[39]

135. In 2002 the UK's Financial Reporting Council said:

In emphasising reliability rather than prudence, the approach of the draft standard is more in keeping with the ASB's Statement of Principles and FRS 18 'Accounting Policies'.40

136. The FRC therefore initially claimed that the removal of prudence was not illegal. It would later be forced to backtrack on that claim, following the Bompas Opinion in 2013 where the matter is referred to in paragraphs 10 and 11.

[39] https://www.bis.org/bcbs/commentletters/iasb19.pdf

[40] https://www.frc.org.uk/getattachment/a5272057-3f46-46bb-b472-d4c54182aecf/FRED-28-Inventories-Construction-and-Service-Contracts.aspx

137. **Despite all the above**, in 2004 the ECB wrote to the International Accounting Standards Board[41] supporting the IASB's intention to roll out that controversial accounting standard, IAS 39. At the time, the architects behind this standard stated that banks would be allowed to hide losses and overvalue certain loans.

138. In 2006 the IASB took a formal decision to drop prudence. It said:

Financial information needs to be neutral - free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty42

139. In 2006 also the ECB confirmed its awareness that under IAS 39 banks can hide losses 'until a fairly late stage'.

In the case of a broad interpretation of the respective provisions of IAS 39 (Financial Instruments: Recognition and Measurement), the IFRS approach can be implemented in very different ways, but the most immediate one would be to refer to the "incurred loss" pattern and therefore not to recognise credit risks through provisions until a fairly late stage.[43]

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[41]

[42] http://www.ifrs.org/Meetings/MeetingDocs/IASB/Archive/Conceptual-Framework/Previous%20Work/CF-0505b07.pdf

[43] https://www.ecb.europa.eu/pub/pdf/other/assessmentaccountingstandards2006en.pdf?a1415598edf0845669bc3b33248da0d3

10.1 APPENDIX THREE - IAS 39 – THE LEGAL ARGUMENTS

140. The accounting profession argued that it had a legal obligation to comply with accounting standards and since those accounting standards were incorporated into EU regulation it had no alternative but to comply, even if it led to a misleading or deceptive financial position. The situation was summarised by the Irish Chartered Accountants Regulatory Board (CARB) as follows:

"CARB believes it unfortunate that compliance with an accounting standard is deemed of itself to result in a true and fair view of a company's financial position. Accordingly, CARB believes that in the future the first principle that should apply is true and fair; followed then by adherence to the individual standards."

141. The CARB view is based on a legal opinion commissioned by the UK's Financial Reporting Council (FRC), from Martin Moore QC based on an Opinion issued in 2008. According to the FRC:

The introduction of [IASB rules] in the UK did not change the fundamental requirement for accounts to give a true and fair view. Indeed, for the avoidance of doubt, the FRC obtained an Opinion from Martin Moore QC in 2008 which confirmed that the true and fair concept remains paramount in the presentation of UK company financial statements, even though the routes by which that requirement is embedded may differ slightly. The Opinion also confirms that fair presentation under [IASB rules is] equivalent to a true and fair view

142. However this is an oversimplification. It attempts to suggest that blind compliance with an accounting standard will get bankers off the hook if they provide misleading information to the markets. Firstly, UK barrister Martin Moore QC, in giving this advice, does not make clear if he is referring to the David Tweedie version of the rule (where all losses must be revealed) or the Sue Lloyd (which requires banks to hide losses). A second important point is that later in the opinion Moore warns ***against*** blind compliance with an accounting standard. Unlike the CARB view above, Moore warned that if an entity complies with an accounting standard, and that accounting standard is misleading then the entity must override it, i.e. ignore the accounting standard, but must of course disclose why it has taken this course of action. He said ***"It does not follow from that observation that the preparation of financial statements can now be reduced to a mechanistic process of following the relevant standards without the application of objective professional judgment applied to ensure that those statements give a true and fair view, or achieve a fair presentation".***

143. A legal opinion from George Bompas QC in 2013 confirms that it is illegal to ignore **prudence** (an accounting and company law concept that prevents entities from hiding losses). He also issued a legal opinion claiming that if the accounting standards forced banks to hide losses directors of those banks would be forced to commit a criminal offence. He said:

The practical importance of this debate is that if a company director whose company is preparing IAS accounts as its statutory accounts and who believes that the accounts so prepared fail to give a true and fair view may not be able to rely on Mr Moore's Opinion,

or the statement of the Minister in the debate on CA06 s.393, to permit departure from particular requirements of an international accounting standard which may have been incompatible with the production of accounts giving a true and fair view. The director would be faced with a dilemma. On the one hand his obligation would be to have his company produce its statutory accounts to be laid before the company, and to do this applying international accounting standards where that was the applicable accounting framework; and he would commit a criminal offence if he approved them not believing that they complied with international accounting standards (CA06 s.414). On the other hand he would be faced with the s.393 statutory prohibition against approving accounts which he did not believe to give a true and fair view.

144. Also in 2013 the UK's Financial Reporting Council obtained a legal opinion from Martin Moore QC which attempted to undermine the Bompas argument. Although Moore disagreed with Bompas in many areas, both agreed on the importance of 'prudence'. Bompas stated that an accounting standard which attempted to undermine prudence by forcing or even allowing banks to hide losses would be illegal. Mr Moore stated in paragraph 76a of his 2013 Opinion that prudence was a legal requirement:

Before developing this analysis, I should explain that I do not share Mr Bompas's concerns at the absence of any reference to 'prudence' in the Conceptual Framework for two reasons:

First, because the version of IAS1 adopted by the EU refers to the 2001 Framework, and that version has not been amended to refer to the Conceptual Framework. As a result, there can be no debate as to whether 'prudence' has been, and remains now, a component of a true and fair view (or fair presentation) for the purpose of determining the application of the override in IAS1, paragraph 19. . .

145. Both Mr Moore and Mr Bompas agree that 'prudence' is an essential ingredient of company law and that accounting standards which ignore, or even compel the dropping of, prudence are automatically illegal. It follows from this that there should be no doubt as to whether the hiding of losses, which is imprudent, is illegal. If the concept of prudence requires the immediate recognition of losses, then, any accounting standard which promotes or encourages the hiding of losses is potentially aiding and abetting a criminal offence.

146. Although there is an obligation on banks to disclose their accounting policy, there is strong evidence that they failed to do so both to regulators and retail shareholders, though they may have informed some institutional shareholders. If the bank is concealing information from some shareholders, but releasing it to others, there is the increased risk of aiding insider trading and oppression of those shareholders that were not informed of the accounting policy change.

147. The extract below from a House of Lords Inquiry shows that auditors felt that they were not obliged to show the true financial position of a bank, even though it is a legal requirement. The auditor (Mr Connolly) appears to claim that because failed banks are automatically supported by the government, there is no need to reveal the losses the bank may have suffered:

Lord Lawson of Blaby:

You would know about it because you were the auditor of the Royal Bank of Scotland Group, weren't you?

Mr Connolly:

That's right.

Lord Lawson of Blaby:

Which went belly-up within a few months of your giving it a clean bill of health.

***Mr Connolly**:*

Yes. Well, of course, it didn't go belly-up. It was supported and that's—

Lord Lawson of Blaby:

*No, it went belly-up. **That's why it was supported**.*

148. The Companies Act together with EU company law directives require entities to disclose their true financial position to all creditors and shareholders before they raise money either through borrowings or the issue of shares. The measure doesn't offer complete protection but at least any creditor or shareholder's financial damage is only confined to future losses, not losses the entity has already suffered and hidden. EU company law directives force company executives to produce accounts that give a 'True and Fair view' of the financial position. It is clear, from a principle known as the 'True and Fair override', that company directors cannot hide behind flawed accounting standards to conceal losses. Accounting standards are used *to help* companies to achieve the True and Fair view and **blind compliance with a standard is insufficient if it results in a misleading financial position.**

149. In testimony given to the 2015 Irish Banking Inquiry, Professor Walsh stated:

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

150. When Professor Walsh made this statement he was aware that some bankers assumed that the international financial reporting standards allowed banks to hide losses. His claim above, put simply, is that blind compliance with an accounting standard automatically achieves a true and fair view and goes on to argue that the 'true and fair view' has 'become largely redundant' because of the detailed accounting rules. Ironically, the 'legal opinion' he refers to is that of the above-mentioned Martin Moore QC. However, in a legal opinion published in 2008, when asked if blind compliance with

accounting standards achieves a true and fair view stated Mr Moore gave a very different opinion[44]:

Against this background, it may be said, that a preparer of financial statements in accordance with IAS can be certain that a fair presentation will always have been achieved if those standards are followed.

In my view a seeker after such certainty, whether in relation to IAS individual accounts or Companies Act individual accounts would be confusing outcome with process. In the case of IAS, any such suggestion is clearly contradicted by the fact that IAS I expressly provides for IFRS standards to be departed from and that the effect of the legislation is to require compliance with adopted IAS.

151. In summary, Mr Moore argues that if directors of a company make a decision to mislead investors, they cannot claim as a defence that they were merely complying with the accounting standards. **A standard is used to help producers of accounts to comply with the law, it is not a substitute for the law.** Even the International Accounting Standards Board (IASB) confirmed in paragraph IAS 1.17 that if an accounting standard prevents an entity from portraying the correct financial position, that standard must be departed from and the reason for the departure must be disclosed[45].

152. The legal position is quite straightforward. It has not changed. Firstly, even if an accounting standard did allow banks to hide losses, a bank would be obliged to override it because if an entity decides to hide substantial losses it is unable to give a true and fair view. Secondly, IAS 39 the accounting standard that supposedly allows banks to hide losses, contains no such provision. If it did, and the EU was aware of it, the standard could not be endorsed as giving a misleading financial position is contrary to law since it undermines the protection that EU company law directives provide to shareholders and creditors of limited liability companies.

153. In response to a letter from Pearse Doherty, an Irish politician, the FRC had no choice to accept that 'the concept of prudence' has an important role in the preparation of accounts but claimed that contrary to an EU Directive 78/660, the concept of prudence does in fact allow banks to hide losses. That letter stated:

We agree that the application of prudence is necessary for the presentation of a true and fair view and this is made clear in UK accounting standards and IAS 8. Companies applying UK Standards must also comply with the Companies Act schedules that have been derived from the 4th directive that also reiterates this requirement.

There is no comprehensive legal definition of true and fair or prudence against which specific accounting policies can be judged. The 4th Directive does require that assets be valued on a prudent basis, but does not explicitly state that assets, such as bank loans, cannot be shown at above their recoverable amount or that all future expected losses should be recognised.

[44] https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Martin-Moore-QC-Opinion-3-October-2013.pdf

[45] http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32008R1126&from=EN

154. By 2013 however, there was a change of tactic. George Bompas QC issued a legal opinion, critical of Martin Moore QC in 2002. Moore claimed that there was nothing illegal about IAS 39 and other standards. Bompas said that because IAS 39 dropped prudence it was illegal, confirming that the removal of prudence may constitute a criminal offence. In response, Moore published a second legal opinion in 2013 where he confirmed that he agreed with George Bompas QC on this matter. The UK's Financial Reporting Council (FRC) also agreed:

As a result, there can be no debate as to whether 'prudence' has been, and remains now, a component of a true and fair view (or fair presentation) for the purpose of determining the application of the override in IAS1, paragraph 19.

155. In the same Opinion Mr Moore was forced to admit that the IASB did attempt to drop prudence. He said[46]:

[The IASB] made it very clear that the motivation for the removal was (a) convergence with US GAAP, which did not have a definition of prudence, and (b) that in practice, the concept of prudence was used as a pretext for what he described as "cookie jar accounting" and for income smoothing; that is effectively to under-report in good times and over-report in bad so that in good times performance is depressed but, more critically, in times of downswing hidden reserves are released to increase earnings thereby over-stating profits and masking a deterioration in an entity's performance.

156. The IASB also appears to have agreed that the dropping of prudence was potentially illegal. Moore used an assurance from the IASB to justify his view that the IASB rules were not flawed from a legal perspective. He said in paragraph 52 of his 2013 Opinion (quoting from the IASB):

Yet, I have also demonstrated that the basic tenets of the concept of prudence are still vital for our work. Indeed, the exercise of caution is visible in many of our standards and is also an important issue in the development of new standards. Indeed, one might very well conclude that the old Concept is not dead, but alive and kicking indeed.

157. The conclusion we can reach from this is that attempts by the International Accounting Standards Board to drop prudence from its standards is potentially illegal for entities using the IASB rules in Europe. Prior to the Bompas legal opinion, both the IASB and the FRC argued that it was possible to comply with European law and drop prudence. Both organisations have now changed their tactic. They agree with Bompas that prudence is a necessary ingredient of company law but have claimed that the definition of prudence has 'evolved' so that banks who hide losses and deliberately overvalue assets can claim to comply with the concept of prudence.

158. In 2010, a House of Lords inquiry titled *Auditors Market concentration and their role* said of the IASB rules (known as IFRS International Financial Reporting Standards):

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[46] https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Martin-Moore-QC-Opinion-3-October-2013.pdf

Some witnesses argued forcefully that adoption of IFRS in the UK had led to lower standards of audit. The central criticism is that, because IFRS is more rule-based than UK GAAP, it leads auditors to place conformity with IFRS rules before traditional, sceptical reliance on "the true and fair view, the prudence principle and the principle of substance over form.

159. One European regulator who supported the IASB's plan to hide losses was the UK's Financial Reporting Council (FRC). This body enforces compliance with the International Accounting Standards within the UK. It said:

Any changes to the Accounting Directives should generally be limited to those necessary to remove inconsistencies with [IASB rules], and it is important that those changes should be made promptly, and swiftly reflected in UK legislation. Any other changes to the Directives should be limited to cases where their need can be clearly demonstrated and where new requirements are similar to, and wholly consistent with, those of [IASB rules].

160. Following this backlash, the IASB appears to have recognised that the dropping of prudence was illegal, at least in Europe. In a prepared speech titled The Concept of Prudence: dead or alive, given in September 2012, Hans Hoogervorst, Chairman of the IASB, attempted to reassure the markets that his rules did not drop prudence, a significant U-turn. The problem for the banking sector is that by 2012 they had adopted the practice of hiding losses for almost a decade, on the grounds that the IASB standards compelled them to do so. Mr Hoogervorst now appeared to be saying something different.

161. Had the FRC succeeded in changing the UK legislation, it would have opened the door towards legitimising 'Ponzi type' fraud schemes where investors are paid dividends financed from the money they invested rather than from profits.

162. Although some committee members of the IASB encourages banks to hide losses, it as an organisation does not have legislative powers and therefore cannot amend company law in Ireland or indeed in Europe. Its role is simply to develop reporting standards that companies must meet in order to comply with the law.

163. It is impossible to comply simultaneously with company law which prevents entities from hiding losses and also comply with accounting standards that apparently force directors to hide losses.

164. In summary, the IASB created confusion which encouraged reckless banking. It:

i) Devised an accounting standard that was so confusing that people would not read it. Instead they would rely on interpretations by the IASB on how to interpret the standard;

ii) Gave an assurance to the European Regulators that IAS 39 observes the concept of prudence and therefore forces banks to hide losses

iii) Gave a very different assurance to bankers and auditors that IAS 39 allows entities to hide losses.

In 2013 the House of Lords made a second attempt at establishing whether banks were complying with the law by hiding losses, contrary to prudence, (the previous attempt being the inquiry titled Auditors Market Concentration and their Role in November 2010

The inquiry titled ***Changing banking for good*** attempted to examine why banks could hide losses and claim to be prudent. A number of investor groups claimed that prudence was removed from accounting and therefore banks hid losses. The accounting profession, however, denied that prudence was removed, leaving the House of Lords Committee utterly confused. One of the exchanges:

Chas Roy-Chowdhury:

Can I just step in, before Robert jumps in with the technicalities behind it? Lord Lawson, in terms of the conceptual framework, prudence is not in there, but in terms of the underlying basis on which you apply the IFRS standards, it very much is still there. It is very much behind how you draw on the rules within IFRS, in terms of the principles-based system we have in Europe, to draw up the financial statement. So it is very much there. It is very much something that the preparers of the financial statements have to focus on. So it has not disappeared at all.

HQ168 Chair:

I find that difficult to accept.

165. It now appears that different witnesses were using different definitions of prudence when they gave evidence. The accounting profession failed to tell the House of Lords that its definition of prudence allowed banks to hide losses. That inquiry contained about 737 pages of evidence and witness statements, which was probably more confusing than illuminating.

166. After the George Bompas Opinion was published in 2013 there was general consensus that the dropping of prudence was illegal. However, as banks were already hiding losses, the only possible defence that banks could use to justify hiding losses was that the definition of prudence had changed or ‘evolved’ in accordance with the latest accounting developments. The law however had not changed. EU Directive 78/660, known as the ‘Company Law Fourth Directive’ had made clear that all losses must be recognised and stated explicitly that a provision must be made for losses that were not yet recognised.

11 APPENDIX FOUR – BANK OF IRELAND SHAREHOLDERS

11.1 Bank of Ireland shareholders

167. There is the possibility that minority or retail shareholders suffered in the hands of Bank of Ireland. The bank adopted the flawed version of accounting standard IAS 39 but incorrectly stated at the Bank Inquiry that the 'market' was aware that it had done so. John O'Donovan, former group chief financial officer, who gave evidence to the banking inquiry admitted that Bank of Ireland was not providing for losses correctly but claimed that 'the market was clearly aware' of what the bank was doing. He said

"I understood the pro cyclical nature of provisioning under IAS 39 and I and the market were clearly aware that loan losses in the low teens basis points (e.g. 11 BPS y/e 3 1 March 2006 9BPS y/e 31 March 2007 and 14BPS (excl SIVS) y/e 31 March 2008) were not representative of likely "through the cycle" loan losses."[47]

168. Mr O'Donovan's statement is possibly not correct for three reasons. Firstly, in its accounting policies, listed in its annual report, Bank of Ireland makes no reference to the fact that it was hiding losses. Secondly, if it was, it is highly likely that retail shareholders would have sold their holding and thirdly, some regulators within the Irish Central Bank were not aware that Bank of Ireland had changed its accounting policy so that it could hide losses. According to the Irish Central bank:

As with other Regulators worldwide, the Central Bank used audited financial statements as a primary tool in its supervision of regulated firms'. Despite receiving 'clean' audit reports, they were 'under-providing for impairment[48]

169. If the Irish central bank was not aware that banks were hiding losses it is reasonable to conclude that other retail shareholders were also not aware. The likelihood is that Bank of Ireland briefed certain institutional investors who knew that for the few years after the Incurred Loss Model was introduced, the bank would show huge artificial profits before revealing substantial losses. Some institutional investors therefore had insider information, not available to everyone.

170. In 2011 Bank of Ireland admitted that it allowed US investor Wilbur Ross and other major funds to carry out due diligence on its assets Mr Ross therefore had access to the loss details that Bank of Ireland kept hidden from retail shareholders. Between 2011 and 2014 Mr Ross is reported to have made Euro 477 million from the purchase and sale of

47 https://inquiries.oireachtas.ie/banking/wp-content/uploads/2015/08/John-ODonovan-WSW.pdf page 16

48 http://www.bankinginquiry.gov.ie/The%20Irish%20Banking%20Crisis%20Regulatory%20and%20Financial%20Stability%20Policy%202003-2008.pdf

Bank of Ireland shares. Retail shareholders were denied this opportunity, which suggests that they were oppressed, or in plain English, the profit that Mr Ross accumulated was largely at their expense.

171. Bank of Ireland confirmed that it offered the shares on preferential terms. It follows that Wilbur Ross would have seen details of the losses that Bank of Ireland failed to reveal.

Following the announcement by the State on 25 July 2011 of an investment of up to €1.123bn by a group of significant institutional investors and fund managers, Bank of Ireland is now able to confirm that the investors are led by Fairfax Financial Holdings and include WL Ross, Capital Research (part of The Capital Group), Fidelity Investments and Kennedy Wilson. The Bank has been advised that each of these investors will manage their individual stockholdings independently[49]

11.2 Due Diligence and insider trading

172. The extract below states that if an investor has insider information from due diligence he or she, must reveal that information to the general public before they take action to buy or sell the shares.

173. International investor Wilbur Ross would have known that he had details of losses that Bank of Ireland refused to publish on the grounds that a loophole in IAS 39 allows banks to hide losses. It follows that he should have made this information public when he decided to buy the shares.

"The core argument is that, from a theoretical perspective, the due diligence objective of acquirers can be reconciled with the goals of insider trading regimes in order to preserve the interests of the target shareholders as long as certain restrictions are placed on the conduct of the acquirer. Due diligence temporarily causes information asymmetry whereby the acquirer becomes privy to inside information that is unavailable to the other shareholders, but parity can be restored if the acquirer (or the target) is required to publicly disclose any such inside information to the market before the acquirer proceeds with the transaction (a phenomenon referred to as "cleansing"). This must be accompanied with the condition that the acquirer cannot trade in the target's shares while it is in possession of inside information, nor can it disclose that information to any other person. The only advantage the acquirer gains is that it is able to examine the affairs of the target and then decide whether it wishes to proceed with the transaction or not. If it does decide to proceed, it must give up any informational advantage through a cleansing announcement. This can be considered a "win-win" situation whereby the acquirer is motivated through the due diligence exercise to embark on a transaction that may be beneficial to the target and its shareholders, but at the same

[49]https://www.bankofireland.com/fs/doc/wysiwyg/Significant%20investment%20in%20Bank%20of%20Ireland.pdf

time it must relinquish its informational advantage before it actually acquires the shares so that a similar level of information is available to all shareholders at that stage."[50]

174. Mr Ross appears to have been aware of the flawed accounting model as used by Bank of Ireland. In January 2016, his name was mentioned in a court case. Ocwen, a US financial corporation was investigated by the Securities and Exchange Council. Like Bank of Ireland. it used a variant of the flaw in IAS 39 to hide losses. This led to shareholders being misinformed and suffering losses. Ocwen used the 'amortised cost' method of accounting to value certain distressed mortgages.

175. Extracts from paragraph 5 of a document titled Securities Exchange Act of 1934 Release No. 76938 / January 20, 2016 stated:

"Although Ocwen reported that it accounted for the Rights to MSRs at amortized cost and that the carrying value of the Rights to MSRs "approximate[d] fair value," the valuation for the Rights to MSRs assigned by HLSS was not a fair value estimate."[51]

176. The document went on to state:

"The best-point estimate in the valuation reports fluctuated from quarter to quarter; however, under its valuation methodology, HLSS did not make any adjustment to the fair value of its Rights to MSRs because the Inception BPS used to calculate carrying value did not differ by 5 percent or more from the best-point estimate. Consequently, Ocwen did not make any adjustments to the net present value of the liability. HLSS revisited the use of its valuation methodology in 2014 and determined that the carrying value of the Rights to MSRs was not a fair value measurement under GAAP. HLSS, therefore, determined that it was required to restate the value of its Rights to MSRs to the best point estimate of fair value provided in the valuation reports"

177. In summary, unless assets and liabilities are shown at 'fair value' on their balance sheets, there is a heightened risk that banks will hide losses. Ocwen, used an 'amortised cost' method to value assets (similar to that used in IAS 39) and therefore concealed from the markets, the huge losses that the entity suffered.

11.3 Insider Trading

178. The ECB's stance of encouraging banks to hide losses has created insider trading problems. In essence, if a bank fails to reveal losses on its annual report but makes details of those losses available to institutional shareholders or hedge funds through due diligence, then the institutional shareholders have an advantage over ordinary retail

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50 https://www.law.ox.ac.uk/business-law-blog/blog/2016/05/due-diligence-acquisition-transactions-and-insider-trading-concerns

[51] https://www.sec.gov/litigation/admin/2016/34-76938.pdf

shareholders, one that did not exist prior to 2005 when banks revealed details of their losses to **all shareholders.**

179. By failing to prosecute bankers and auditors who mislead the markets, large foreign hedge funds and vulture funds are placed at an unfair but considerable advantage over ordinary retail shareholders who are unable to tell if a bank is solvent or not. Through damaging Irish government policy, certain vulture funds are given rights that are denied to retail shareholders which places the vulture funds in a very advantageous position. Vulture funds for instance are, are allowed to do 'due diligence'. This is where vulture funds, unlike retail investors, are allowed to have access to the books of the bank and are therefore in a better position to determine losses that are not revealed in the annual report. From a legal perspective, proving insider trading is quite difficult. However, it is much easier to prove shareholder oppression. This arises where one group of shareholders ie institutional investors is treated differently to others, not so privileged, retail shareholders.

180. Broadly, corporate governance is the term given to rules and procedures such that company directors act in the best interests of all shareholders. The concept attempts to discourage or even outlaw instances where directors, through deception ie by inflating profits, serve their own self-interest by becoming entitled to bonuses based on activities that a damaging to the company and therefore the shareholders that they are paid to represent.

181. Unfortunately, insider trading is difficult to prove. Assembling the evidence for insider trading and proving an intent, is painstaking. Carefully sifting evidence and assessing trading pattern is costly and is probably best left to state enforcement agencies like the US Securities and Exchange Council. It is nevertheless possible for shareholders to take legal action for shareholder oppression. This is essentially where the controlling group of shareholders, normally Institutional investors such as hedge and vulture funds, are treated differently to minority shareholders, such as retail investors. Minority shareholders may be awarded compensation by the courts for mismanagement and unfair treatment by majority shareholders.

182. In Ireland, Section 212 of the Companies Act 2014, deals with the protection of minority shareholders and provides that if a court is of the opinion that a company's affairs are being conducted or the directors' powers are being exercised in a manner oppressive to a member of the company or in disregard of its interests, it may make any order it thinks fit with a view to correcting the matter.

12 APPENDIX FIVE – Protium Deal

12.1 Letter from Lord Turner to Marcus Agius, 10 April 2012

Dear Marcus

As promised, this letter follows up our recent meeting and sets out FSA concerns relating to aspects of Barclays' approach to regulatory and other issues.

Obviously where we have specific areas of concern which merit it, our Supervisory Team will directly make those concerns known at the appropriate level, and require any appropriate action in response. The purpose of my meeting with you was therefore not to focus on any one specific issue which requires remedial action. Rather I wished to bring to your attention our concerns about the cumulative impression created by a pattern of behaviour over the last few years, in which Barclays often seems to be seeking to gain advantage through the use of complex structures, or through arguing for regulatory approaches which are at the aggressive end of interpretation of the relevant rules and regulations. Andrew Bailey also expressed these concerns at your Board meeting on 9th February.

The specific examples which I mentioned at our meeting included two examples which I accept are 'old news', but also four relating to recent events.

<u>Old news</u>

I cited two examples.

· The development of the Protium structure in 2009 which, although not delivering Barclays any regulatory capital advantage and while within accounting rules, was perceived by many external commentators as a convoluted attempt to portray a favourable accounting result.

· The approach to the valuation of monoline CVA positions which became apparent in FSA analysis in early 2009, and which showed Barclays choosing valuations clearly at the aggressive end of the acceptable spectrum.

<u>More recent events</u>

Examples I cited were:

· Our concern that in the run up to the latest year-end, Barclays was not fully transparent with us about the RWA impacts of a proposed extension of model approaches (AIRB and IMM) applied in Barclays Capital Inc. Ultimately, we felt that the need for us to unpick the real impact of these proposed changes caused unnecessary friction and burdened our internal processes.

· [Redaction]

· Protracted communication between ourselves and Barclays about your desire to move index hedges of own credit from the trading book to the banking book, with the impact of materially reducing RWAs. In this case, after the initial outcome was not resolved in Barclays' favour, our team felt that Barclays continued to argue for capital optimization in a way which inefficiently used up our resource and goodwill.
· The confusing and potentially misleading impression created by Barclays' initial presentation of its position under the EBA stress tests, which appeared to be an attempt to leave FSA senior management with the impression that Barclays would be above the then intended 10% CT1 threshold, whereas at the relevant date of September 2011 it was actually at 9.8%. In fact given that the eventually chosen 'pass mark' was 9%, this did not turn out to be of crucial importance. But it nevertheless left our senior management with an impression that Barclays were seeking to 'spin' its messages in an unhelpful fashion.

I also mentioned at our meeting the recent publicity in relation to Barclays UK tax management. I recognise that since adequate provisioning had been put in place, this was not a regulatory issue per se. But as I know you recognise, and whatever the extent of advice which Barclays received in advance, the net impact has clearly been unfavourable to the degree of external trust in Barclays' approach to issues such as tax, regulation and accounting.

Clearly these examples vary in both currency and importance. And it is of course acceptable for a bank to argue for a favourable approach on any one specific issue, even if the regulator does not immediately agree. But the cumulative effect of the examples set out above has been to leave us with an impression that Barclays has a tendency continually to seek advantage from complex structures or favourable regulatory interpretations. These concerns are sufficiently great that I felt it was appropriate to communicate them directly to you, and to urge you and the Board to encourage a tone of full co-operation and transparency between all levels of your Executive and the FSA.

I know from our conversation that you take these issues seriously.
[Redaction]

Yours sincerely,

[Signed]
Adair Turner

12.2 Letter from Marcus Agius to Lord Turner, 18 April 2012

Dear Adair,

Thank you for your letter of 10 April, 2012.

It is a matter of regret for us that you have the concerns outlined in your letter. Barclays has invested significant effort and time in building and improving its relationship with

the FSA. It is very important to us to have a strong, open, cooperative and transparent relationship with the FSA and with all of our regulators globally. The Board and I took note of Andrew Bailey's comments in our February meeting and, while he specifically excluded Bob Diamond and Chris Lucas from his comments, it was clear that "tone from the top" is one of the FSA's concerns. Our objective is and has always been to have a strong and mutually beneficial relationship with the FSA and you have my commitment that we will work harder in the future to procure this outcome.

Your letter notes six examples of areas of concern to the FSA and without wanting to prolong the debate on these; I do feel the need to make one or two comments in relation to these specific points.

· With regard to Protium, I believe this has been discussed exhaustively. As you know, we reconfirm that our objective at the time was to change the repayment profile and maximize shareholder value. As it turned out, this is exactly what occurred. As you note, this was done within accounting rules and with no regulatory capital advantage and with explicit FSA approval.

· The monoline CVA positions from 2009 represent a highly subjective area where we are and were aware of at least one other major European based bank which had valuations very similar to Barclays. As you note, these valuations were within the acceptable spectrum. Time and markets have proven these to be less aggressive than suggested.

· On the more recent experience of the run up to year-end, we recognise that we asked a lot of your team with regard to model approvals. These were waiver requests which came about later than expected but they were necessary given the late changes to our capital guidance at year end via the FPC to FSA. A guideline of 10% was moved to 10.30% at the very end of the year and so the criticality of these model approvals was paramount for us. We greatly appreciate the time and effort contributed by your team to facilitate these reviews.

[Redaction]

· The discussions surrounding the index hedges of own credit were protracted because we had very strongly held views. Of course, the FSA has the ability to set rules and we respect the outcome of those discussions.

· We believe the concern you mention regarding capital stress tests refers to two separate but parallel requests from last year to assess the effect of EBA capital definitions: 1) an FSA request to ascertain whether 10% CT1 could be achieved by mid-2012 using a constant balance sheet and Basel 2.5 for December 2011 and 2) an EBA stress test request to estimate CT1 for June 2011 assuming the early adoption of Basel 2.5. Although both requests were related, we thought we were clear where differences existed in our responses because of the slightly different requests. We did not intend to mislead in any way and we will ensure that we communicate more clearly in the future.

Finally with regard to the UK tax issue, we fully understand the potential damage to our reputation. On the other hand, as tested recently through a third party review, our tax procedures are robust and sound but no procedure can guard against retroactive tax law changes. We acknowledge that this is not a comfortable place for us to be. Despite our voluntary disclosure to HMRC of the transactions, they did not inform us of their intention to change the law.

I appreciate your taking the time to write. I can assure you that the points you have raised have my full attention as well as the Board's. We are committed to ensuring the full cooperation of all levels of our Executive when engaging with the FSA and we take these matters very seriously, particularly as they relate to the transparency and openness of our interactions.

Yours sincerely,
[Signed]
Marcus Agius

13 APPENDIX SIX- Daily Telegraph Flaws

13.1 Coalition Admits Concerns Over 'Flawed' IFRS

The Government has admitted it has been notified of concerns over Britain's financial reporting standards, particularly over banks, and has pledged to review the system before it is extended.

Tom Bush claims the root of the 'fatal flaw' lies in the adoption of the new IFRS accounting system to work alongside the Companies Act.

By Louise Armitstead, Chief Business Correspondent

Following **revelations in *The Daily Telegraph*** on Thursday that a senior accountant had informed ministers of his worries that British banks were adhering to flawed rules, the Department of Business (BIS) said that he was "not alone in expressing the concerns".

Tim Bush, a member of the Urgent Issues Task Force that reviews the work of the Accounting Standards Board (ASB), **wrote a letter to the BIS** last week describing a "regulatory fiasco" in bank company reporting.

He claimed that the ASB had "not fully understood" the International Financial Reporting Standards (IFRS) and implemented a system in the UK that was both different and flawed to the one adopted elsewhere in Europe.

A BIS spokesman said: "We can confirm BIS has received the letter from Tim Bush and we have noted his analysis of the impact of IFRS during the credit crisis. Tim Bush is not alone in expressing these concerns either in the UK or internationally."

The ASB has proposed rolling out the IFRS standards, which currently only apply to listed companies, more broadly, including to small and medium-sized firms.

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- UK bank accounting rules 'fatally flawed'

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Mr Bush, whose letter was in response to a consultation on the roll-out, claims that the IFRS standards fail to reflect accurately the level of cash within a company.

Although all companies across Europe applied the standards for group accounts, the UK was in a minority by allowing the system also to be used to audit subsidiaries.

He argues that while accounts were distorted in other countries, the UK was "doubly" hit by inaccurate audits. He claims that directors and regulators failed to notice the build-up of risks within the banks.

In a letter to *The Daily Telegraph* on Thursday Ian Mackintosh, chairman of the ASB, defended the body and dismissed Mr Bush's claims as "simply wrong".

He wrote: "The ASB is made up of eminent and experienced professionals and it is both consultative and responsive to market need. The point Mr Bush makes about IFRS adoption is simply wrong."

Mr Mackintosh added: "An ASB consultation on the future of [UK accounting regulations] over the last six years has led us to believe that the blending of IFRS for small and medium-sized firms into UK GAAP is the best way forward."

He was backed by Pauline Wallace, partner at PriceWaterhouseCoopers and also a member of the ASB. She said: "These rules have been reviewed before and we believe IFRS not only helped during the crisis but is the best system going forward."

However, other accountants have admitted Mr Bush's analysis is correct. One senior accountant said: "He is in completely right. There is a real problem with IFRS, not just internationally, but specifically in the UK and specifically with banks."

A senior director of an influential City group added: "This is a controversial subject. But [Tim Bush's] analysis is both good and very important. There is certainly an issue here than needs to be addressed urgently.

"It's more cock-up than conspiracy but it's vital these standards are fit for purpose and before they are rolled out to other companies, I can't see how a full review can be avoided legitimately."

14 APPENDIX SEVEN

15 Ireland central bank governor Patrick Honahan attacks 'unsatisfactory' accounting rules for banks

The Governor of the central bank of Ireland has described the accounting rules for British and Irish banks as "unsatisfactory" in a speech that will be used to back the argument for some of the standards to be scrapped.

Patrick Honahan has 'railed against the backward-looking loan-loss provisioning practises' that IFRS requires Photo: PA

Patrick Honahan, who addressed the Chartered Accountants of Ireland on Tuesday, criticised the way in which the International Financial Reporting Standards (IFRS) reports risks within banks.

Discussing the banking crisis that has engulfed Ireland, he told the accountants that he has "railed against the backward-looking loan-loss provisioning practises" that IFRS requires.

He said: "I find it unsatisfactory that expected losses in many parts of the portfolio are clearly higher than the provisions already taken because I fear that this evident and in some cases explicit discrepancy may awaken doubts in the minds of investors as to the relevance of other aspects of the reported accounts."

The Governor called for banks to be more transparent about their balance sheets. Suggesting that "disclosure practices by Irish banks were formed during good times", he called for banks to "build confidence by going further, to disclose much more information to the market".

His comments on IFRS are already being seized upon by critics who have argued that the current rules have disguised the build-up of risks within banks.

One source said: "The Governor should have gone further and called for IFRS to be dismantled entirely."

City veteran Tim Bush has sparked controversy by claiming that IFRS allowed banks in Britain and Ireland to unwittingly "produce false profits and overstated capital" which then "misled creditors, misled shareholders, the Bank of England, the Financial Services Authority and others". The claims were made in a letter to the Treasury revealed by *The Daily Telegraph* in August.

The Accounting Standards Board and a range of accountants have dismissed Mr Bush's theories and all suggestions that the rules contributed to the financial crisis.

However, Lord Lawson, who sits on the House of Lords Economic Affairs Committee, this week told the Big Four that this denial "seems to be extraordinarily self-satisfied in light of what we know to be the case".

The Committee, which is investigating the role of auditors in the financial crisis, asked the representatives of the four firms to respond directly to the theories that have been raised by Mr Bush within the next few weeks.

Who is going to hold the ECB accountable for this mess?

At the Banking Inquiry Ajai Chopra agreed that our debt burden was unfair, but is there any kickback, asks Colm McCarthy deputy director of the IMF leaving the Banking Inquiry

16 APPENDIX EIGHT:

16.1 Colm McCarthy

Ireland's two-year bank guarantee introduced at the end of September 2008 was meant to cost nothing at all. The banks were solvent, people were assured. They were just temporarily short of liquidity due to some incomprehensible snafu at banks in New York. This was not credible at the time and was not widely believed. Every single domestic bank duly went down in one of the biggest bank busts ever recorded anywhere. Through 2009 and into 2010, the Government scrambled to keep the system functioning, principally through injecting vast quantities of taxpayer's cash. Meanwhile, the Government's own deficit soared, adding to the State debt. Several other governments around the eurozone struggled to borrow on the bond market.

The first country to go under was Greece, the recipient of a 'bailout' in May 2010 as the troika of European Commission, European Central Bank and International Monetary Fund made its inauspicious debut. The IMF, a credit union for governments, had never before accepted a junior role with regional bodies in mounting financial rescues of members in trouble. It is unlikely ever to do so again given the bruising (third) re-run of the Greek crisis, and some of the reasons were in plain view at the Banking Inquiry last week.

On Monday, it was announced that the ECB had declined to attend the inquiry. Its retired former president, Jean-Claude Trichet, turned up for a curious performance, not at the inquiry proper but at a contrived meeting in Kilmainham on April 30 last. Trichet was questioned by inquiry members but was conceded the bizarre privilege of vetting the questions in advance, which did not inspire him to offer candid or informative answers.

On Thursday, Ajai Chopra, who headed the IMF team on the Irish programme, turned up at the inquiry proper and performed as an international civil servant (retired) might be expected to do. He explained, he was candid and he answered questions sight unseen. The contrast with Trichet was impossible to miss.

Trichet's ECB was a less than sure-footed practitioner of the delicate art of the financial rescue programme. By the summer of 2010, the botched troika surgery in Greece, pushed through against opposition from many IMF staff, was creating nervousness in the next batch of potential patients.

The next patient was Ireland and the outcome very different. Had the Irish programme failed, and it could easily have done, Chopra's evidence on Thursday makes it clear that it could very well have been the ECB's fault; not Jean-Claude Trichet's personal fault, to be fair: it appears that Trichet operated throughout in accordance with the policies of the ECB's governing council.

Most of the eventual debt load in Ireland arose from the accumulation of budget deficits, but the extra costs of bank rescue made a bad situation desperate.

The expiry of the guarantee in October 2010, provided the opportunity to impose losses on rash investors in unsecured bonds issued by Irish banks, all of which had to be rescued and some of which were in process of closure.

For the record, Anglo lost about eight times its capital, Nationwide even more. The ECB (for practical purposes Ireland's central bank) insisted that these investors be paid in full, courtesy of the (bust) Irish exchequer. This was done, incredibly, subsequent to the country's resort to official lenders. A country whose debt was admitted to be unsustainable without official financing was required (by its own central bank) to pay unsecured and unguaranteed creditors of bust banks to whom it did not legally owe any money.

This additional debt burden made the success of the programme less likely and was naturally opposed by the IMF team. In all of its history I am not aware of a single instance in which the IMF extended loans to a troubled member only on condition that the country should borrow some extra funds to pass along to unsecured creditors of failed private institutions.

The ECB's insistence on this unprecedented condition, apparently motivated by concerns about the fragility of continental European banks, was opposed without success by the IMF team, who were over-ruled at political level. It threatened the programme directly, through the imposition of extra exchequer debt, but also indirectly.

Public acceptance of fiscal consolidation - tax increases and expenditure cuts over a period of years - is weakened through any perception of unfairness in the distribution of the burden of adjustment.

The public saw the pay-outs to bondholders in zombie banks as unfair and so did the IMF. Ajai Chopra described the imposition in precisely those terms on Thursday and questioned why the Irish taxpayer should have picked up the bill for reassuring lenders to banks in the broader eurozone.

The ECB has never answered this question, relying instead on a far-fetched argument, for which there is no empirical support that a bust state which adds to its debt by paying billions to people to whom it does not owe any money thereby becomes a better credit risk.

If Ireland had declined to pay these creditors of failed private banks, its sovereign creditors would have been discouraged, according to this intriguing doctrine. The country owes you money, you are nervous, they borrow more to dish out to people with no claim, and you are emboldened to lend to them again, apparently. It is sobering to think that this remarkable notion has been promulgated by both the ECB and the European Commission, and given a hearing in Ireland by numerate people.

The ECB and the European Commission hampered the prospects for a successful Irish programme in other ways. At no stage, even after its agitation for a programme had

succeeded, did the ECB indicate a longer-term commitment to funding the Irish banks, which could have mitigated the need for such funding. Both institutions proceeded as if the Irish problem was essentially one of fiscal excess, as in Greece, rather than a monster banking bust, which it clearly was.

At times, the ECB seemed to be thinking like a private bank, more concerned about its own balance sheet than it was about its role in promoting financial stability in Ireland. It did not even offer costless verbal support to the Irish banking system after the programme was in place. Both institutions appeared content with initial interest costs on the European loans well ahead of what looked to be sustainable.

In November 2010, IMF officials viewed the Irish programme as not being assured of success and their assessment was shared. A sharp recovery would have turned things round, but that did not happen. What did happen was Trichet's replacement with Mario Draghi at the helm in Frankfurt and the first piece of good luck Ireland enjoyed - Spain and Italy got into trouble in 2012. This was an existential crisis for the eurozone and serious measures were finally taken, resulting in an ECB backstop for eurozone sovereign bond markets.

The Banking Inquiry will report in January about the performance of the troika and its components in the management of the fallout from the Great Irish Banking Bust. If there are medals for accountability, I fancy the ECB for the bronze.