



Dublin Business School
excellence through learning

Course Title: MBA Finance [Part-time]

Supervisor Name: Mr. Michael Kealy

Assignment Title: MBA Finance Dissertation

Word count: 20'076 (from the introduction to self-reflection report)

Submitted by: Katerina Ryzhenkova 1633129

**The role of International Accounting Standard (IAS) 39
'Financial Instruments: Recognition and Measurement
in the Ireland's banking crisis.**

August 2013

Table of Contents

Abstract.....	4
Chapter 1: Introduction.....	6
Chapter 2: Literature Review	11
2.1 The Sources of Ireland’s Banking Crisis.....	11
2.1.1 Banks Business Policies & Strategies.	12
2.1.2. Evidence of herding behaviour in banking industry.....	15
2.2 The sources of EU Banking crisis.	16
2.3 Adoption of International Financial Reporting Standards (IFRS) in Europe.....	18
2.3.1 International Accounting Standard (IAS) 39 ‘Financial Instruments: recognition and measurement’.....	20
2.3.2 Review of the IAS 39 “Incurred loss” model.....	22
2.3.3 Review of the loan impairment provisions requirement under IAS 39.....	23
2.4 Fair Value Accounting: a friend or foe?.....	23
2.4.1 Arguments against of fair value accounting.....	23
2.4.2 Arguments in favour of fair value accounting.....	26
2.5 Alleged controversy between International Accounting Standards (IAS) and company law.....	28
2.5.1 Martin Moore QC legal opinion and Companies Act requirements for financial statements.....	29
Chapter 3: Methodology.....	33
3.1 Research Questions	34
3.2. Research Methodology.....	35
3.2.1 Research philosophy.....	36
3.2.2. Research approach.....	36
3.2.3 Research strategy.....	37
3.2.4 Research Choice.....	37
3.2.5 Time Horizon.....	38
3.2.6 The choice of method is qualitative research.....	38
3.2.7. Non-probability purposive sampling:.....	39
3.3 Ethics:.....	39
3.4 Limitation:	40

Chapter 4. Data Analysis, Findings and Conclusion.....	41
4.1. Analysis of the impact of the Held for Trading and Available for Sale (AFS) Financial Instruments in the Ireland’s Banking Crisis.	42
4.1.1 Analysis of the fair value - quoted prices in an active market (mark-to-market).....	43
4.1.2 Analysis of the fair value valuation models.	44
4.2. Analysis of the impact of the Held to Maturity (HTM) and Loans and receivables Financial Instruments in the Ireland’s banking Crisis.	46
4.2.1 Analysis of the Held to Maturity Financial Instruments (Assets).	47
4.2.2 Loans and receivables Financial Instruments in the Ireland’s banking Crisis.	47
4.2.3 Analysis of IAS 39 loan’s impairment requirements.	48
4.2.3a Analysis of IAS 39 ‘incurred loss’ model.	49
4.2.3b Interpretations of ‘objective evidence’ IAS 39’s requirement by banks.	50
4.2.3c Analysis of the critical assumptions made by Irish banks during the 2008-2009. ...	52
4.3 Conclusion.....	54
Chapter 5. The Self-reflection on own learning and performance.	58
Bibliography.....	63
Appendices.....	71
Appendix 1.	71
Appendix 2.....	73
Appendix 3.....	75
Appendix 4.....	77
Appendix 5.....	78
Appendix 6.....	107
Appendix 7.....	125
Appendix 8.....	148
Appendix 9.....	170

Abstract.

This research is focused on the role of the International Accounting Standard (IAS39) 'Financial Instruments: Recognition and Measurement' in the Ireland's recent banking crisis. Specifically it sought to answer the following questions:

Whether any limitations exist in the IAS39? What role existing limitations in IAS39 had on the Ireland's banking crisis? Was IAS39 a contributing factor in the Ireland's banking crisis?

Qualitative research was conducted in order to investigate in depth the specific requirements, models and concepts fundamental to IAS39. Interviews were conducted with five highly qualified accounting professional employed by prominent international accounting firms.

In particular this research analysed the fair value measurement requirement imbedded in IAS39 for two out of four categories of the financial instruments; 'objective evidence', 'Incurred loss' model and financial instruments impairments requirements under IAS39.

After the examining IAS39 in great details and analysing opinions of the interviewees this research came to conclusion that IAS39 contained some limitations associated with unclear requirements for the financial instruments impairment and loss provisioning. 'Incurred loss' model which is fundamental to the impairment recognition in IAS39 have not allowed institution to recognise more losses earlier. The 'objective evidence' requirement in IAS39 is very flexible and allowed institutions to interpret the loss events with different degree of conservatism. This research therefore conclude that IAS39 had contributed to the way banking crisis was reported and stretched recognition of losses over a prolonged period of time, but it was not a root cause of the Ireland's banking crisis.

Due to the sensitivity and debate which is still continuing on this topic and due to the high positions in the prominent international accounting firms and their association with the banking industry all interviewed accountants will remain anonymous and be referred to as Accountant 'A', 'B', 'C', 'D' and 'E'. Their input and assistance with this research in to the role of the IAS is invaluable and research would not be completed without their kind assistance. The identities of the interviewees are known to my Dissertation Supervisor.

Acknowledgement

I would like to express my sincere gratitude to all my lecturers for their continuous support and guidance over the last two years. I would especially like to thank my dissertation supervisor Michael Kealy for his continuous motivation, support, guidance, critical advice and patience.

I would also like to express my sincere thanks to my excellent interviewees for giving up their time and providing me with their expert knowledge and insights on the Irish banking institutions.

Last but not least I want to thank my family and friends, work colleagues and my employer for all the support, understanding and help that they gave me while I worked on this thesis.

Chapter 1: Introduction

Ireland is currently recovering from one of Europe's worst Banking collapses following the US financial crisis in 2008. The recession and austerity measures are still felt everywhere in the country. Rising unemployment and a lack of available jobs led to many foreign and Irish people leaving the country in search of employment elsewhere. Three Ireland's major banks: Bank of Ireland (BOI), Allied Irish Bank (AIB) and Anglo Irish Bank (Anglo) had to be nationalised to avoid complete collapse of Ireland's banking system. Much controversy surrounded the extent of possible losses and the cost of the bailout for the three banks. The initial assessment of the cost of nationalisation of €7.5 billion proved to be inadequate and further injections of government funds were required to keep the banks afloat with the current total bailout cost, as at July 2013, reached €62 billion.

Needless to say the lending banking practises of the Irish banks were much investigated and alleged to be the main cause of the Irish Banks collapse (Honohan, 2010; Regling and Watson 2010; Nyberg, 2011).

Following the banking crisis of 2008 the Irish Government and Department of Finance commissioned investigations into the causes and sources of the failures in the Irish Banking system. Three comprehensive reports were subsequently issued between 2010 and 2011. The Minister for Finance has commissioned two of these reports. The first report conducted by Klaus Regling and Max Watson (2010) which deals with macro-economic developments internationally and in Ireland, as well as the role of markets, policies and institutions. The second report conducted by Governor of the Central Bank of Ireland Patrick Honohan (2010) concentrated on the role of the authorities (the Financial Regulator (FR) and the Central Bank (CB)) in relation to financial stability policy. It also looked at banking regulation prior to the

crisis, as well as the events leading up to the Government bank guarantee decision announced on September 30, 2008.

Following consultation with Ireland's Central Bank and the Financial Regulator The Irish Government put in place, effective immediately (30th September 2008), a 'blanket' guarantee arrangement to safeguard all deposits (retail, commercial, institutional and interbank) and liabilities: covered bonds, senior debt and dated subordinated debt, with the major Irish banks; Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society. The guarantee was in effect on existing and new facilities for the period of up to 28th September 2010 and later was extended up to March 2013.

"Government's objective in taking this decisive action is to maintain financial stability for the benefit of depositors and businesses and is in the best interests of the Irish economy" (Department of Finance , Press release 30/09/08).

The guarantee decision was a significant move by the Irish government to safeguard national banking system following the global financial crisis. It also turned out to be very costly for the taxpayers as mentioned before. In a recent press release on 26 February 2013 while announcing the end of the guarantee Ireland's Minister for Finance Michael Noonan said "The Irish banking system failed the Irish people and the mismanagement of the banks and the crisis has cost the Irish taxpayer over €62 billion" (Department of Finance, 26 February 2013 press release).

The final report investigating causes of the Irish banking crisis was conducted by Peter Nyberg who was commissioned by Irish Government in January 2010 to assess actions and practices in the banking sector along with the Central bank and Financial Regulator practices.

The findings of all three reports identified the main causes of the crisis to be 'home-grown', singling out actions and decisions made within Irish Banks as the main causes of the Ireland's Banking crisis with additional contribution from the global financial crisis pressures and failures of regulatory and supervisory authorities (Honohan, 2010; Regling and Watson 2010; Nyberg, 2011).

Other authors in Ireland and European Union (EU) have also pointed out that the accounting standards, and in particular the International Financial Reporting Standards (IFRS) which are compulsory for the financial reporting in the EU for all listed companies since 2005 had played a significant negative role during the crisis. Cormac Butler, a UK based consultant of Regulatory risk and financial reporting and the author of ‘Accounting for Financial Instruments’ argues that “EU negligence on accounting standards allowed Irish banks to legitimately concealed losses from regulators and shareholders in the run-up to the banking crisis” (Butler, 2013, January 21, p.1). According to Butler certain accounting standards allowed banks (particularly in Ireland and Britain) to conceal losses on some troubled loans until they were realised.

This view is also shared by the Bank of England. The ‘Financial Stability Report’ issued by the Financial Policy Committee (FPC) of the Bank of England in November 2012 identifies in particular signs of overvaluation of assets on Bank’s Balance sheets and suggests that expected future losses on some Banks loans were unrecognised and under provisioned. In particular Bank of England points out that “incurred loss” accounting rules mean that provisions can only be made where there is evidence that current or imminent impairment will reduce the present value of loans. As such, banks have limited ability to fully provision for expected losses” (Bank of England, Financial Stability Report, 2012, p.19).

However not everybody agree that International Accounting Standards had a negative impact on the banks financial reporting requirements in the years prior to the Banking crisis. Sir David Tweedie, who was a chairman of the International Accounting Standards Board (IASB) between 2001 and 2011, asserts in The Telegraph article ‘Bank of England is wrong on accounting rules, says Sir David Tweedie’ by Louise Armitstead in January 2013, that “Bank of England was wrong to think the International Financial Reporting Standards (IFRS) prevented banks from making proper provisions against bad loans” and in demanding changes to accounting standards. He admitted that in 2008, the IASB had recognised that banks needed to make more loss related provisions; however, he insisted that accounting rules wasn’t at fault but rather “banks and their efforts to get around them” (2013, p.1).

Financial institutions in Ireland are subject to extensive regulation and supervision from the Central Bank, Financial Regulator and Irish Stock Exchange. Their annual financial statements

are audited by ‘The big four’ internationally recognised auditing firms to make sure that the financial statements are properly prepared and give a true and fair view in accordance with International Accounting Standards as adopted by European Union from 2005. These standards are mandatory in the preparation of financial statements by all listed companies in European Union. They also ensure that the accounts are properly prepared in accordance with Ireland’s Companies Acts, 1963 to 2006. Those respected firms in the years up to the crisis auditors of all largest Irish Banks concluded that the banks’ financial statements were properly prepared and gave a true and fair view in accordance with International Accounting Standards and were properly prepared in accordance with Ireland’s Companies Acts, 1963 to 2006.

This ultimately means that the auditors who had conducted extensive examinations and verifications of the banks’ annual activities and transaction and their respective values and balances, in the years before prior to the crisis, have confirmed that banks had fully complied with International Accounting Standards in preparation of their financial statements in those years 2005 to 2008. The question is therefore arises about the adequacy of those accounting standards.

Consequently, this researcher is interested in investigating whether limitations existed within the International Accounting Standards during the crisis in 2008 and if these limitations were a factor in the sudden deterioration of Irish financial institutions in 2008-2009. In particular, this researcher is interested whether the alleged limitations of the new EU (after 2005) IAS requirements for the banks’ loan book loss provisioning and impairment had a critical role in Ireland’s banking crisis.

In setting the above mentioned aims and objectives for this research it will contribute to the existing literature on the causes of Ireland’s banking crisis in the following way: by examining and analysing requirements of IAS 39 for loss provisioning and impairment and by analysing resulting financial statements of the two Irelands largest banks for the year 2009. This research will conclude whether International Accounting Standards (IAS) have contributed to the Ireland’s banking crisis.

The research undertaken by this researcher in order to achieve its objectives will proceed as follows.

Chapter 2 of this research will examine existing literature that is relevant to the research objectives themes. In particular this section will summarise business policies and strategies in the Irish banks prior to the crisis as this was named in the prior researches (Honohan, 2010; Regling and Watson 2010; Nyberg, 2011) as a main cause for the Ireland's banking crisis. Sources of the EU Banking crisis will also be reviewed to get a fuller picture about the generally accepted causes of the Banking crisis within the European Union (EU). This is particularly interesting in the context of the present research because International Accounting Standards are mandatory for all listed companies within the EU. Hence all banks in the EU have to apply IASs for the preparation of its financial statements. Therefore conclusions of the reports in to the sources of EU Banking crisis may also be relevant to the causes of Ireland's banking crisis.

Also in this section the general background and events surrounding the adoption of the IASs/IFRSs by the EU will be reviewed. It will also examine in detail IAS39 'Financial Instruments: Recognition & Measurement', as this is the particular accounting standard which specifies how financial instruments (assets and liabilities) must be recognised, derecognized and measured. Financial instruments under IAS39 have to be recognised either at fair value or amortised cost. Fair value as defined in the IAS39.9 is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" (IFRS, 2009, p.2001). IAS39 has huge implications for the banks profit and loss reports and their balance sheet, because financial instruments (assets) are the largest part of the banks overall assets. It is important in this researcher's opinion to examine all models/concepts used in the IAS39. Such as 'incurred loss' model as this is used for the impairment recognition, fair value and amortised cost models as this is how the financial instruments are measured and the loss impairment requirements calculated.

Chapter 3 will explain the most appropriate methodology that was used in order to complete the comprehensive research of the topic. It also includes ethical and legal principles for completing this research.

Chapter 4 will provide the discussion on the findings of the primary data gathered from the publically available annual reports of the three Irish banks: Bank of Ireland, AIB and Anglo-Irish Bank, The Central Bank of Ireland quarterly statistical reports on Ireland's Credit Institutions. It will also discuss the findings gathered in-depth discussions with five highly qualified accounting professionals who are currently hold high level positions within the top five global accounting firms and the International Accounting Bodies based in Ireland.

Overall Qualitative Research Question

The overall research question is whether International Accounting Standards and in particular IAS 39 played a critical role in the Ireland's Banking crisis.

Overall Qualitative Research Objectives

The overall research objective is to explore the role and effects of International Accounting Standards IAS 39 in Ireland's Banking crisis.

Chapter 2: Literature Review

2.1 The Sources of Ireland's Banking Crisis.

Following the Banking crisis of 2008 the Irish Government and Department of Finance commissioned investigations into the reasons why the Irish Banking system failed. Three comprehensive reports were subsequently issued between 2010 and 2011. The Minister for Finance have commissioned reports of Klaus Regling and Max Watson which deals with macro-economic developments internationally and in Ireland, as well as the role of markets, policies and institutions. The report by Governor Patrick Honohan which concentrates on the role of the authorities (the Financial Regulator and the Central Bank) in relation to financial stability policy and regulation prior to the crisis, as well as the events leading up to the Government Guarantee decision of September 29, 2008.

The final report of Peter Nyberg was commissioned by the Irish Government in January 2010 and dealt with actions and practices in the Banking sector along with the Central bank and Financial Regulator.

The findings of all three reports identified the main causes of the crisis to be 'home-grown', singling out actions and decisions made within Irish Banks as the main causes of the Irish Banking crisis, with additional contribution from the global financial crisis and failures of regulatory and supervisory authorities.

While business practices at the Irish banks were found to be the main causes of the Banking crisis, Nyberg (2011) also highlighted the financial reporting standards change in the period beginning from January 2005 up to the banking crisis and in particular he noted the shortcomings of the new loan-loss provisioning process for banks. The objective of the new rules was to reduce subjectivity in the preparation of financial statements and, in the case of banks, to have a more objective loan-loss provisioning process. Nyberg notes however that new accounting rules proved to be pro-cyclical and in the period prior to 2008 reduced banks' ability to make more prudent general loan-loss provisions, or anticipate future losses in their loan books, particularly in relation to property lending in a rising property market. He states that the change in accounting rules led to a reduction of provisions made by banks as provisions could only be made where objective evidence of impairment existed at the closing balance sheet date and "General provisions, which tended to produce a "smoothing" of a bank's results from year to year, could no longer be made" (2011, p.42). As a result, loan-loss provisioning charges on loans in the covered banks¹ got reduced between 2001 and 2007 from €5bn to €1.7bn per annum (2011, p.43).

The following section will cover the banking policies and strategies that have been highlighted as the main causes of the Irish banking crisis.

2.1.1 Banks Business Policies & Strategies.

¹ Covered banks are financial institutions covered by Irish Government guaranty of 30 September 2008.

“Systemic financial crises, like the recent Irish one, require a great number of institutions, enterprises and individuals to simultaneously follow unsound policies or practices”

P.Nyberg (2011).

In responding to increased competition from Anglo Irish Bank (Anglo) and pressure from shareholders and management for higher profits, banks set aggressive targets for profit growth. According to Nyberg (2011, p 88) this drive for profits growth rarely implied corresponding necessity to change business model and strategy and strengthening of governance and procedures.

With time it led to a gradual adoption of lower credit standards by Irish Banks as a strategy to sustain market share and profitability.

“In some covered institutions this strategy was consciously adopted by the board and was properly delimited. In other banks, boards seem to have simply decided on higher target growth rates, with little apparent realisation of the attendant risks... Bank loans have expanded very rapidly because neither banks nor borrowers apparently really understood the risks they were taking. Property-related lending was seen as “really the only game in town” for growth-oriented banking. The purchase of second or more properties by individuals was seen as “a no-brainer” P.Nyberg (2011, p.ii).

This behaviour was largely due to a comfort of several years of unprecedented economic growth and stability. There was also the feeling among the general public that this was the best time to get onto the property ladder or to trade. Households, investors and lenders had seen their incomes and wealth increase substantially; easy access to credit only encouraged belief in a never-ending boom.

“The few that admitted to feeling any degree of concern at the change of strategy often added that consistent opposition would probably have meant formal or informal sanctioning” Nyberg (2011, p.V).

Nyberg further states that both sides of the market assumed that the other side knew what it was doing. Hence ensuring continued growth, profitability and funding in the market in the short term. A so called self-reinforcing spiral developed: increase in property prices and values caused increased speculative buying of housing and land; evaluations were based on these higher prices;

this increased the demand for bank lending, which in turn increased prices as more funding was made available (Nyberg, 2010).

Once the housing prices reached their peak in 2007 and as bank funding dried up, the credit-driven property development sector began to experience liquidity problems. From then on, the link between property prices and funding accelerated the downturn spiral development and reduced banks' creditworthiness.

It is evident from the P.Nyberg's report that so called "herding" existed within the Financial Market in Ireland prior to crisis. This would explain why all the largest domestic Banks failed simultaneously. Herding implies that the management of different banks implicitly follow each other's strategies with little or no analysis. The most obvious explanation for this is the pressure to retain market share and achieve similar profitability as competitors and to earn bonuses in the case of the banks management.

"Herding" refers to the willingness of investors and banks to simultaneously invest in, lend to and own the same type of assets, accompanied by insufficient information gathering and processing. While often superficially resembling the normal process of competition, herding implies lack of rigorous analysis by members of the herd. Some of the participants in a herd have only a partial idea of the economic advantages and disadvantages of a particular course of action – for instance, investing or property lending. However, they assume that others have a clearer view and follow them, thus demonstrating what is commonly referred to as a bandwagon effect" P.Nyberg (2011, p.7.)

The cause of Ireland's banking crisis may be summarised as follows. Cheap and easily accessible funding was made available to credit institutions; they in turn made this easily accessible available to individuals and investors which in turn created a continuous demand for housing and commercial properties which in turn increased the property prices and demand for further funding. In the race to achieve similar profitability as competitors, not to surrender market share and to increase their share price banks lowered their credit lending criteria to allow for the increased demand for new customers. These actions by market participants created unsustainable upwards spiral.

The authorities who had the power to control the ever growing property bubble, the Central Banks and Financial Regulator did very little and often nothing to take the situation under control and assumed the role of silent observers, perhaps because it was widely accepted in the years prior to crisis that the financial market and regulatory policies were influenced by the efficient market hypothesis. “This paradigm was widely accepted, particularly in the US and UK, and provided the intellectual underpinning for financial innovation and reduced regulation. One important consequence of the concept was the assumption that self-regulating financial markets tended to remain stable” P.Nyberg (2011, p.4). Hence it is agreed in all three reports that the events of September the 2008 were only a catalyst for the eminent ‘home-grown’ crisis within Ireland’s Banking.

2.1.2. Evidence of herding behaviour in banking industry.

In an environment where there is an absence of clearly defined instructions for the loans and loan losses accounting in IFRS and an increasing reliance on management’s judgement it is imperative to examine management behaviour through the economic cycle to examine how they make decisions.

There is an overwhelming interest in the literature on the banks behaviour throughout the economic cycle. Diamond & Dybvig (1983) made an initial connection of banks behaviour with herding. Haiss (2005) had synthesised dozens of previous researches into herding behaviour of banks during credit crunch, financial crises, bank runs and currency crisis. He notes that bankers, tend to construct their respective reality together by way of interaction, i.e. they seem to develop common rules of behaviour through interaction with each other. In another research, Crook (2003) states that “if information about underlying values is absent or unusual, bankers are likely to become preoccupied with the views of others in the financial community. In extreme cases, the views of other market participants are taken seriously even when flatly contradicted by facts as may be readily available. Group pressure may rise by bringing certain moves and investments in fashion. From time to time, such mental aberrations are even dignified by being presented as “schools of thought”: from “momentum investing”, “cash-burn-rate” to the “new economy” (Crook, 2003).

The herding behaviour is also noted by Nyberg (2011) who argues with reference to the Ireland's banking crisis that the crisis of this proportion require many institutions, enterprises and individuals to simultaneously follow unsound policies or practices.

Lending practices of Ireland's financial institutions prior to the crisis were subsequently heavily criticised by authorities. The two biggest banks were under pressure to sustain or grow their market share and to report similar or higher profits as a rapidly growing Anglo-Irish Bank. Consistent with herding theory mentioned above Irish banks engaged in the unhealthy lending behaviour and greatly reduced their lending criteria. During the favourable economic conditions this helped banks to greatly boost their earnings with little apparent risk of default by borrowers as long as the property prices were going up. The whole country got involved in exacerbating the economic boom. While property prices were going up and unemployment was very low and other economic indicators are favourable there was little need for banks to anticipate and provision for loan book impairment. Therefore IAS39.59, which provide specific instructions how loan impairment is recognised, was never tested.

Once Ireland's economic conditions began to deteriorate in 2008, housing prices began to fall and unemployment increased dramatically, mainly due to layoffs in the previously booming construction industry. Banks were faced with situation where the default on both residential and commercial loans became increasingly probable. However according to IAS39 loan impairment rules banks were not permitted to provision for expected losses even though it was obvious that losses were very likely.

2.2 The sources of EU Banking crisis.

Monetary policy for the 17 member states is determined by the European System of Central Banks (ESCB), which includes the European Central Bank (ECB) and the national central banks. The ECB and all national central banks are independent from the governments. The primary objective of the ESCB is to maintain price stability by safeguarding the value of the euro. ESCB is also responsible, for supporting the EU's economic policy, maintaining the low level of

inflation and sound public finances (Howells, 2008). The supervision of the credit institutions and stability of the financial systems remained with member states.

In 2008 following EU's financial crisis, European Commission requested a comprehensive report on the causes of the crisis and on the future of European financial regulation and supervision. The report provided by the group chaired by Jacques de Larosière identified that apart from the global financial problems; the causes of the crisis in EU were largely associated with existing banking and regulatory structures. In particular, according to the report (de Larosière, 2009) the following areas of EU structures/regulations were particularly weak.

Risk management at all levels including EU level.

The regulators, supervisors and entities failed in assessing the risk. The Basel 1 framework had not provided adequate structure for, and actually encouraged, pushing risk taking off balance-sheets. This was only partly corrected by the Basel 2 framework. Major growth of unregulated credit derivatives markets, which were supposed to reduce risk, but in fact added to it, is another example of ESCB failure to have adequate supervision over financial markets.

An over reliance on the Credit Rating Agencies CRAs; It has been identified that investors and firms' executives over-relied on the CRAs. The EU and ECB failed to regulate these agencies and identify major conflicts of interest within the parties involved.

Regulatory, supervisory and crisis management failures; there were serious problems in the information exchange, general communication and collective decision making between ECB, national central banks, supervisors and finance ministries. For example in Ireland, according to an interview featured in the BBC documentary 'The love of money – back from the brink' B. Lenihan made an overnight decision about the full government guarantee for 6 major Banks in Ireland without any consultations with EU counterparties.

The crisis highlighted the limitations of the supervisory structures that existed globally, within the EU level and on an individual national level. Derivatives markets grew rapidly and off-balance sheet vehicles were allowed to expand dramatically. Many of EU financial institutions

had accumulated – often in off balance-sheet constructions – extremely high exposure to highly complex CDO's which later become illiquid.

EU supervisors had no adequate structures or policies in place to assess the extent of exposure of the subprime risk in EU-based financial institutions or EU financial market as a whole (de Larosière, 2009).

In this research I will explore the role of EU's accounting rule and in particular IASB's accounting standard IAS39 in Irish Banking crisis with similar implications for the wider EU area.

Examining if the EU's accounting rules was a factor in causing or exacerbating the banking crisis in Ireland and indeed in EU is imperative if one is comprehensive picture of possible effects that these standards had on the financial reports of the banks. All listed entities in EU countries, including Irish Banks, have been required to use accounting standards issued by IASB and approved by EU Commission since 2005. Hence the soundness of these rules is of the great importance and must be assessed in order to understand Banks reporting practices.

2.3 Adoption of International Financial Reporting Standards (IFRS) in Europe.

In June 2002, European Union (EU) Council of Ministers adopted a regulation on the harmonization of accounting standards in the EU under IFRS starting from 1 January 2005. The regulation EU IAS 1606/2002 made it mandatory for all publicly traded companies in the member states to adopt and report according to IASs/IFRSs beginning on 1 January 2005 (Chartered Accountants Ireland, 2009, p.8). This represented a significant shift from country-specific accounting standards to consistent for all EU member states standards.

The statutory instruments giving effect to the options available in Ireland are: European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005, SI No 116 of 2005 and European Communities (Fair Value Accounting) Regulations 2004, SI No 765 of 2004 (Irish Statute Book, online).

As a result of this regulation, two financial reporting frameworks are available in Ireland according to ‘International Financial Accounting and Reporting’ standards manual issued by Chartered Accountants Ireland (CAI) (2009, p.8). These are:

- Company law-based financial statements prepared in accordance with the formats and accounting rules of Republic of Ireland company law. The accounting standards are the Financial Reporting Standards Issued by Accounting Standards Board in UK; and
- Financial statements prepared in accordance with IASs/IFRSs issued by the International Accounting Standards Board (IASB) which is the only option for the listed companies whose shares are trading on the European market.

In theory harmonization of accounting standards in the EU member states should be beneficial for investors, entities and countries across EU alike. It eliminates the requirement for converting accounting information into a consistent format for comparing companies’ performance and thus facilitates free flow of capital and makes European market more globally competitive.

The IASs/IFRSs standards were issued by International Accounting Standards Board (IASB), a private international accounting standards setting body. The formal objectives of the IASB are to:

- “develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in the financial statements and other financial reporting to help participants in the world’s capital markets, and other users who make economic decisions” (Chartered Accountants Ireland, 2009, p.9).

The debate about the acceptability of IASs to all stakeholders’ continued for several years and ultimately centred on IAS39. European Banking Federation² (FBE) was one of the organisations continuously expressing its concerns with different aspects of IAS39 stating that the proposed

² European Banking Federation (FBE) is the voice of the European banking sector. It represents the interests of over 4,000 banks from the 15 EU Member States as well as Hungary, Iceland, Norway and Switzerland, with over 2 million employees and total assets of 20,000 billion euros.

rules would inflict needless volatility especially on the bank's balance sheet caused by cash-flow hedging and market value methodology for some assets and liabilities. In particular it stated in the letter FBE sent to IASB in June 2004 that:

"The present IAS39 hedging rules are not satisfactory and should be amended before the EU can consider endorsing IAS39. Otherwise it cannot be considered as providing fair and truthful information on the financial situation of companies that will use it, especially in the case of financial institutions" (FBF online,2004,p.1).

2.3.1 International Accounting Standard (IAS) 39 'Financial Instruments: recognition and measurement'.

IAS39 'Financial Instruments: Recognition & Measurement' is an accounting standard issued by International Accounting Standard Board (IASB) which outlines the specific requirements for the recognition and measurement of financial assets and financial liabilities. All listed companies in EU countries have been required to use accounting standards issued by IASB since 2005.

IAS 39 classifies financial assets into four categories which are valued either at fair value or amortised cost (IAS 39:45). The impairment of value of the assets is recognised either through profit and loss report or through reserves in the balance sheet. The four categories are as follows (IAS 39:9):

Financial Instruments Held for Trading: these are financial assets which are acquired for the principal purpose of selling in the near term or initially designated by the entity as at fair value through profit or loss. The impairment of value of these assets is recognised through profit and loss report (IAS 39:55).

Held-to-maturity financial investments (HTM): these are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity. HTM instruments are measured at amortised cost (IAS 39:46) and ones this financial instrument is derecognized or impaired the gains/losses are recognised through the profit and loss report (IAS 39:55).

Loans and receivables: these are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables financial instruments are

measured at amortised cost (IAS 39:46) and ones this financial instrument is derecognized or impaired the gains/losses are recognised through the profit and loss report (IAS 39:56).

Available-for-sale financial assets (AFS): these are non-derivative financial assets designated as available for sale or are not classified in any other of 3 above categories and is measured at fair value (IAS 39:46). The gain and losses in this category are recognised through ‘Other comprehensive income’ (IAS 39:55) if it’s considered temporary. If however there is objective evidence that asset is impaired, the cumulative loss in ‘other comprehensive income’ shall be reclassified from equity (balance sheet) to profit and loss (IAS39:67).

Cormac Butler a consultant on Regulatory risk and financial reporting and author of ‘Accounting for Financial Instruments’ stated in his publication in The Irish Times “Evidence emerged last week that suggested European Union negligence allowed Irish banks to conceal losses from regulators and shareholders in the run-up to the banking crisis” (2013, p.1). By ‘EU negligence’ he means the accounting rules indorsed by EU and in particularly IAS39 which outlines how financial instruments and assets and liabilities must be measured.

In the UK, a House of Lords inquiry opened in January 2013 to examining why annual reports produced by Irish and UK banks were misleading. According to the Bank of England’s Financial Stability Report, Irish and UK’s Banks published accounts which concealed losses by overvaluing assets and the practice is still permitted by the EU (Bank of England, 2012).

According to Cormac Butler because of inadequate accounting standard between 2005 and 2010 insolvent and bankrupt banks presented their books of accounts as healthy and profitable (Butler, 2013). Gerard Flynn a lecturer at the Dublin Institute of Technology argues in his research examining banking regulation that Irish banks first dropped prudence when the IASB rules were rolled out in 2005. His view is backed up by Central Bank governor Patrick Honohan and confirmed by The Bank of Ireland (Butler, 2013).

However, “Between 2005 and 2010 a document called the IASB Framework reassured investors all entities must apply prudence. This document clashed with the accounting standard IAS39, another IASB publication. It tells auditors in very opaque language that banks can ignore prudence and override its reference in the framework” (Butler, 2013, p.2).

P.Honohan (2009, p.219) 'Resolving Ireland's Banking Crisis' noted in relation to banks solvency post crisis that as a result of constraints relating to accounting conventions (including International Financial Reporting Standards) banks accountants are "almost sure to overstate the true underlying value of bank capital.

2.3.2 Review of the IAS 39 "Incurred loss" model.

The largest part of the bank's balance sheets is represented by the loans to the different stakeholders. Under IAS39 category 'loans and receivable' is measured on an amortised cost basis. Deterioration of the loan quality is recorded in the profit and loss report through provisions for loss impairment. Adoption of IAS39 signifies a very important change in the EU and Ireland's banks recognition of loan loss impairment. Because IAS39 is an "Incurred loss" model it specifically instructed banks to provide only for incurred losses and disregard future expected losses regardless how likely they are. Ernst & Young in the paper 'The Impact of IFRS on European Banks (2005, p.19) raised a concern with 'incurred loss' model on the that basis.

This was a direct contradiction to accounting concept of prudence which requires the recognising of losses through profit and loss as soon as they become probable.

IFRS were adopted by EU with the main purpose of harmonisation of reporting and convenience in comparison for accounts reader. Hence a reader might assume that for example differences in bank loan impairment which is a key performance indicator (KPI) would not arise, however IAS39's loan impairment rules do not clearly state how quickly impaired loans must be written off. Therefore banks can exercise their judgement and hence a variation in approach is not surprising. While this may not be an issue in the 'good times', it certainly allowed banks to use this obscurity for earnings management during the economic downturn. Hence the benefit of consistent accounting standards for the reader of the banks accounting reports might be distorted by ambiguities within the standards themselves. The above argument is confirmed by Ernst&Young in their 'The Impact of IFRS on European Banks' (2005, p.27) who state that the

differences in the write off policies substantially effect some of the KPIs of banks and accounting reports of banks in different countries are not directly comparable.

2.3.3 Review of the loan impairment provisions requirement under IAS 39.

IAS 39 'Financial Instruments: Recognition & Measurement' specifies rules on how financial assets and liabilities must be recognised, derecognized and measured. It was compulsory for the use by EU listed financial institutions since January 2005. In particular IAS 39.59 explicitly instructs banks to only provide for credit risk at the level that was evident at the balance sheet date. Furthermore it specifies that expected post balance sheet date losses are not allowed to be recognised. However banks are allowed to make collective provisions for example for a group of loans in a same risk category on the basis of a wide range of economic and country specific indicators including: unemployment rate, mortality statistics, and commodities prices. This however gives rise to concerns by Ernst&Young ('*The Impact of IFRS on European Banks*' 2005, p.19), regulators and other practitioners that the lack of informed data would lead to under-provisioning and too much discretion in the judgment exercised by management and would lead to inconsistencies in financial reporting by EU banks.

2.4 Fair Value Accounting: a friend or foe?

Following the global financial crisis fair value accounting was heavily criticised especially in US for the credit crunch and banks failures.

2.4.1 Arguments against of fair value accounting.

Critics claim that where fair value is established with mark to market, while markets are illiquid, like during the 2008 crisis, fair value accounting forces banks to write down assets although these losses in value may never be realised if the bank was to keep these assets for a long term. Hence these synthetic write downs create further volatility in already stretched market, erode

banks capital, forces further selloff of assets creating the downward spiral for market prices and aggravate the write downs. For example, research in 2012 conducted by Bischof, Bruggemann and Daske into the effects of IAS39 amendment allowing for reclassification of assets out of fair value after October 2008 on to the banking balance sheets of 302 publicly traded IFRS-reporting banks concluded that as a result of the deterioration and subsequent illiquidity of the market, banks within the research sample, following the reclassification “ On average, increased their pre-tax net income by EUR 182.96m or by 43.7% after reclassification...The pre-tax impact on shareholders’ equity, which includes the additional effects from reclassification of AFS securities, is even larger (EUR 287.07m on average)” (2012, p.26). Above example clearly highlight the magnitude of the possible write downs of the assets value within the sample group if the fair value was used during 2008 and seem to confirm the argument that fair value accounting forces banks to recognise synthetic losses which may never realise.

This also is a general consensus with the Bank of France Financial Stability Report of October 2008 where Plantin, Spira and Shin argue that while market prices allow for timely signals that can aid decision making in the stable times, in the presence of distorted and illiquid markets, there are other effects that input artificial volatility to prices and distort decisions. “In a world of marking-to-market, asset price changes show up immediately on the balance sheets of financial intermediaries and elicit responses from them. Banks and other intermediaries have always responded to changes in economic environment, but marking-to-market sharpens and synchronises their responses, adding impetus to the feedback effects in financial markets” (2008, p.85).

Sighting the above problems with fair value accounting some of the critics have called for its suspension all together. William Isaac³, the former Chairman of the US’s Federal Deposit Insurance Corporation (FDIC) had placed the blame for financial crisis primarily with fair value

³ William Isaac was the member of the board of the Federal Deposit Insurance Corporation (FDIC) from 1978 and served as its Chairman from 1981 through 1985. He’s widely credited, including by President Reagan and former Fed Chairman Paul Volcker, with helping to maintain stability in the financial system during a period of severe stress. While at the FDIC, Isaac served as a member of the Depository Institutions Deregulation Committee, Chaired the Financial Institutions Examination Council, and served on the Vice President's Task Force on Regulation of Financial Services.

accounting for forcing the banks to make huge write downs of marked to market assets for which there wasn't an active market and the latest prices were at the fire-sale levels. In the interview to CNBC on 09th October 2008 Isaac stated:

“I would get rid of fair value accounting ...The SEC has destroyed \$500 billion of bank capital by its senseless marking to market of these assets for which there is no marking to market, and that has destroyed \$5 trillion of bank lending ...That's a major issue in the credit crunch we're in right now. The banks just don't have the capital to start lending right now, because of these horrendous markdowns that the SEC's approach required... (CNBC, 2008).

Critics also argue, that historical cost accounting, which states that an asset should be reported in the balance sheet at its cost (cash or cash equivalent amount) at the time of purchase is a better option than less accurate and unreliable valuation based on obscure value creation process by mixing present profit with unrealised gains and losses.

Another argument is that conservatism had always been a foundation for accounting profession and reliability was considered more important than relevance. However following the shift towards wider use of fair value accounting, accounting facts and verifiable values of assets and liabilities are now replaced by assumptions of hypothetical fair value with questionable accuracy. The conclusion of the Dixon & Frolova research (2013, p.328) in to current fair value challenges seem to confirm the above argument and state that following the fair value accounting standards reform “... financial statements have become factually opaque, with an illusion of mathematical rigor, and a density of mandatory disclosures. This raises daunting challenges for boards of directors tasked with fairly presenting the financial condition of the reporting business entity”. They further conclude that neither board of directors nor stakeholders of an entity can take for granted that prepared financial statement report fairly the financial position of an entity, as “neither management nor auditor can either affirm the correctness (truthfulness) of the fair value accounting estimates, or attest to the absence of unintentional financial misstatements in audited financial statements” (2013, p.328).

2.4.2 Arguments in favour of fair value accounting.

There are a number of arguments that exist in support of fair value accounting. Firstly the proponents argue that fair value accounting is more accurate than historic cost accounting because fair value more accurately represents the current value of assets and liabilities while historical cost accounting measures financial assets and liabilities at their origination value. This can lead to an inability for the creditors and investors to evaluate the real financial situation of the entity, as adjustments are not made for current changes in market value. Caruana and Pazarbasionlu state in the Bank of France Financial Stability Report of October 2008 that during the upturn, the historical cost accounting will lead to an undervaluation of the asset, and vice versa during the downturn the asset will be overvalued (2008, p.17).

Another argument in favour of fair value accounting is noted in the letter to SEC Chairman from the CEO and Directors of CFA⁴ Institute voicing their concerns about the pressure on the SEC to suspend the fair value accounting. In the letter CFA urges not to consider such action as it would be not in the investor and public interest. They went on to say that:

“No one disputes that these are trying economic times. However, the current crisis of liquidity, credit, and confidence was not caused by fair value accounting; rather, sound accounting principles helped expose the problem. Fair value accounting with robust disclosures provides more accurate, timely, and comparable information to investors than amounts that would be reported under other alternative accounting approaches” (CFA, 2008).

Recently a member of CFA Vincent Papa wrote an article entitled ‘Were Fair Value Accounting Concerns Overblown?’ concluding that fair value accounting has not caused the 2008 crisis. He asserted that fair value is the only accounting method that on a continuous basis can meaningfully inform stakeholders and other users of financial statements about company risk exposures and it is method that allows for maximum transparency in the financial reporting. He noted that over half the value of banking balance sheets consists of loans and leases, around 45-60 percent, and these are accounted for on an amortised cost basis. Therefore banks have likely overstated values of assets in their balance sheets and the large amounts of losses seen during the crisis were not fair-value related and the attribution of excessive write-downs to FVA is

⁴ CFA Institute is a global association of investment professionals. Was established in US in 1962. The organization offers the Chartered Financial Analyst (CFA) designation.

ungrounded. To further demonstrate this point Papa refers to research by Badertscher-Burks-Easton dated 2010 that provides empirical evidence from analysis of 150 commercial banks in US, showing that between September 2007 and December 2008 the proportion of Other-than-temporary-impairment (OTTI) was insignificant compared to the loans related losses. “There were \$19 billion losses of OTTI compared to \$214 billion of bad debt (loan relating) expense during this period” (Were Fair Value Accounting Concerns Overblown?, 2012).

The above argument is consistent with the research by Laux and Leuz in 2009. They note that although most of the debate is focused on the fair value accounting, the role of historical cost accounting (HCA) which impacts valuation of the loan book and other held to maturity financial instruments seem to be overlooked. They state that “HCA may have fed into the securitization boom. Moreover, there is evidence suggesting that banks’ loan losses exceeded fair-value losses on securities in particular...It is conceivable that the opacity of banks’ loan books and the lack of strict impairment rules have considerably contributed to the current crisis and investor uncertainty” (2009, p.9).

Securities and Exchange Commission (SEC) is also a big proponent of fair value accounting in the US. Following the 2008 banking crisis both SEC and fair value accounting were heavily criticised for making the banks to mark to market financial instruments and forcing the write downs of assets. However, former SEC Chairman Arthur Levitt⁵ in response to aggressive lobbying from some banking and financial services trading groups to suspend the mark to market or fair value accounting wrote in the Wall Street Journal article that fair value accounting is only a messenger that provides information to the investors, regulators and other decision makers about the fair value of the assets and liabilities of an entity and “To ask for a suspension in fair-value accounting is to ask the market to suspend its judgment... Ultimately, those who blame fair-value accounting for the current crisis are guilty of the financial equivalent of shooting the messenger. Fair value does not make markets more volatile; it just makes the risk profile more transparent” (How to Restore Trust in Wall Street, 2008). Levitt however acknowledged that we

⁵ Arthur Levitt was the longest serving Chairman of the Securities and Exchange Commission (SEC) from July 1993 till February 2001.

are experiencing the crisis of trust in the financial reporting which in his opinion can only be solved with further requirements for fair value disclosures which will bring transparency to the markets and renew investor confidence.

Finally, Ian E.Scott of Harvard Law School (2009, p.46) made a valid point about the sound banking system in Canada, where banks had also been applying fair value accounting and are in a strong capitalization position. Furthermore he concludes that fair value accounting did not cause or contributed to the financial crisis.

2.5 Alleged controversy between International Accounting Standards (IAS) and company law.

Cormac Butler, who has been a prominent critic of IAS standards in the various articles over for the number of years stating that: “EU negligence on accounting standards allowed Irish banks to conceal losses” (2013), “... IFRS abandoning the prudence concept, allowing banks to conceal losses and record profits prematurely” (2011), “... accounting rules has not only encouraged bankers to lend recklessly but to award themselves bonus payments on transactions that are loss-making” (2012). In addition Mr.Butler affirms that Irish Banks ignored company law by not revealing losses and continued trading while insolvent and auditors are knowingly allowed them to do so (2012).

Furthermore in the April 2011 Mr.Butler wrote that “Although the International Financial Reporting Standards (IFRS) allow insolvent banks to conceal or at least delay recognising losses company law certainly does not. Auditors must therefore not only comply with IFRS rules but give appropriate warnings to shareholders and investors that their bank may contain hidden losses or artificial profits – or face possible negligence claims” (2011). In stating the above Mr.Butler refers to a legal opinion written by Martin Moore QC⁶ to the UK Financial Reporting

⁶ Martin Moore QC is an expert on company law litigation and advice, corporate finance, financial services, insolvency, corporate reorganisations and insurance company schemes. He written an opinion for the Financial

Council (FRC)⁷ in 2008 entitled ‘The True and Fair Requirement Revisited’ which considered the impact of European legislation and international accounting standards.

According to Butler, Martin Moore’s wrote in opinion that “mechanical compliance” with IFRS accounting standards alone is insufficient to meet the requirement of company law” (2012). Based on that extract from Moore’s opinion Butler seem to conclude that Company Law and IFRS accounting standards contradict each other on the subject of presentation of the ‘true and fair’ state of the companies affairs in annual accounts and there is a different requirement under the Company Law for the recognition and reporting of losses.

At the same time both the Irish Institute of Chartered Accountants and the FRC argue that Moore’s opinion to the contrary confirms that the IASB rules meet Irish Company Law requirements. In view of such polar views it is therefore essential to examine the full version of Martin Moore’s opinion and the Company Law requirements to financial statements preparation.

2.5.1 Martin Moore QC legal opinion and Companies Act requirements for financial statements.

In 2008 UK Financial Reporting Council (FRC) had commissioned Martin Moore QC to provide a legal opinion which considered whether “the provisions of the European Directives and Regulations governing the preparation and audit of financial statements and/or the requirements of the Companies Act 2006 and, in particular, Sections 393-397⁸ and Section 495⁹ of that Act

Reporting Council entitled The True and Fair Requirement Revisited in 2008 which considered the impact of European legislation and international accounting standards on the true and fair requirements.

⁷ The Financial Reporting Council is the UK’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment, promoting high standards of corporate governance through the UK Corporate Governance Code and setting standards for corporate reporting and actuarial practice and monitor and enforce accounting and auditing standards.

⁸ Sections 393-397 of UK Companies Act 2006 outline requirements to preparation of company’s annual accounts and Directors responsibility to make sure that accounts give a true and fair view of assets, liabilities, financial position and profit and loss. That company’ accounts must be prepared in accordance with ‘Companies Act individual accounts’ requirements or with International Accounting Standards (IAS). The balance sheet and profit

require any revision to the approach to be taken to the concept of “true and fair” as articulated in the opinions of L.Hoffmann QC and M.Arden written in 1983 and 1984 and by M.Arden QC written in 1993” (Moore, 2008).

Butler writes in the article of June 2012 entitled ‘Accountants Ignored Company Law and Protected Bankers’ that as per Moore’s opinion “mechanical compliance” with IFRS accounting standards alone is insufficient to meet the requirement of company law”. On that basis he argues that although Ireland’s Bankers and auditors complied with IAS, by not revealing losses they ignored the Company Law.

However what Moore has actually said is that “The preparation of financial statements is not a mechanical process where compliance with relevant accounting standards will automatically ensure that those statements show a true and fair view, or a fair presentation. Such compliance may be highly likely to produce such an outcome; but it does not guarantee it” (2008, p.3). He further adds that “Compliance with general accepted accounting principles as set out in relevant statements of standard accounting practice will be prima facie evidence of satisfaction of the true and fair standard and vice versa” (2008, p.5) and further on he says 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”.

Moreover, in reference to the Court’s judgment he affirms that most likely the Court would take a position that compliance with accounting standards is necessary to meet the true and fair requirement. Hence this can be interpreted that compliance with accounting standards will be viewed by Court as compliance with Company Law.

Moreover, pursuant to the IAS Regulation, EC had incorporated IASB issued accounting standards into European law by means of series of regulations, each of which is compulsory to those preparing the consolidated accounts of the listed companies whose securities are trading on

and loss account must give a true and fair view of the state of affairs of the company as at the end of the financial year and in case of profit and loss, for the financial year.

⁹ Sections 495 of UK Companies Act 2006 outlines requirements to the auditor’s report on company accounts.

regulated market in EC. Hence every EU Member State had to incorporate IAS Regulation in their respective Companies Acts and it became an integral part thereof since ^{January} 2005.

Moore was writing a legal opinion notably on the bases of requirements of UK Companies Act 2006 and, in particular, Sections 393-397 and Section 495. His opinion however is transferable to Ireland as well in view of great similarities between two countries Companies Acts and the fact that both countries have adopted in full IAS Regulation. In UK the changes to Companies Act were incorporated by Regulation S.I.2004/2947 and in Ireland by Regulation S.I.116/2005 in years 2004 and 2005 accordingly.

It is important to note that Sections 397 'IAS individual accounts' and 406 'IAS group accounts' of UK Companies Act 2006 requires a company which prepares accounts in accordance with International Accounting Standards to state this in the notes to accounts. Moreover auditors by means of Section 495 must clearly state whether in their opinion annual accounts give a true and fair view, in case of the balance sheet, of the state of affairs at the end of the year and in case of profit and loss account, of profit and loss for the year and to verify that annual accounts were prepared in accordance with Companies Act or in case of listed companies in accordance with IAS Regulations. Hence auditors have to make sure that listed companies/Banks are strictly following IAS accounting rules.

Similar to UK, in Ireland, Micheal Martin, Minister for Enterprise, Trade and Employment by means of Regulation S.I.116/2005 'European Communities (International Financial Reporting Standards and Miscellaneous Amendments) gave full effect to Regulation (EC) No 1606/2002 of EU Parliament on application of international accounting standards (IAS) of 19 July 2002 making it obligatory for the companies and auditors to comply with IAS in terms of preparation and supervision of companies accounts. The appropriate amendments were entered in to Companies Act 1963, Companies Act 1986, Companies Act 1990 and Companies Act 2003. Hence from January 2005 onwards IAS accounting standards were incorporated and their tenets became integral with Ireland's Companies Acts.

For instance, Section 150 'Obligation to lay group accounts before holding company' of Companies Act 1963 requires listed companies whose securities are admitted to trading in any

EEA State starting 01 January 2005 to prepare their group accounts in accordance with IFRS. It further obliges any company who prepares account according to IFRS to clearly state that in the notes to annual accounts.

Furthermore by virtue of Sections 8 ‘Objects’, 9 ‘Functions’ and 26 ‘Review of whether accounts comply with Companies Acts’ of Companies (Auditing and Accounting) Act 2003 there are clear instruction to auditors to make sure that listed companies are strictly comply with Articles 4¹⁰ of the IAS Regulation i.e. prepare their accounts in accordance with IFRS.

In November 2003 EU Commission issued comments regarding certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of IAS. It is states there in reference to Article 5¹¹ that:

“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” (2003, p.10). This comment makes it quite pellucid that while a listed company is legally obliged to prepare its consolidated accounts in accordance with IAS, it is also permitted to choose to prepare its annual accounts in accordance with IAS.

¹⁰ *Article 4* ‘Consolidated accounts of publicly traded companies’. For each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2) if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State within the meaning of Article 1(13) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field(9).

¹¹ *Article 5* ‘Options in respect of annual accounts and of non-publicly-traded companies’ MS may permit or require: (a) the companies referred to in Article 4 to prepare their annual accounts, (b) companies other than those referred to in Article 4 to prepare their consolidated accounts and/or their annual accounts, in conformity with the IAS adopted in accordance with the procedure laid down in Article 6(2).

In light of it is fair to conclude that following Ireland's comprehensive adoption of Regulation S.I.116/2005 'European Communities (International Financial Reporting Standards and Miscellaneous Amendments) and confirming full effect to Regulation (EC) No 1606/2002 of EU Parliament on application of international accounting standards (IAS) of 2002 it became obligatory for the listed companies and auditors to comply with IAS in terms of preparation and supervision of companies accounts and neither had a choice in the matter once IAS was integrated with Ireland's Companies Acts. Furthermore, ones IAS Regulation was fully adopted listed companies whose consolidated accounts their prepared in accordance with IAS could choose to prepare its annual accounts in accordance with IAS as well.

While controversy and criticism surrounding IASs exist, especially towards IAS39 which mostly concerns banks and was already discussed previously, banks and their auditors cannot be held totally liable for preparing apparently obscure financial statements and providing stakeholders with misleading financial information about the state of their affairs. Such were the requirements of IAS and Companies Acts respectively.

At the same time Ireland's government, who fully adopted IAS relating Regulations in 2005, as a result of being part of the EU to adopt Regulation (EC) No 1606/2002 of EU Parliament on application of international accounting standards (IAS) of 19 July 2002. Consequently it appears that it is most appropriate to place the responsibility for enforcing inadequate accounting standards on to EU Parliament together with IASB who issued the controversial IAS standards.

Chapter 3: Methodology

The main purpose of this research is to analyse the role of International Accounting Standard (IAS39) in the Irish banking crisis. The following section explains the methodology adopted by researcher in order to complete the comprehensive research in to the proposed topic. It will also consider ethical and legal principles for completing this research.

3.1 Research Questions

The main purpose of this research is to analyse the role of International Accounting Standard (IAS39) to the Irish banking crisis. The following questions were formulated for this research.

a) What limitations (if any) exist in the IAS39?

IAS 39 'Financial Instruments: Recognition & Measurement' is an accounting standard issued by International Accounting Standard Board (IASB) which outlines the specific requirements for the recognition, measurement and impairment of financial assets and financial liabilities.

In order to answer this research question we have reviewed the opinions of opponents and proponents of the models and concepts used in the IAS39. The concepts and models researched were: fair value model, as it provides requirements for measuring financial instruments; the 'incurred loss' model, as it specifies how loss impairment should be recognised and the term 'objective evidence', as it is very important for understanding in what circumstances IAS39 recognises the impairment.

b) What role existing limitations in the IAS39 had in the Ireland's banking crisis?

In order to answer this question, extensive interviews were conducted with five highly qualified accounting professionals who are currently hold high level positions within the top five global accounting firms and the International Accounting Bodies based in Ireland. All five professionals possess very comprehensive knowledge and substantial experience working with Financial Institutions in Ireland and Central Bank in the fields of auditing, technical accounting advisory and financial accounting advisory services. All interviews were very comprehensive and this research has answered the research question.

3.2. Research Methodology

The following section explains the methodologies which were adopted by this researcher in order to execute a comprehensive research of the research topic. The research onion as depicted by Saunders, Lewis, and Thornhill (2009) is the basis for this section.

Saunders, Lewis, and Thornhill (2009) use the ‘onion’ as a metaphor to explain the different philosophies which could be adopted by a researcher in order to complete the research. One started at the outside layer; it represents the more general philosophies, and worked inwards to the more specific layers: approaches, strategies, choices, time horizons and finally techniques and procedures.

Figure1: The research ‘onion’

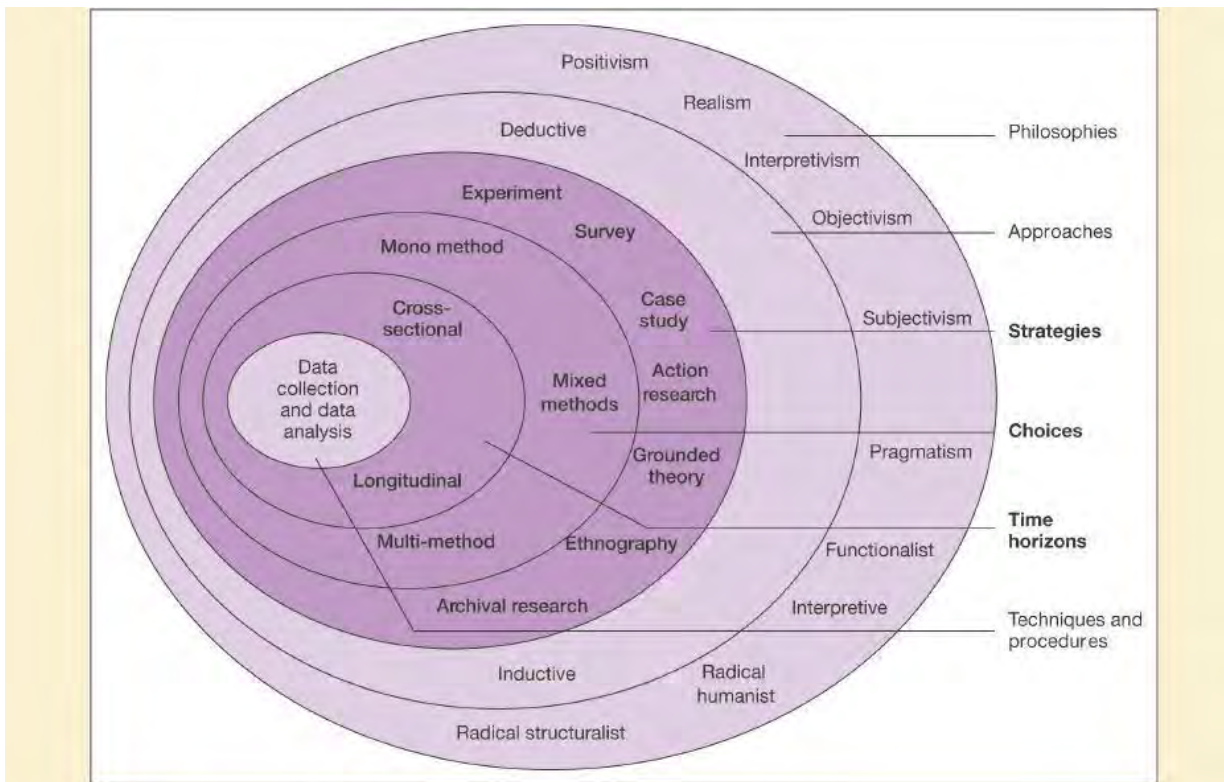


Figure 5.1 The research ‘onion’

Source: © Mark Saunders, Philip Lewis and Adrian Thornhill 2006

Source: Saunders, Lewis and Thornhill (2009, p.108)

3.2.1 Research philosophy

The research philosophy that best fitted in with the qualitative research used by this researcher for this research is the epistemological philosophy of interpretivism. It describes the difference between conducting research among people rather than objects (Saunders, Lewis, and Thornhill, 2009, p. 116). Moreover according to (Ryan et al, 2003, p.150) “In interpretive research the nature of accounting and its role in organisations and society is open to question and is often the object of research. In such research it is important to explore how accounting practices interact with social practices”. This philosophy was the best fit for this research as the qualitative research involved conducting interviews with five participating Accounting professionals. The roll of ‘feelings’ was adopted as importance was given to subjective comments resulting from the feelings and attitudes of interviewed participants. For the purposes of this researcher has accepted and recorded the views of five accounting professional and have not tried to influence their answers in any way.

3.2.2. Research approach

There are two main research approaches: inductive and deductive. An inductive approach research involves the development of a theory as a result of analysing of empirical data (Saunders, Lewis, and Thornhill, 2009). The deductive approach involves the development of a theory that has been subjected to probing (Saunders, Lewis, and Thornhill, 2009).

This researcher has used a combination of both inductive and deductive research approaches in order to take advantage of both. The theory was tested that International Accounting Standards (IAS) have contributed to the Ireland’s banking crisis. Saunders, Lewis, and Thornhill (2009) state that “deduction can be used to explain causal relationships between variables”. This researcher therefore used the deductive strategy to establish relationship between IAS39 and Irelands banking crisis.

This research have also benefited from the inductive approach to research which involved the development of a theory as a result of the observation of empirical data. Observations and primary date collection were made as a result of five interviews with experienced accounting professionals.

3.2.3 Research strategy

As one has conducted a **qualitative research** one adopted a mix of exploratory case study and archival research. The exploratory case study strategy was conducted in an attempt to explore relationship between IAS39 and Ireland's banking crisis (Saunders, Lewis, and Thornhill, 2009). The case study research strategy involved exploring the various models and concepts used in the IAS39. According to (Ryan et al 2003, p.144) exploratory case study "can be used to explore reasons for particular accounting practices. They enable this researcher to generate hypotheses about the reasons for particular practices". Through conducting the case study This researcher explored the role of IAS39 accounting rules in the Irish Banking crisis.

Saunders, Lewis, and Thornhill (2009) describe **archival research** as a "research strategy that analyses administrative records and documents as principal source of data because they are the product of day-to-day activity". As one has reviewed the annual reports of three Irish Banks and accessed historical information from the Central Bank Statistical and Economical reports and that data has already been collected and categorized, my research strategy falls under this category.

3.2.4 Research Choice.

A **multi - method qualitative study** research choice was used to conduct this research. In-depth interviews with five accounting professionals were conducted with participants in order to collect qualitative data and annual accounts of Irish banks and Statistical and Economical Quarterly Reports from the Central Bank of Ireland. The experience and professional opinions of the participants were of particular importance for this research. The format of interviews was semi-structured. This researcher had a set of prepared questions which one needed to be answered in order to collect comprehensive information on the research topic; however during the interview additional questions were asked as result of the interviewee answers. They all freely agreed to participate in this research. They had the right to decline answering any question for whatever reason: being it sensitivity or the inappropriateness or company's policies. At the

interviews this researcher did ones best to be non-judgmental and encouraged the interviewees to respond to the open questions without trying to influence their answer in any way.

The additional benefit of multi – method research choice is the possibility of triangulation of data. Silverman and Marvasti (2008, p.260) identify triangulation as the “attempt to get a true fix on a situation by combining different ways of looking at it or different findings”. This researcher was able to collect richer data on the same research question from the interviews and also from annual accounts of Irish banks prior and post crisis for deeper insight research.

3.2.5 Time Horizon

A **Cross sectional** study focuses on a particular phenomenon at a particular time (Saunders, Lewis, and Thornhill, 2009). My research was conducted over a short period of time and data collected from the interviewees represents their opinion on the role of IAS39 played in the Irish banking crisis, i.e. prior and after 2008. Therefore, this research was a cross sectional study.

3.2.6 The choice of method is qualitative research.

This researcher collected primary data mainly from the interviews and transcribed, analysed and utilised primary and secondary research data in a qualitative ‘non-numerical’ way which allows for rich, full and in depth exploration of the topic (Saunders, Lewis, and Thornhill, 2009). According to Silverman and Marvasti the unique feature of qualitative research is that data collection is not limited to a certain collection instrument or set variable, but is an open-ended process that incorporates all the contextual information regarding research topic (Silverman and Marvasti, 2008, p.50). In choosing the qualitative research one was able to collect data from the in-depth interviews, banks archival documents/reports and this researcher was able to expand data collection in other forms that was needed for thorough research.

The interviews were audio recorded and later transcribed into the word format. While transcribing the interviews the emphasis was placed on the tone of voice and reaction to the questions. This researcher did not offer the interviewees a copy of the transcription of their

interview in order avoid the situation where they could amend what they had said at the interview and hence change the meaning of the initial answers.

The qualitative data will be classified in the meaningful way to 'fit' in to categories of my research: International accounting standard (IAS39), Ireland's supervisory and regulatory structures. All collected information: primary and secondary research was analysed which enabled me to come to conclusion on the research topic.

3.2.7. Non-probability purposive sampling:

According to Saunders, Lewis and Thornhill (2009) there are two different sampling techniques: probability and non-probability sampling. Due to sensitivity of the topic this researcher could not obtain interviews with banking officials, therefore, probability sampling was impossible for my research. One therefore selected purposive sampling method. It allowed one to use one's own judgment in selecting the cases that enabled this researcher to answer the research questions. I therefore selected the International accounting Standard 39 and the Irish regulatory and supervisory structures to be the unit of analysis in the context of Ireland and the role of IAS39 played in the Irish banking crisis. This researcher has purposely selected to interview only Irish professionals; accounting lecturers, accountants in order to collect data on the impact IAS39 had on the Irish banking crisis.

3.3 Ethics:

According to Saunders, Lewis and Thornhill (2009) various ethical issues arise during the business and management research which arise from two philosophical viewpoint: deontology and teleology. This researcher does not agree with the teleology viewpoint that getting to the end of the research justifies any means. This researcher thinks that this is morally unacceptable. This researcher however agrees with deontological viewpoint that argues that the ends served by research should never justify the use of unethical research. This researcher conducted research and data collection on principles of honesty and respect for the people one came into contact with during the research process and one followed DBS's guidelines on Ethics in the research.

Participants were supplied with the literature review part of my proposal and questions that this researcher was attempting to answer. They were be able to freely agree to or withdraw from participation in the research. According to Bryman and Bell (2011) informed consent is very important and every participant has the right to the informed consent and right to withdraw.

Furthermore, participants were insured of confidentiality/anonymity for them and their companies. They had the right to decline answering any question for whatever reason: being it sensitivity or the inappropriateness or company's policies.

According to Silverman and Marvasti the key to acceptance in many settings is being non-judgmental (Silverman and Marvasti, 2008, p.310).

3.4 Limitation:

The research had to be completed in less than 4 month. Taking in to account this researchers full time job and family commitments, time management was a limitation. To this end one adhered to a strict 'time allocation' plan in order to deal with time limitation to the best of ones abilities.

There is an abundance of relevant critical secondary information in artistes, books and internet, however participating professionals may not want to go on record with too critical opinions they may have about the regulatory and supervisory structures and especially about quiet fresh debate about the possibility that IASB's accounting rule IAS 39 allowed Irish banks to conceal losses prior to the 2008 crisis. The fact that the participants were not this researcher's colleagues and didn't know this researcher prior to the interview means that even though it appeared that the interviewees were being frank and open when answering question, it is not clear due to the sensitive nature of the topic and lack of familiarity with this researcher if the interviewees were holding back or not. This researcher was unable to obtain an interview or comments from banking officials or financial regulator which limited the scope of opinion to a small number of accounting professionals.

In addition, as this researcher conducted qualitative research personal bias and one's personal opinions may have influenced the questions and direction of the interview and in fact the research as a whole. This researcher tried not to influence or interfere with the process of interviews and tried to be as impartial as possible when analysing primary and secondary data.

Chapter 4. Data Analysis, Findings and Conclusion.

The purpose of this chapter is to discuss the findings of the primary data gathered from the publically available annual reports of the three Irish banks: Bank of Ireland, AIB and Anglo-Irish Bank for the years 2007-2009, The Central Bank of Ireland quarterly statistical reports on Ireland's Credit Institutions and during the in-depth discussions with five highly qualified accounting professionals who are currently hold high level positions within the top five global accounting firms and the International Accounting Bodies based in Ireland. All five professionals possess very comprehensive knowledge and substantial experience working with Financial Institutions in Ireland and Central Bank in the fields of auditing, technical accounting advisory and financial accounting advisory services. Their input and assistance with this research in to the role of the IAS 39: Financial Instruments: Recognition and Measurement is invaluable and research would not be completed without their kind assistance.

As mentioned in the literature review IAS 39 classifies financial assets into four categories which are valued either at fair value or amortised cost (IAS 39:45). The impairment of value of the assets is recognised ether through profit and loss report or through reserves in the balance sheet.

In order to analyse the role of IAS 39 in Ireland's banking crisis this chapter will focus separately: first on the analyses of the two categories measured at fair value i.e. Held for trading and Available for Sale (AFS) financial instruments and the requirements for the recognition of the impairment specified for these two categories and secondly on the two categories measured at amortised cost i.e. Held to Maturity (HTM) and Loans and receivables financial instruments and the requirements for the recognition of the impairment specified for these two categories.

4.1. Analysis of the impact of the Held for Trading and Available for Sale (AFS) Financial Instruments in the Ireland's Banking Crisis.

Held for trading are financial assets that acquired for the principal purpose of selling in the near term, usually less than one year, or initially designated by the entity as at fair value through profit or loss. These are bonds, stocks, derivatives that are traded on the market, equity instruments of another entity or a contractual right to receive cash or another financial asset from another entity or to exchange financial assets that are obtained with an intention to sell or receive cash for within one year. The impairment of value of these assets is recognised through profit and loss report (IAS 39:55).

Available for Sale (AFS) financial assets by definition are quite similar to Held for trading and are also measured at fair value. It is bought with intention to sell, but an entity may also wait and see what happens in the market, but it is not planning to trade the investment actively. These investments are available for sale given the right market factors and entity's cash situation and are under one year. AFS is generally a default category: when an entity acquires an investment, not for an active trading or to be held to maturity the company classifies its investment as AFS (IAS 39:9).

There is one big difference between the accounting for trading instruments and AFS instruments. This difference pertains to the recognition of the changes in fair value and impairment. For trading securities, the changes in fair value and impairment are recorded in the profit and loss report. However, for AFS securities the changes in fair value go into the 'other comprehensive income', which is located in stockholders' equity in the balance sheet and the income statement remains unaffected (IAS 39:55). If however there is objective evidence that asset is impaired, the cumulative loss in 'other comprehensive income' is reclassified from equity (balance sheet) to profit and loss (IAS39:67).

The reason for the different approach in accounting for AFS securities and trading securities is a big concern that including in net income unrealized holding gains and losses on AFS investments will make income appear more volatile than it really is. Hence an entity may purchase AFS

investments for the purpose of having the changes in fair value of those investments offset changes in the fair value of liabilities and use it as a hedging mechanism.

Financial assets in the held for trading and AFS categories are measured at fair value and the best evidence of the fair value are quoted prices in an active market. If however quoted market price for the certain financial instrument does not exist or the market for this instrument is not active, an entity must establish fair value for this instrument by using a valuation technique. The objective of such valuation is to establish what the transaction price would have been on the balance sheet date in an arm's length exchange between willing parties (IAS 39:IN18). Wherefore essential that we analyse the fair view as at quoted prices in an active market (mark-to-market) and fair value as at valuation technique separately to establish the possible role thereof in the Ireland's banking crisis.

4.1.1 Analysis of the fair value - quoted prices in an active market (mark-to-market).

While fair value per quoted price in a market seems quite straight forward valuation, it is far from it. Some very important considerations are permitted per IFRSs/IASs when using quoted price to establish the fair value. Firstly, (IAS 39:AG71) states that quoted price in an active market is considered a fair value when it was established as a result of an arm's length transaction between two willing parties in the most advantageous market to which an entity has an immediate access. Secondly, it is further clarified in (IAS 39:AG69), that fair value is not an amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. Both considerations have very different possible implications depending on the economic cycle.

First, because these specific requirements prescribed an entity to use the most advantageous market quote, during the upturn in economic conditions this would arguably limit entities capability to understate the fair value of an asset which could be used as a way to depress the profit at the reported date. According to the Accountant 'C' allegations were made towards the IFSC companies before the mandatory use of IFRS's/IASs rolled in 2005 that they used general provisions to reduce profits and hence the tax bills. This is a circumstantial evidence, but it

shows the general intention of the financial institutions to use available measures to get to the most advantageous for them financial results.

Furthermore, (IAS 39:AG71) specifically states that quoted price in an active market is considered a fair value when it was established as a result of an arm's length transaction between two willing parties in the most advantageous market is not an amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. This clarification meant that in the illiquid and distressed market which existed following the 2008 financial crisis an entity didn't have to accept a market quote for a held for trading and AFS instruments as a fair value for that instrument, because arguably the latest transactions in the market were the results of the distressed sales to boost entities liquidity and would not be considered an arm's length transactions between two willing parties in the most advantageous market.

4.1.2 Analysis of the fair value valuation models.

The same pro and cons point mentioned about the mark-to-market above are valid for fair value valuation models. In addition, due to various inputs required for the establishing the fair value through the valuation technics such as evidence of the recent arm's length market transactions, discounted cash flow analysis, option pricing models, credit risk and estimates of the market volatility measure. Some of these inputs are much dependent on the bank's management's assumptions and opinions and can be very subjective. For these reasons results of fair value valuation models are criticised for replacing accounting facts and verifiable values of assets and liabilities by assumptions of hypothetical fair value with questionable accuracy. Dixon & Frolova research (2013, p.328) argue that due to many assumptions "... financial statements have become factually opaque, with an illusion of mathematical rigor" and "neither management nor auditor can either affirm the correctness (truthfulness) of the fair value accounting estimates, or attest to the absence of unintentional financial misstatements in audited financial statements".

During the interviews with accounting professionals the same question was asked i.e. to share their opinion on the impact of fair value measurement of AFS and Held for trading financial assets in the Ireland's banking crisis. The general consensus throughout the discussions was that fair value measurement approach in IAS 39 during the financial crisis when market went in to

the free fall and became dysfunctional proved to be inadequate and caused the understatement of assets valuations which then caused business decisions that weren't optimal because it was based on the wrong fair value answer (Accountant 'E').

However it is debatable whether IAS 39 approach to fair value is wrong or the people's interpretations of IAS 39 is wrong. IAS39, along with the other IFRSs/IASs became mandatory in January 2005 and we were in a boom economy then, so people's interpretations of the IAS 39 were never tested. Accountant 'A' affirmed that "unfortunately the first time we had to test people's interpretation of IAS39 was not in a normal recession but a global crisis. Had we had a normal recession I think peoples interpretation of IAS39 and particularly "objective evidence" would have changed but it mightn't have resulted in a need to change the accounting standard. It was only the fact that it was part of global crisis, which is why I say IAS39 amplified the problem. So firstly the circumstances were part of the problem".

Number of issues with IAS 39 during the crisis was noted by interviewed accountants. Accountant 'A' in particular noted few issues with fair value measurement during the crisis. In particular he stated that difficulty arose in the AFS category, which recorded assets on the balance sheet at fair value and changes in the fair value in the 'other comprehensive income', however if impairment is recognised, it would have to be reclassified from 'other comprehensive income' to the profit and loss. Banks during the crisis took the view, that the reduction in the fair value was not considered to be 'prolonged or significant', then rather than taking the impairment to the profit and loss account entity put it through reserves in the balance sheet.

Hence by allowing banks to use their opinion in determining whether or not value reduction was temporary or an actual impairment the IAS 39 allowed banks to understate their losses and inflate the assets values in the balance sheet. This view was shared also by Accountant 'E' who thought that banks used this opportunity to inflate their balance sheets.

Moreover, Accountant 'D' stated that fair value accounting doesn't work as it's too erratic and it's hard to have an idea of the underlying value of an asset. Accountant 'A' also agreed that "fair value is not a very good measure to be used in financial statements because of the fact that many

instruments that carry a fair value don't have a market and there is no objective index" and the models are used to come up with a value and then we are getting away from the true and fair value. "Fair value is an extremely difficult concept to apply in practise and for that reason I would personally suggest that it should be used in limited circumstances" stated Accountant 'A'. Accountant 'E' had criticised IAS39 for being too simplistic in its approach to fair value and particular marking to market. "When the market is dysfunctional there should be some other method" because when the market went into free fall and when the market became dysfunctional it produced the wrong answers and produced business decisions that weren't optimal because it was based on the wrong answer" asserted Accountant 'E'.

When market went in to free fall in 2008 reductions in the marked to market fair value led to a capital adequacy problem in many banks and a capital adequacy problem requires more liquidity to solve it. In this regard Accountant 'E' agreed that "The only way to get liquidity is to sell (assets) and the act of selling only forces the market down even further. It was a dysfunctional market and it was accounting standards forcing activity on the market that wasn't optimal".

4.2. Analysis of the impact of the Held to Maturity (HTM) and Loans and receivables Financial Instruments in the Ireland's banking Crisis.

Held-to-maturity (HTM) and Loans and receivables financial investments are both a non-derivative financial assets with fixed or determinable payments. The difference between them is that unlike Loans and receivables, HTM assets have the fixed maturity and an entity has the intention and ability to hold them to maturity (IAS 39:9).

Both HTM and Loans and receivables financial assets are measured at amortised cost (IAS 39:46) and ones these assets are derecognized or impaired the gains/losses are recognised through the profit and loss report (IAS 39:55,56).

4.2.1 Analysis of the Held to Maturity Financial Instruments (Assets).

Accountant 'A' had asserted in the interview that the "as a category, Held to Maturity was not used very much across Europe by most banks" and is measured at the amortised cost with is easily determinable and does not require any imputes dependent on managements judgment. According to the AIB Bank FSs for the year end 2009 for example, they disclosed in the Note 32 'Financial instruments held to maturity' (AIB, 2009, p.214) that the AIB Group had €1.58billion and €1.5billion of Held to Maturity instruments in the years 2009 and 2008 respectively, all of it in the non-Euro Government securities. While AIB Plc at the end of both years had reported no assets in the Held to Maturity category at all (AIB, 2009, p.214). The review of BOI FSs for year ended 2009, despite having highest level of detailed information and disclosures in the FSs reviled no reported information on the Held to Maturity instruments. We therefore conclude that that category was not used by the bank. The review of Anglo-Irish Bank FSs for year ended 2009 reviled no reported information on the Held to Maturity instruments as well. We therefore conclude that that category was not used by Anglo either. Wherefore for the purposes of this research we dimmed Held to Maturity category irrelevant I the context of impact thereof in the Ireland's banking crisis.

4.2.2 Loans and receivables Financial Instruments in the Ireland's banking Crisis.

Loans and receivables is by far the most important financial instruments category where the most of the assets held by Irish banks concentrated. The total value of Loans and receivables assets held by Irish Resident Credit Institutions in the years 2007, 2008, and 2009 was €488.8billion, €565.4billion and €538.1billion respectively (Appendix 4). These loan volumes represented 82.4%, 87.6% and 86.6% of the total assets in the Irish Resident Credit Institutions at the end of years 2007, 2008 and 2009 respectively (Appendix 4). It is therefore apparent that this is category where accounting standards and in particular IAS 39 measurement and impairment requirements could be potentially very important.

All interviewed accountants unanimously asserted that loan book is where the real issue was in the Irish Banking crisis. Accountant 'A' stated "in terms of retail banks and particularly in terms

of the Irish banks, where the real issue was around is loan book that was classified as loan and receivable”. Accountant ‘B’ noted that “Anglo-Irish Bank had a massive loan portfolio in land and development which was lent against the wrong type of exposures...Those loans were not capable of being repaid and that’s what happened to Anglo, that’s what happened to Irish Nationwide, that’s what happened to ACC, that’s what happened to AIB and that’s what happened to Bank of Ireland. It’s the fact that they over-lent into property in Ireland in the wrong concentrations to the wrong people”. Accountant ‘B’ further stated that the business model in the banks was predicated on “if you lend for example €400 million, they buy the site, they develop it and sell the houses at extortionate prices in two years’ time and then they pay bank’s loan in full. That was the business model in too many banks at the same time and that’s what drove the collapse of the Irish Banks”. Once the property prices began to fall in 2008 this model was never going to work.

Hence from the year 2008 onwards Irish banks were looking at their huge loan portfolios associated with ‘Construction and Property’ and ‘Personal mortgages’ seeing the declining values of both commercial and residential properties knowing that most going in to negative equity and those loans are less or not at all secured. For example, at the year end 2009 AIB Bank reported €27.2billion in loans to Construction and Property and €33.1billion in loans for Personal mortgages (AIB FS, 2009, p.196). For year end 2009 BOI reported €22.4billion in loans to Construction and Property and €60billion in loans for Personal mortgages (BOI FS, 2009, p.20). Those figures for year 2009 already include deductions of loans to be transferred to NAMA of €9.5billion by BOI (BOI FS, 2009, p.20) and €10.96billion by AIB (AIB FS, 2009, p.184) as at the year end 2009. From that point IAS 39 loan’s impairment requirements became very important and more so people’s interpretations of them.

4.2.3 Analysis of IAS 39 loan’s impairment requirements.

IAS 39:59 states that “A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a ‘loss event’) and that loss event (or events) has had an impact on estimated future cash flows of the financial asset or group

of financial assets that can be reliably estimated”. Furthermore IAS 39:59 specifies that “Losses expected as a result of future events, no matter how likely, are not recognised”. It further specifies what is meant by ‘objective evidence’.

Three important points in connection with IAS 39 impairment requirements were noted by interviewed accountants. First, the fact that IAS 39 specifically instructs prepares to only recognise the impairment loss if it’s incurred. Secondly, it specifies that there have to be an ‘objective evidence’ for the impairment loss to be recognised. Thirdly, the assumptions used by banks to estimate the amount of individual or collective loss provision. This research will therefore discuss these points separately.

4.2.3a Analysis of IAS 39 ‘incurred loss’ model.

As per ‘incurred loss’ model of IAS 39 an entity is only allowed to recognise an impairment loss that existed on the balance sheet date and the expected losses, no matter how likely, are not allowed to be recognised.

In the ‘Basis for conclusions’ appendix to IAS 39:BC108,109 (IFRS, 2009, p.2124) IASB addressed the comments made to them regarding the incurred versus the expected losses. They sighted the comments both in favour and against the incurred model. The comments against suggested that expected future losses “should be considered in the determination of the impairment loss for a group of assets even if the quality of a group of assets has not deteriorated from original expectations” (IFRS, 2009, p.2124). The IASB however decided that impairment losses should only be recognised if they have been incurred. The Board stated that it would be inconsistent with an amortised cost model to recognise expected losses based on the future events.

From the interviews with accountants it was evident that opinions are still divided on the subject of whether the incurred model is optimal. Accountant ‘A’ for example said that “Conceptually an incurred loss model is the right model, because you should be recognising the losses as, and when they arise, rather what you expect them to be in the future”. However this means that information in the bank’s Financial Statements is only relevant on the balance sheet date and becomes out of the date on the following day. Stake holders who would view those FSs three

months later, after it was audited and published would have historic information which is already irrelevant. Anybody who makes any investment decisions should realise this. Accountant 'B' believes that if accounting standards were working correctly, banks would have to recognise losses as much as they could in 2008. So in effect he argued that the accounting standards are retrospective, as they require the assessment of incurred loss on the balance sheet date only. That's where general provisions could have come he continued, however those were not allowed per IASs since 2005. The global banking crisis had happened, banks had a good reason to expect the devaluation of their loan portfolios and future value impairment, however if for example nobody defaulted on the loan repayment yet or said he couldn't repay the loan, banks according to IAS 39 could not start making provisions for future losses, as there was no 'objective evidence'. Accountant 'D' had pointed out however that although banks had to report on an incurred loss only, the macro-economic triggers were beginning to show, such as: onset of recession, unemployment is beginning to go up, people are going to start to default of mortgages. All these indications were present and should have prompted banks to look at making collective provisions which are allowed per IAS 39, but were ignored by the banks.

Accountant 'C' had also agreed that the incurred model is not conservative enough, however he noted that in addition to a list of the loss events in IAS39:59, there are additional types of events that are considered to be an 'objective evidence' for impairment specified in the IAS 39:61. That is "significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates". There was an undeniable liquidity problem in the market in 2008 and that was a trigger for the banks to start provisioning for the losses. Therefore he agreed with Accountant 'D' above stating "All of those loans could be impaired much earlier with a conservative interpretation of the triggers and the examining of impairment events that IAS 39 sets out. But those were never taken by institutions".

4.2.3b Interpretations of 'objective evidence' IAS 39's requirement by banks.

IAS 39:59 provides details of what is considered 'objective evidence' that a loss event had accrued and financial assets are impaired. These include:

- a) significant financial difficulty of the issuer or obligor;
- b) a breach of contract, such as a default or delinquency in interest or principal payments;

- c) the granting to the borrower of a concession, for economic or legal reasons relating to the borrower's financial difficulty;
- d) it becomes probable that the borrower will enter bankruptcy or other financial reorganisation;
- e) the disappearance of an active market for that financial asset because of financial difficulties;
- f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the portfolio, including:
 - i. adverse changes in the payment status of borrowers in the portfolio;
 - ii. national or local economic conditions that correlate with defaults on the assets in the portfolio.

In addition IAS 39:61 specifies additional events that are considered the objective triggers for the impairments. It states that "significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates" (IFRS, 2009, p.2016).

In 2008, especially in the second half of the year it became undoubtful that the economic and market conditions in Ireland have deteriorated and this is evident from the economic outlook by Central Bank of Ireland which showed a forecasted decline of the national GDP by 4% for 2009 and further decline for 2010 (CB, Economic Commentary, January 2009, p.14) and forecasted the increase in national unemployment level from 4.5% in 2007, to 6.2% in 2008 and 9.4% in 2009 (CB, Economic Commentary, January 2009, p.24). This forecast should have triggered increase in the loss provisions within the banks for the year end 2008, because these are the triggers specified in IAS39:61. Accountant 'D' have also agreed that all the macroeconomic triggers 'where there' and it was obvious that more people are going to default on mortgages and on that basis banks should have started booking in impairment provisions which was allowed under IAS 39.

However at this point, at the end of 2008, the requirement for an existence of 'objective evidence' and at the same time requirement to only recognise the incurred loss at the balance sheet date are seem to be confusing. Accountant 'A' also thought that there was an issue around the term 'objective evidence'. He said "Most people took the view that objective evidence of

impairment meant you had to account for objective evidence at the loan level, whereas objective level of deterioration something you can implement across the whole economy. Unemployment started to go up, GDP started to go down and there was less inward investment. All of these are indicative factors of objective evidence that impairment will occur and has occurred but was ignored”. All these factors could have been used as an impairment model inputs, but it depends on “whether you are (bank) interpreting the words ‘objective evidence’ or applying the term ‘objective evidence’ either at an individual account level or are you applying them at a macroeconomic level” argued Accountant ‘A’. Accountant ‘C’ stated that, Irish institutions took the view that the global financial crisis is not a significant event for triggering the impairment, “because it’s not manifested on individual loans”.

The banks took the view that if for example the mortgage or loan is serviced they don’t have evidence that loss provision is needed. Whether if they have looked at the group of loans and the available data on the economic decline and rising unemployment forecast they could, if they were prudent, start increasing the collective impairment provisions based on the facts that if people lose jobs they will not be able to repay their mortgage any longer.

Accountant ‘B’ noted that banks tend to blame accounting standards claiming it have not allowed them to make provisions earlier, because the general provisions are disallowed by the IAS 39. However he stated that “if you (banks) had a conservative view of what an impairment event is, you (bank) could probably have got to a similar number under IAS 39 as you had under previous accounting standards. So that’s a bit of cop-out”.

4.2.3c Analysis of the critical assumptions made by Irish banks during the 2008-2009.

Accountant ‘A’ stated that impairment rules per IAS 39 were probably seen as a biggest contributing factor to the delayed in impairment provision by the banks. Impairment provisions require various inputs in order to determine the amount of estimated impairment. Some of these inputs depend of the management opinions and their perception of the general economic factors

and other estimates. In the context of IAS 39 management's opinions were considered of crucial importance by all interviewed accountants.

One of the inputs for example is a Loss Given Default (LGD), which is the amount of funds that is lost by a bank when a borrower defaults on a loan. For example bank could estimate that in the event of customer default on the loan/mortgage they'd lose 10% of the value, that's based on bank's perception of the economic conditions and falling property prices. Accountant 'A' however argued that in making this decision bank can take an optimistic or a pessimistic view. The 10% loss of the value might be considered a very optimistic outcome by another person looking at the same variables. The bank could be more prudent and have the higher percentage of LDG in their impairment provision calculation. "I have no evidence to suggest it's going to be 10%, so I'll go for 40% and provide a much bigger number, but I am exercising prudence in that instance because I am being pessimistic about the outcome of the situation" stressed Accountant 'A'. The point here is that there is enough flexibility in IAS 39 to allow Irish banks to be more pessimistic in their provision modelling in 2008-2009 if they have identified the macroeconomic triggers correctly.

On the other hand Accountant 'C' noted that the amounts of provision in the Irish banks reflected the general perception of the economic conditions at the time. He stated "When people (banks) were making estimates of their loans at that point in time they were assuming declines in property price of 20-30%, but they were never assuming that it would get to 50% or 60% or 70%". This assumption made by the banks is confirmed in the Central Bank of Ireland Economic commentary in January 2009 where it's stated that house price index nationally fell by 9.4% in 2008 and Commercial property values declined by 23% in 2008 (CB, Economic Commentary, January 2009, p.40,42). So it's seems that there were a general perception in Ireland by institutions and authorities that the crisis will not be very severe.

Even if the property prices have declined and some are in negative equity people were still servicing them, they have not defaulted on the payments. Should this loan be impaired even if there is an impairment event? According to Accountant 'C' this is exactly the type of a judgement call that banks are facing. And the simple advice is "Use IAS 39 in the best sense, in the most conservative sense, as proactive tool rather than a reactive tool" (Accountant 'C').

4.3 Conclusion.

The overall objective of this research was to conclude whether limitations existed within the IAS 39 that contributed to the causes of Ireland's banking crisis. We have reviewed the literature in to the background of the Irelands banking crisis and considered the conclusions and recommendations of the Honohan (2010), Regling and Watson (2010) and Nyberg(2011) reports on the causes thereof. In search of the answers this research reviewed publicly available literature on the models and concepts that are used within the IAS 39 in order to understand the views of opponents and proponents of this accounting standard. We have interviewed five highly qualified accountants with in-depth knowledge and experience with auditing or providing financial advisory services to the largest Irish banks. Following these interviews, all collected data was analysed and presented in the Chapter 4.1 and 4.2. The data analysis and findings sections concentrated exclusively on requirements fundamental to IAS 39: the 'incurred loss' model, the fair value model, the loss impairment triggers and the term 'objective evidence'.

After considering the literature review and the findings following the interviews this research concludes that:

Notwithstanding the comment in the Nyberg report saying that IAS 39 reduced banks' ability to make more prudent general loan-loss provisions, or anticipate future losses in their loan books, particularly in relation to property lending in a rising property market and that as a result thereof loan-loss provisioning charges on loans in the covered banks got reduced between 2001 and 2007 from €5bn to €1.7bn per annum (2011, p.43) this report finds to the contrary. In particular this report concludes that although general provision were not allowed by IAS 39 it was nonetheless flexible enough and allowed banks to make collective impairment provisions. IAS39:59(f:ii) for example identifies that the objective evidence that financial assets is impaired is a national or local economic conditions that correlate with defaults on the assets in the portfolio. Furthermore IAS39:61 identify that "significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in with the issuer operates" is an additional impairment trigger. All Accountants agreed that at the end of 2008 when Irish economy began to contract and the unemployment started to go up, that by all means should have prompted banks to look at their loan books and start making collective provisions, if they have interpreted the triggers conservatively.

IAS39's 'incurred loss' model as a tool for recognising the impairment is where opinions have divided between interviewed accountants. Accountant 'A' agrees with 'incurred loss' model, because entity should be recognising the losses as, and when they arise and not what its expected to be in the future. Accountant 'B' argued that 'incurred loss' model makes accounting standards retrospective and irrelevant the following week. Accountant 'D' had pointed out that even with an incurred loss only, the macro-economic triggers were present and should have prompted banks to look at making collective provisions which are allowed per IAS 39, but were ignored by the banks. Accountant 'C' had also agreed that the 'incurred loss' model is not conservative enough, however agreed with Accountant 'D' that if banks interpreted term 'objective evidence' conservatively they could under IAS39:61 start provisioning for the losses.

Accountants also stressed that banks continuously structured their products in such a way that as to avoid the requirements of IAS39 impairment requirements. Accountants 'B', 'C' and 'E' have stated that most of the banks construction relating loans were an interest roll up loans. Meaning there was no requirements for the repayments of the loans and the interests till the end of term and then the interests were capitalised and the whole amount rolled over for the next term. In this situation, by a definition a default event is imposable, hence this type of loans were not assessed for impairment provisions. Information on the values of these type of loans were not disclosed in the bank's annual reports, as it is not required per IASs. There is an indication of the value of these loans in the Central Bank of Ireland statistical reports which researcher had summarised in the Appendix 2. According to the Aggregate Balance Sheet for the Credit Institutions in Ireland, figure 5.4 'Term/revolving loans', the values thereof in the years 2007-2009 were €209.4billion, €221.5billion and €119.1billion respectively, which represent nearly 30% of the overall loans value. Therefore banks' lending practices very too risky to begin with and accounting rule cannot be blamed for everything what happened to the banking industry in Ireland.

Fair value model was extensively analysed in this research as it is fundamental to the measurement requirements of the two categories of financial instruments. During the down-turn following the 2008 financial crisis the role of the fair value model was heavily debated by academics and practitioners. On one side it was criticised for causing huge write downs in the value of assets creating volatility in the market which caused the downturn spiral and further exacerbated the crisis (Plantin, Spara and Shin, 2008; Isaac, 2008). All interviewed accountants

have also criticised fair value model as it is not a good measure because many instruments do not have the market and the models are used to come up with fair value. Those models are heavily dependent on the manager's opinion and assumptions and can be subjective. Once the market became dysfunctional and went in to free fall fair value model produced the wrong answers based on the stressed sales and led to the business decisions which wouldn't otherwise be made.

On the other hand it was hailed for timely exposing the problems within financial industry and named the only measure that provides more accurate, timely, and comparable information to investors than amounts that would be reported under other alternative accounting approaches" (CFA, 2008). Levitt (2008) stated that those who blame fair-value accounting for the banking crisis "are guilty of the financial equivalent of shooting the messenger" to ask for a suspension of fair-value accounting is like "to ask the market to suspend its judgment".

Notwithstanding the above comments and criticism noted from all interviewed Accountants towards IAS 39's fair value measurement requirement, it is evident from the Central Bank of Ireland Quarterly statistical reports on the Ireland's Credit Institutions for the year ends 2007 to 2009 (Appendix 3) that the Holdings of Securities (Number 6 - assets) and the Holdings of shares and other equity (Number 7 - assets) represent for the Irish residents (Irish Domestic Banks) 2.77% in 2007, 4.82% in 2008 and 6.61% in 2009 an insignificant portion of their overall assets. It is further evident from these reports that aggregate assets in these categories held by other Credit Institutions operating in Ireland: including Credit Institutions who are operation in Ireland, but are residents in the other European Union countries and the Rest of the world residents that their overall proportion of these assets are 17.5% in 2007, 17.81% in 2008 and 17.28% in 2009 respectively (Appendix 2), much larger than in the Irish domestic Credit Institutions.

Therefore we conclude that domestic Irish Banks did not hold a meaningful portion of their overall assets in the fair values: neither AFS nor Held for trading and therefore fair value did not have a significant impact in the Ireland's banking crisis. Accountant 'B' was also of this opinion and said the "fair value is not the right place to look in the first place if one was looking for the causes of the Ireland's banking crisis simply because the holding of AFS and Held for trading assets was quite insignificant", as we saw in the Central Bank of Ireland quarterly statistics

reports, and “the assets that caused the issues in the Irish banking crisis were never subject to the fair value category”. Accountant ‘B’ further stressed that “when the bank is sitting there with €40 billion land and development portfolios, €40 billion mortgage book, €25 billion in SME portfolios in Ireland. It was pretty much concentrated all on the same thing, so that’s where the issues came from and caused the collapse...” Accountant ‘A’ had noted however that “the existence of fair value had an implication around how the banking crisis was reported ... and it created quite a bit of uncertainty and perhaps it could be suggested that the use of fair value masked the situation for a period of time”.

Although it is evident that fair value did not cause nor had a significant impact in the Ireland’s banking crisis it is worth noting that based on the above comments fair value had impacted companies abroad, particularly in USA, where they had a significant holdings of AFS and trading instruments.

In conclusion, this research finds that while risky lending practices in the Irish banking were the root cause for the crisis. The flexibility within accounting standards (IAS39) which allowed various interpretations of the imbedded principles influenced the timing and the levels of impairments and provisions which were made by the banks have contributed to the way banking crisis was reported. Last, but not least, the role of financial regulator was critical! All interviewees stated that financial regulator is the only authority who has the comprehensive overview and receives the information from all the banks. It has authority to request any information, reports from the banks and any format they think best for the prudential regulation. They are the ultimate policemen of the banking system and had the ability and authority to control and should have controlled the situation in the banking sector better.

Chapter 5. The Self-reflection on own learning and performance.

Rational for undergoing MBA

There were a number of interconnected reasons to why I have chosen to do MBA course. Firstly, although I have gained valuable knowledge and experience in my present job, it is a small company and there are no prospects for further career and knowledge enhancement. This was evident to me couple of years prior to MBA. However, while I have clearly outgrown my job and should have moved a while ago, the comfort, familiarity and flexibility of my position in the company along with settling in to married life and having a child greatly prolonged my stay and reduced my ambitions.

Secondly, while considering new jobs possibilities I realised that entering transactions, doing bank reconciliations and producing accounting/financial reports is not very interesting to me anymore. I wanted to be involved in decision making process, financial strategy and business analysis. I became increasingly interested in Financial and Banking Industry and in particular operations of Investment funds and Investment Banking. I thought that taking in to account my highly analytical, logical, practical and problem solving skills I should do well in the more challenging environment, hopefully within the Financial Industry.

Finally, I thought that successful completion of MBA-Finance programme and gaining the most respected qualification worldwide would give me great advantage in competing for jobs in Financial Industry.

Dissertation topic selection.

MBA Dissertation is a pinnacle of the two hard years of postgraduate education and this reflective piece on the dissertation process and MBA course provided me with opportunity to think through the whole process and recognise the milestones: what I have achieved, the knowledge and skills I gained, the challenges I overtook and lessons learned.

Selecting the topic for the dissertation was a very challenging task. Number of lecturers gave us advice and guidance regarding the dissertation. They have stressed that considering that it was going to be arguably a most important academic work we would have done to date and

considering the time commitment and its magnitude we should be selecting an interesting and exciting for us topic: the topic, which we would like to research and would be able to concentrate on for a number of months.

For me, the process of selecting the topic was very long and quite difficult. I was adamant to have the topic for my dissertation that would first of all be advantageous for my career, be interesting to me, challenging and currently relevant. I had a number of topics shortlisted at the end. The topics shortlisted were: a moral hazard in the merger and acquisitions, a research in to Ireland's and Iceland's responses to banking crisis (could Ireland let the banks fall) and the research in the role of accounting standards in Ireland's banking crisis. I found all the topics interesting, but in reality I would not be able to find people who would agree to interviews on the subject of moral hazard in the mergers and acquisitions and there are no Icelandic professionals in Ireland to interview about their response to the crisis. So at the end I decided on take on the research in to the role of accounting standards (IFRS/IAS) in Ireland's banking crisis.

The challenge however with this topic was that I haven't actually studied IFRSs previously and I don't have exposure to it at work. I however recognised the opportunity, to simultaneously do this interesting research and study IAS 39, which is the accounting standard that most influence financial institutions. I had recognised the challenge ahead associated with undertaking a research in to an unfamiliar topic and basically having to study the IAS 39 before I could write anything about it, but because I am planning to redirect my career in to the Financial sector, I thought it would be really beneficial for my future.

Reflection on the Dissertation Process.

From thereon I started to research IAS 39, its original implementation in 2005, the models involved i.e. fair value, amortised cost, incurred loss and researching about any pros and cons associated with them in the literature. It's worth mentioning that on the early stage on secondary data collection I came across many publications by an Irish academic/practitioner Cormac Butler in the Irish Times, who was very critical of the IAS 39 and alleged for number of years (2010-2013) that it allowed Irish banks to conceal losses, that auditors are covering up for the banks and that banks are in the breach of Irish company law by complying with IASs. Because of my inexperience on the subject I accepted his view at a face value and approached the research from the point of view that the accounting standards were inadequate.

I used all available to me search tools: the DBS library electronic database, I got an Athens account to access various business and financial journals and previous research, I used Google scholar and Google to search for research for any available publications in to the fair value, amortised cost, IAS 39 and similar US standard - Financial Accounting Standard (FAS 157) in particular. I found many publications and researches around those topics published by academics, opinions issued on EU and US accounting standards by Big 4 (the four largest and most renowned accounting firms: KPMG, Ernst and Young, Deloitte and PwC), comments and publications by Central Bank of Ireland, Bank of England, Bank of France and European commission.

I have downloaded and read over hundred pieces of reports, researches, comments, publications and opinions and I have really enjoyed the research process. In fact the research process was always my favourite part of any assignment throughout my academic studies. Honey&Mumford have identified four learning styles which influence our preferences and the way we approach the learning process. According to this theory my learning style is a 'reflector', with 'theorist' being a close second. Furthermore according to Carl Jung personalities types theory, I am an 'analytical thinker'. Jung theory is based on his believed that our personality type will influence how we take in information (how we "perceive" things): through senses or intuition, and how we make decisions: through objective logic or subjective feelings and so on. Therefore it is not surprising that research process: finding, reading and selecting relevant information interests me the most. What I have noticed though during the dissertation process that because of this influences I spent much of the time on the research part of the dissertation and the literature review and having the discussions/interviews with knowledgeable professionals that I found myself under substantial pressure before the dissertation submission to complete the analysis and conclusion part of the dissertation and I had to ask for the time off work to actually finish it.

Reflection on learning.

When I enrolled for the MBA course my two main goals were to gain theoretical and practical knowledge in Finance and the MBA degree itself. I have considered those to be the most important components for successful career development.

MBA – Finance programme provided me with required theoretical knowledge and helped me to enhance quantitative, analytical, logical, research, critical thinking and problem solving skills

and gave me an opportunity to build contacts with similar minded people and enhance on my social skills.

One of the most valuable lessons I've learned during MBA programme is the tremendous importance of enhancing my social and networking skills and taking advantage of professional site like LinkedIn for future career development. Being an introvert I am very private person, I don't like to talk about myself and I have a small group of friends who I know for a long time and I never considered joining networking sites like LinkedIn and Facebook.

“Unless you try to do something beyond what you have already mastered, you will never grow.”

Ronald Osborn

When I selected unknown to me topic for the dissertation I have realised what it would be difficult and challenging. I however underestimated just how difficult and stressful it was going to be to learn about IAS 39, to review available literature, to decide what part of IAS 39 is the most controversial and currently relevant to formulate and questions for the interviews and most importantly to get access to professionals who worked within the auditing and advisory services of Financial Institutions. Moreover following the banking crisis banks and auditors were heavily criticised for misreporting financial information, underprovisioning and understating possible losses within the industry. It therefore was very difficult to find someone within the Big 4 firms, who had an experience and exposure to auditing Irish banks. I only managed to overcome this obstacle with the help of one of my friends and one of the Directors in my company who personally knew a couple of Big 4 accountants and helped to set up the interviews.

As I have mentioned before my learning style and personality type had a lot of influence on me throughout the dissertation process. Original timetable for completing various tasks for the dissertation were not kept by me largely because I spent extra time reading more and more literature. Sometimes I read comments like on accounting standards in US or how accounting standards affected other EU countries, which are very interesting, but not relevant to my topic. This interest in research process had substantially reduced the time I had left for the interviews and analyses of the interviews data. I realise now how impractical I used my time and how unfair I distributed the time between the different parts of dissertation.

Winston Churchill ones said – “He who fails to plan is planning to fail”.

This quote is very appropriate in the context of my dissertation and the most important lesson I learned from this experience. A plan and a timetable need to be the first thing that is organized

for the dissertation or any research and I need to follow it exactly and I need to control my personal preferences so I won't get sidetracked.

The most important skills I enhanced throughout the dissertation process are critical analysis skills, critical research skills and gained project management skills. Although the project management skills and decision making need to be much enhanced further. I always considered analytical and research skills as my strengths. I always do thorough research on the topic and can provide in depth non-bias critical analysis. I however realise that in a business environment I will not always have the time and enough information to enable me to perform adequate research and analysis for making practical decisions and I need to work on being comfortable to making the best decision with imperfect information and limited time. And the best way to make sure everything is completed on time is a proper planning and following the agreed timetables.

Looking back at the whole process of the dissertation and thinking about what I would have changed, a number of points come to mind. Firstly I admit that while my topic was extremely interesting I have underestimated its complexity and time needed for it studying. It would be more logical to write dissertation on a topic I was already familiar with. Hence the next time I will be more realistic and honest about the topic selection. The second thing I would do differently is have better planning and project management. I believe that if I followed the original timetable I created for this project and not taken longer time for the part that I like most about the research i.e. secondary data collection and literature review, I would have appropriate time to do better analyses and conclusion parts and I would do more justice to the topic. Better planning would also help to avoid the unexpected expenses associated with the transcription of most interviews.

The last point I want to make about the MBA programme is that it help me to realise that knowledge is not constant and if I want my career to progress I'll have to continuously enhance my existing skills, improve my social skills, networking and leadership skills and continuously expand my cognitive knowledge and professional experience.

Bibliography

Accountingweb.com (2004) 'Accounting Rule on Derivatives Sparks Veto by 4 EU Nations'.

Available at: <http://www.accountingweb.com/topic/accounting-rule-derivatives-sparks-veto-4-eu-nations> (Accessed: 08 June 2013)

Armitstead L. (2013) The Telegraph [online] 'Bank of England is wrong on accounting rules, says Sir David Tweedie'. Available at:

<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9832602/Bank-of-England-is-wrong-on-accounting-rules-says-Sir-David-Tweedie.html> (Accessed: 08 June 2013)

Bank of England (2012) 'Financial Stability Report' November 2012, Issue No. 32. Available at:

<http://www.bankofengland.co.uk/publications/Documents/fsr/2012/fsrfull1211.pdf> (Accessed: 08 June 2013)

Bank of France (2008) 'Valuation and Financial stability', October 2008. Available at:

http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/rsf_1008.pdf (Accessed: 08 June 2013)

Bischof J., Bruggemann U., Daske H. (2012) 'Fair Value Reclassifications of Financial Assets during the Financial Crisis'. Available at:

<http://sfb649.wiwi.hu-berlin.de/papers/pdf/SFB649DP2012-010.pdf> (Accessed: 03 June 2013)

Bomcke N. (2004) Federation of French Banks [online] 'European Banks Request Progress on

IAS 39 Before Endorsement'. Available at: <http://www.fbf.fr/en/banking-issues/accounting/european-banks-request-progress-on-ias-39-before-endorsement> (Accessed: 08 June 2013)

Brown-Hruska S., Satwah S. (2009) 'Financial disclosure and SFAS 157: seeking transparency in a perfect storm'. Capital Markets Law Journal, Volume 4, Issue 2 Pp. 133-154. Available at:

<http://cmlj.oxfordjournals.org/content/4/2/133.extract> (Accessed: 08 June 2013)

Bryman A. and Bell E. (2011). Business Research Methods. 3rd edn. Oxford: Oxford University Press.

Butler C. (2013, January 4) 'Bank regulation a worry for Ireland's legacy debt negotiations'. Available at: <http://www.irishtimes.com/newspaper/finance/2013/0104/1224328418861.html> (Accessed: 02 March 2013)

Butler C. (2013, January 21) 'EU negligence on accounting standards allowed Irish banks to conceal losses'. Available at: <http://www.irishtimes.com/newspaper/finance/2013/0121/1224329102849.html> (Accessed: 02 March 2013)

Butler C. (2012) 'Badly run banks should be subjected to serious scrutiny'. Available at: <http://www.irishtimes.com/business/sectors/financial-services/badly-run-banks-should-be-subjected-to-serious-scrutiny-1.550652> (Accessed: 02 March 2013)

Butler C. (2012) 'Barclays scandal shows flaws at heart of accounting'. Available at: <http://www.irishtimes.com/business/sectors/financial-services/barclays-scandal-shows-flaws-at-heart-of-accounting-1.536916> (Accessed: 02 March 2013)

Central Bank of Ireland (2008) Quarterly Bulletin/02/April 08: Statistical Appendix. Available at: <http://www.centralbank.ie/publications/Documents/2008%20No.%20%20Statistical%20Appendix.pdf> (Accessed: 28 July 2013)

Central Bank of Ireland (2009) Quarterly Bulletin/02/April 09: Statistical Appendix. Available at: <http://www.centralbank.ie/publications/Documents/2009%20No.%20%20Statistical%20Appendix.pdf> (Accessed: 28 July 2013)

Central Bank of Ireland (2010) Quarterly Bulletin/Q2 /April 10. Available at:
<http://www.centralbank.ie/publications/Documents/Quarterly%20Bulletin%20Q2%202010.pdf>
(Accessed: 28 July 2013)

Central Bank of Ireland (2011) Impairment Provisions and Disclosure Guidelines, December 2011. Available at: <http://www.centralbank.ie/press-area/press-releases/documents/impairment%20provisioning%20guidelines-%20central%20bank%20of%20ireland%20-%20decemeber%202011.pdf> (Accessed: 13 August 2013)

Central Bank of Ireland (2012) Valuation Processes in the Banking Crisis – Lessons Learned – Guiding the Future. Available at: <http://www.centralbank.ie/regulation/industry-sectors/credit-institutions/documents/central%20bank%20valuation%20processes%20lessons%20learned.pdf>
(Accessed: 13 August 2013)

CFA (2008) [online] ‘Fair Value Supporters Urge SEC Not to Suspend Mark-to-Market Accounting Rule’. Available at:
http://www.cfainstitute.org/about/press/release/Pages/10152008_16447.aspx (Accessed: 21 July 2013)

de Larosiere J. (2009) ‘High-Level group on Financial supervision in the EU’. Available at:
http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (Accessed: 24 February 2013)

Department of Finance [online] (2008) Press release 30 September 2008 ‘Government decision to safeguard Banking System’. Available at:
<http://www.finance.gov.ie/documents/pressreleases/2008/blo11.pdf> (Accessed: 24 July 2013)

Department of Finance [online] (2013) Press release 26 February 2013 ‘Minister for Finance announces the ending of the Bank Guarantee (Eligible Liabilities Guarantee Scheme)’. Available at: <http://www.finance.gov.ie/viewdoc.asp?DocID=7577> (Accessed: 24 July 2013)

Dixon J., Frolova Y. (2013) ‘Accounting for good governance: the fair value challenge’. Corporate Governance, Vol. 13 Iss: 3, pp.318 – 331. Available at:
<http://www.emeraldinsight.com/journals.htm?articleid=17086153> (Accessed: 08 June 2013)

Doty J. (2011) ‘Testimony Concerning the Role of the Accounting Profession In Preventing Another Financial Crisis’. United States Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Insurance, and Investment. Available at:
http://pcaobus.org/News/Speech/Pages/04062011_DotyTestimony.aspx (Accessed: 12 June 2013)

European commission (2004) ‘Accounting standards: Commission endorses IAS 39’. Available at: http://europa.eu/rapid/press-release_IP-04-1385_en.htm (Accessed: 24 February 2013)

Ernst&Young (2005) ‘The Impact of IFRS on European Banks’. Available on:
http://www2.eycom.ch/publications/items/ifrs/single/200610_impact_euro_banks/200610_ey_impact_ifrs_euro_banks.pdf (Accessed: 08 June 2013)

Fest-Pell D. (2012) ‘APPLYING MACRO-PRUDENCE IN FINANCIAL STANDARD SETTING’. ACRN Journal of Finance and Risk Perspectives, Vol. 1, Issue 1, p. 15-31, Oct. 2012. Available at: <http://www.acrn.eu/resources/Journals/JOFRP0101/201201b.pdf> (Accessed: 08 June 2013)

Griffin C. (2008) ‘Basel II Capital Adequacy Regulations & the Credit Crisis Cause or Cure?’. Available at: <http://www.accountancyireland.ie/Archive/2008/June-2008/Basel-II-Capital-Adequacy-Regulations--the-Credit-Crisis-Cause-or-Cure/> (Accessed: 02 March 2013)

Haldane A. (2011) ‘Accounting for bank uncertainty’. Available at:
<http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech540.pdf> (Accessed: 24 February 2013)

Hansen R.S. and Hansen K. (no date) ‘ Using a SWOT Analysis in Your Career Planning’. Available at: http://www.quintcareers.com/SWOT_Analysis.html (Accessed: 14 August 2013).

Harris I., Mainelli M. (2012) 'Confidence accounting: a proposal – 2012 ACCA'. Available at: <http://www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/tech-af-cap.pdf> (Accessed: 08 June 2013)

Honohan P. (2009) 'Resolving Ireland's Banking Crisis'. The Economic and Social Review, Vol. 40, No. 2, Summer, 2009, pp. 207–231. Available at: <http://www.tara.tcd.ie/bitstream/2262/58797/1/Vol-40-2-Honohan.pdf> (Accessed: 20 July 2013)

Honohan P. (2010) 'The Irish Banking Crisis. Regulatory and Financial Stability Policy 2003-2008'. Available at: <http://www.bankinginquiry.gov.ie/The%20Irish%20Banking%20Crisis%20Regulatory%20and%20Financial%20Stability%20Policy%202003-2008.pdf> (Accessed: 09 March 2013)

Howells P. and Bain K. (2008) The Economics of Money, Banking and Finance. 4th edn. London: Prentice Hall.

HumanMetrics Site (no date) 'Jung Typology Test'. Available at: <http://www.humanmetrics.com/cgi-win/jtypes2.asp> (Accessed: 14 August 2013).

IASC (2009) 'Statement of the Monitoring Board for the International Accounting Standards Committee Foundation on Principles for Accounting Standards and Standard Setting'. Available at: <http://www.fsa.go.jp/inter/etc/20091002/02.pdf> (Accessed: 08 June 2013)

IASCF (2009) International Financial Reporting Standards (IFRS). London: IASC Foundation Publications Department.

Irish Statute Book [online] 'S.I. No 116/2005 European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005. Office of Attorney General. Available at: <http://www.irishstatutebook.ie/2005/en/si/0116.html> (Accessed: 20 July 2013)

Jicking M. (2010) 'Causes of the Financial Crisis'. Congressional Research Service. Available at: <http://www.fas.org/sgp/crs/misc/R40173.pdf> (Accessed: 08 June 2013)

King M. (2012) 'Financial Stability Report'. Available at: <http://www.bankofengland.co.uk/publications/Documents/fsr/2012/fsrfull1211.pdf> (Accessed: 24 February 2013)

Laux C., Leuz C. (2009) 'The crisis of fair-value accounting: Making sense of the recent debate'. Available at: <http://www.cepr.org/2432/LauxFinal.pdf> (Accessed: 20 July 2013)

Levitt A. (2008) The Wall Street Journal [online] 'How to Restore Trust in Wall Street'. Available at: <http://online.wsj.com/article/SB122238715655877159.html> (Accessed: 20 July 2013)

MindTools Site (no date) 'Personal SWOT analyses. Available at: http://www.mindtools.com/pages/article/newTMC_05_1.htm (Accessed: 14 August 2013)

McMahon G. (no date) 'Mark-to-market's real role in the crisis: helping build the super bubble'. Available at: <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821412391&blobheader=application%2Fpdf> (Accessed: 08 June 2013)

Nyberg P. (2011) 'Misjudging Risk: Causes of the systemic banking crisis in Ireland'. Available at: <http://www.bankinginquiry.gov.ie/Documents/Misjudging%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf> (Accessed: 02 March 2013)

Official Journal of the European Union (2004) 'COMMISSION REGULATION (EC) No 2086/2004 of 19 November 2004. Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:363:0001:0065:EN:PDF> (Accessed: 12 June 2013)

O'Sullivan and Kennedy T. (2010) 'What caused the Irish banking crisis?' Available at: <http://www.emeraldinsight.com/journals.htm?articleid=1876048&show=abstract> (Accessed: 09 March 2013)

Papa V. (2012) CFA Institute [online] Were Fair Value Accounting Concerns Overblown? Available at: <http://blogs.cfainstitute.org/marketintegrity/2012/03/08/were-fair-value-accounting-concerns-overblown/> (Accessed: 20 July 2013)

Plantin, Sapra, Shin (2008) Bank of France 'Financial Stability review'. Available at: http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/rsf_1008.pdf (Accessed: 20 July 2013)

Regling K. and Watson M. (2010) 'A Preliminary Report on the Sources of Ireland's Banking Crisis'. Available at: <http://www.bankinginquiry.gov.ie/Preliminary%20Report%20into%20Ireland's%20Banking%20Crisis%2031%20May%202010.pdf> (Accessed: 02 March 2013)

Ryan B., Scapens R., Theobald M. (2003) Research Methods and Methodology in Finance and Accounting. 2nd edn. London: Thomson Learning.

Saunders M., Lewis P. and Thornhill, A. (2009). Research Methods for business students. 5th edn. Essex: Pearson Education Limited.

Scott I.E. (2010) 'Fair Value Accounting: Friend or Foe?' Available at: http://www.law.harvard.edu/programs/about/pifs/llm/select-papers-from-the-seminar-in-international-finance/llm-papers-2008_2009/scott.pdf (Accessed: 08 June 13)

Silverman D. and Marvasti A. (2008) Doing Qualitative Research. London: Sage Publications Inc.

Sopelsa B. (2008) 'Former FDIC Chair Blames SEC for Credit Crunch'. CNBC, 09th October 2008. Available at: <http://www.cnbc.com/id/27100454> (Accessed: 20 July 2013)

The Performance Juxtaposition Site (2012) 'Learning styles and preferences'. Available at: http://www.nwlink.com/~donclark/hrd/styles/honey_mumford.html (Accessed: 14 August 2013).

Appendices

Appendix 1.

Interview Questions for accountants on the role of accounting standard IAS39 in Ireland's banking crisis.

All questions directed at the period before year 2010.

All interviews progressed in the semi structured form. The questions below are for the guidelines purposes. All the questions were answered during the interviews, but were not asked in the order as they are appearing below.

1. What do you think about the findings of the report of Governor of Irish Central Bank in to causes of the Irish Banking crisis namely: Patrick Honohan' s report 'The Irish Banking Crisis. Regulatory and Financial Stability Policy 2003-2008'?
2. What do you think about the findings of the report issued by Regling and Watson to the Irish Ministry of Finance namely: 'A Preliminary Report on the Sources of Ireland's Banking Crisis'?
3. What do you think about the findings of the report issued by Commission of the Investigation into the Banking Sector in Ireland headed by Peter Nyberg namely: 'Misjudging Risk: Causes of the systemic banking crisis in Ireland'?
4. The general consensus of the three above reports is that Irish Banking crisis was mainly caused by 'home-grown' factors. Do you share this opinion? Please elaborate?
5. Do you think Irish Banks would have been ok if the global financial crisis has not happened?
6. How regulation of the Irish Banks was carried out prior to 2009?
7. 'de Larosiere report' criticised EU's supervisory and regulatory structures. Were the shortcoming of these EU's structures were evident before the crisis? Or were the findings of the report something new?

8. What do you think about Irish Financial Regulator's performance prior to 2009?
9. What do you think about EU's supervisory and regulatory structures prior to crisis?
10. What did you think about Irish economic situation in 2007, before the crisis?
11. Was the imminent burst of the Irish property bubble in 2008 was obvious to you?
12. In 2005 EU adopted International Accounting Standards (IAS). What do you think was the impact of the IAS on to Irish Banking sector?
13. What do you think about the adoption of the IAS 39? Was the EU Commission correct?
14. What do you think about adopting IAS 39 not fully, but with two 'carve-outs' especially the carve-out of the full fair value option and limiting the scope of the full fair value option?
15. Do you think it is important to value financial instruments in the Banks on the fair value basis?
16. Please give your view on the role of fair value measurement model in Irelands banking crisis?
17. Please give your view on the loans and receivables category of IAS 39. Is it optimal to measure this category at amortised cost?
18. What financial assets do you believe had the most impact in the Ireland's banking crisis?
19. What is your opinion on the loans impairment provisions per IAS 39?
20. Is the 'incurred model' optimal model for losses recognition?
21. Bank of England and Cormac Butler have recently criticised IAS 39 as a tool for the Irish Banks to conceal losses after 2005. What is your opinion on this matter?
22. Andrew Haldane, a Director of Financial Stability at the Bank of England commented in his recent speech that fair value and mark to market accounting polices change each other cyclically, depending on the prosperity, i.e. good or bad times. What do you think about this observation?
23. Do you think IAS 39 could or had contributed to the Irish Banking crisis?

Thank you for your cooperation.

Appendix 2

All Credit Institutions: Aggregate Balance Sheet

€ million	31/12/2007	31/12/2008	31/12/2009
	All Credit Institutions	All Credit Institutions	All Credit Institutions
Liabilities			
1 Capital and reserves	74,353	74,006	85,603
2 Deposits from credit institutions & other MFIs (excluding Central Bank)	516,874	639,459	592,508
3 Deposits from Central Bank	40,088	98,125	90,899
3.1 Short-term	40,088	98,125	90,898
3.2 Other	0	0	1
4 Deposits from general government (central, regional and local)	16,176	18,641	6,070
5 Deposits from other residents (non-MFIs, non-Government)	300,031	290,028	271,988
5.1 Overnight: Current accounts	55,517	54,054	46,971
Demand accounts	61,345	56,561	63,646
5.2 Agreed maturity: Up to and including 1 year	121,852	124,806	94,609
1 to 2 years	4,700	8,992	10,966
Over 2 years	32,103	32,515	30,438
5.3 Notice: Up to and including 3 months	14,110	9,150	16,780
Over 3 months	33	30	0
5.4 Repurchase agreements	10,371	3,921	8,577
6 Debt securities issued	254,022	187,951	179,177
6.1 Up to and including 1 year	105,741	55,591	46,496
6.2 1 to 2 years	14,852	14,172	28,677
6.3 Over 2 years	133,429	118,188	104,003
7 Remaining liabilities	135,812	116,269	80,439
Total liabilities	1,337,356	1,424,479	1,306,685
Assets			
1 Holdings of notes and coin	1,650	1,586	1,320
2 Loans to credit institutions and other MFIs (excluding Central Bank)	335,743	400,704	399,341
3 Balances with Central Bank	22,752	21,181	16,102
3.1 Mandatory balances	11,409	9,303	9,278
3.2 Other	11,343	11,879	6,825
4 Loans to general government (central, regional and local)	22,996	20,574	15,813
5 Loans to other residents (non-MFI, non-Government entities)	607,906	645,389	591,566

5.1	Overdrafts	10,165	8,584	9,286
5.2	Repurchase agreements	8,608	9,322	11,302
Appendix 2 continues				
5.3	Loans up to and including 1 year	69,588	72,395	63,144
5.4	Term/revolving loans	209,363	221,539	192,050
5.5	Instalment credit/hire-purchase/leases	4,334	3,787	2,955
5.6	Residential mortgages	124,458	115,610	111,211
5.7	Other mortgages	18,812	18,627	16,809
5.8	Other loans and securities Issued to other residents	162,578	195,524	184,810
6	Holdings of securities	220,901	237,597	209,580
6.1	Issued by MFIs	132,976	139,275	114,416
6.2	Issued by general government	87,925	98,323	95,164
6.2.1	Exchequer notes	691	3,806	4,649
6.2.2	Securities	87,234	94,517	90,515
7	Holdings of shares and other equity	13,071	16,060	16,254
7.1	Issued by MFIs	4,597	5,668	5,732
7.2	Issued by other residents (non-MFI, non-Government)	8,475	10,393	10,523
8	Fixed assets	2,054	1,879	1,350
9	Remaining assets	110,281	79,509	55,359
Total assets		1,337,356	1,424,479	1,306,685

Source Central Bank of Ireland - Statistical Appendices

Quarterly Bulletin 02/April 2008 - Page 37

Quarterly Bulletin 02/April 2009 - Page 37

Quarterly Bulletin 02/April 2010 - Page 25

Appendix 3

Credit Institutions: Aggregate Balance Sheet (Irish Residents only)

€ million	31/12/2007	31/12/2008	31/12/2009
	Irish residents	Irish residents	Irish residents
Liabilities			
1 Capital and reserves	44,961	42,106	54,764
2 Deposits from credit institutions & other MFIs (excluding Central Bank)	117,034	179,007	171,228
3 Deposits from Central Bank	39,840	98,125	90,899
3.1 Short-term	39,840	98,125	90,898
3.2 Other	0	0	1
4 Deposits from general government (central, regional and local)	2,573	3,155	3,276
5 Deposits from other residents (non-MFIs, non-Government)	180,166	176,157	171,305
5.1 Overnight: Current accounts	38,069	34,271	36,007
Demand accounts	43,814	34,839	39,469
5.2 Agreed maturity: Up to and including 1 year	71,796	80,045	59,910
1 to 2 years	3,357	6,784	9,898
Over 2 years	10,777	11,759	10,067
5.3 Notice: Up to and including 3 months	12,098	8,429	15,949
Over 3 months	31	30	0
5.4 Repurchase agreements	225	0	5
6 Debt securities issued	30,588	36,636	50,753
6.1 Up to and including 1 year	3,345	1,959	4,315
6.2 1 to 2 years	4,487	4,596	12,474
6.3 Over 2 years	22,755	30,082	33,965
7 Remaining liabilities	70,083	31,615	42,097
Total liabilities	485,245	566,801	584,321
Assets			
1 Holdings of notes and coin	1,629	1,561	1,308
2 Loans to credit institutions and other MFIs (excluding Central Bank)	117,034	179,007	171,228
3 Balances with Central Bank	22,428	20,215	15,937
3.1 Mandatory balances	11,409	9,303	9,278
3.2 Other	11,019	10,912	6,660
4 Loans to general government (central, regional and local)	1,047	1,306	1,310
5 Loans to other residents (non-MFI, non-Government entities)	370,752	385,112	365,610

5.1	Overdrafts	8,236	9,400	8,729
5.2	Repurchase agreements	1,676	66	43
Appendix 3 continues				
5.3	Loans up to and including 1 year	60,608	61,494	55,275
5.4	Term/revolving loans	144,245	148,881	132,650
5.5	Instalment credit/hire-purchase/leases	3,768	3,367	2,506
5.6	Residential mortgages	123,002	114,079	109,917
5.7	Other mortgages	18,548	17,092	15,471
5.8	Other loans and securities Issued to other residents	10,669	30,733	41,019
6	Holdings of securities	9,596	21,845	32,596
6.1	Issued by MFIs	8,958	19,707	24,542
6.2	Issued by general government	638	2,138	8,053
6.2.1	Exchequer notes	10	10	717
6.2.2	Securities	628	2,128	7,336
7	Holdings of shares and other equity	6,857	9,254	8,490
7.1	Issued by MFIs	2,077	3,325	3,109
7.2	Issued by other residents (non-MFI, non-Government)	4,780	5,928	5,381
8	Fixed assets	2,054	1,879	1,350
9	Remaining assets	61,782	25,269	23,510
Total assets		593,180	645,447	621,337

Source Central Bank of Ireland - Statistical Appendices

Quarterly Bulletin 02/April 2008

Quarterly Bulletin 02/April 2009

Quarterly Bulletin 02/April 2010

Appendix 4

Assets at Fair Value and Loans and Receivables Assets in the Ireland's Credit Institutions

€ million	2007		2008		2009	
	Irish residents	All Credit Institutions	Irish residents	All Credit Institutions	Irish residents	All Credit Institutions
<u>Assets at Fair Value</u>						
Holdings of securities	9,596	220,901	21,845	237,597	32,596	209,580
Holdings of shares and other equity	6,857	13,071	9,254	16,060	8,490	16,254
Total Assets at fair value	16,453	233,972	31,099	253,657	41,086	225,834
Total Assets at Year End	593,180	1,337,356	645,447	1,424,479	621,337	1,306,685
Assets at Fair Value to Total Assets %	2.8	17.5	4.8	17.8	6.6	17.3
<u>Loans and Receivables</u>						
Loans to credit institutions and other MFIs (excluding CB)	117,034	335,743	179,007	400,704	171,228	399,341
Loans to general government (central, regional and local)	1,047	22,996	1,306	20,574	1,310	15,813
Loans to other residents (non-MFI, non-Government entities)	370,752	607,906	385,112	645,389	365,610	591,566
Total Loans and Receivables	488,833	966,645	565,425	1,066,667	538,148	1,006,720
Total Assets at Year End	593,180	1,337,356	645,447	1,424,479	621,337	1,306,685
Loans and Receivables to Total Assets %	82.4	72.3	87.6	74.9	86.6	77.0

Source Central Bank of Ireland - Statistical Appendices
 Quarterly Bulletin 02/April 2008 - Page 37
 Quarterly Bulletin 02/April 2009 - Page 37
 Quarterly Bulletin 02/April 2010 - Page 25

Appendix 5

Interviews Transcriptions.

Transcript of the Interview with Accountant 'A'

Date: 05th July 2013

Time: 3pm

Place: Dublin

The topic of the interview: The role of IAS 39 in the Irelands Banking Crisis.

Interviewer: Katerina Ryzhenkova

Accountant 'A'

So I think that all the points that you raised are very valid and they are points valid to what we want to discuss. But you are also correct in that it is not black or white. I don't think there is any one factor in all things mentioned which is the bright light or big star of why it happened, where we could point and say, this is the reason why it happened.

My own view is that the accounting standards are not at fault for the crisis. I think the idea or the way that IAS39 is written means the problem was amplified. It just served to amplify the issue.

Let me explain using an example. If you were to go back to about 2003 pre IFRS when the UK accounting standards board introduced FRS17, which was introduced to determine how one deals with defined benefit pension plans. A defined pension plan is a pension plan that provides the employee a guarantee amount in their retirement up to two thirds their final salary.

When that accounting standard was pushed a lot of companies around the same time closed down defined benefit pension plans and a lot of blamed the introduction of FRS17. The reason companies closed down defined benefit pension plans is because people are living longer, so when defined benefit plans were set up, average mortality rate might have been 65 to 70. If someone retired at 60 you gave them this promise and you had to fulfil the promise for three or four years, they died and you could afford to do so. But when people did the wrong thing and

lived a bit longer and lived to 80! That meant you had to fulfil the promise for a lot long that you though you would and couldn't afford to anymore.

So in the same way it was a misnomer or a red herring to say that FRS17 was the reason closed their defined benefit pension schemes, I think the same is true of IA39

IAS39 is not to blame for the crisis, it's not to blame for everything that happened but it has been a contributing factor.

Katerina R.

I think it was a very large contributing factor in the way it was promptly introduced in 2008 after the collapse of Lehman Brothers and the onset of the liquidity problems. The amendment itself is a significant factor in giving the banks tools to move assets between categories and hence change the way it's valued.

Accountant 'A'

When you say the amendment, which one do you mean?

Katerina R.

Well, on 13th October 2008 there was an amendment to IAS39 specifically and the statement from the international accounting standards body said it was to align IFRSs with American standards, in so to allow financial institutions to move assets and liabilities between categories. Say for example assets could be moved from category 'for Trading' to Held to Maturity. In a time of crisis when assets valuation is going down, the fact that one can move assets from trading category into held to maturity and would not have to mark to market them is very significant.

Accountant 'A'

Yes, so there was an element to it. The amendment was primarily based around a classification of assets into different categories.

In my experience, as a category, Held to Maturity was not used very much across Europe by most banks. There were a small number of insurance companies that classified assets as Held to Maturity. I don't think the reclassification itself was a big contributing factor, I think where most

people feel IAS39 was a contributing factor was to do with the impairment rules rather than the reclassification rules with the exception of assets that were available for sale.

Katerina R.

But the impairment rules are based on a class of assets; if your asset is in Held to Maturity class then you weren't allowed to do impairment. They were valued at amortised cost.

Accountant 'A'

That's not strictly true. If you put something into HDM category then you are carrying your asset at amortised costs. Then if your asset falls below its face value or par value or purchase price and there are reasons of deterioration of credit quality of the counterparty of the asset, then you should record an impairment of the asset and that impairment goes across the Profit and Loss Account.

Where the difficulty arose was in the Available for Sale category, which a lot of banks used. Available for Sale requires you to record assets on the Balance Sheet at fair value. But the difference in those instances was if the fall in fair value of assets was not considered to be prolonged or significant then rather than taking the impairment to the Profit and Loss Account you were allowed to take the impairment through reserves into an Available for Resale reserve.

So the difficulty was more to do with AFS than HDM for 2 reasons.

Firstly lots of companies didn't use HDM and secondly HDM was an amortised costs category anyway so you should end up impairing it.

I think the bigger issue was more around Available for Sale and that "prolonged and significant" term in the standard. More so particularly in terms of retail banks and particularly in terms of the Irish banks, where the real issue was around the loan book that was classified not at HDM or AFS but as loan to receivables.

The interpretation of the words "objective evidence" is important because IAS39 is an incurred loss model. Conceptually an incurred loss model is the right model because you should be recording the losses as and when they arise, rather than what you expect them to be in the future.

The problem was twofold. The first problem was that IAS39 only became widely used in 2005. We were in a boom economy and unfortunately the first time we had to test people's interpretation of IAS39 was not in a normal recession but a global crisis. Had we had a normal recession I think peoples interpretation of IAS39 and particularly "objective evidence" would

have changed but it mightn't have resulted in a need to change the accounting standard. It was only the fact that it was part of global crisis, which is why I say IAS39 amplified the problem. So firstly the circumstances were part of the problem.

The second reason was a problem around the term "objective evidence". The reason there was a problem was that most people took the view that objective evidence of impairment meant you had to account for objective evidence at the loan level, whereas objective level of deterioration something you can implement across the whole economy. So the fact that unemployment started to go up, GDP started to go down and there was less inward investment. All of these are indicative factors of objective evidence that impairment will occur and has occurred but was ignored.

So when looking whether a bank should take a provision on a loan, the bank said for example Katya is still paying her mortgage therefore the loan is not impaired. What they didn't take into account of was that Katya had lost her job 6 months before year end and the reason she is still paying her mortgage is that she is using her savings to pay. We are now in December and from 1st of February Katya won't be able to pay her mortgage because all her savings will have dried up. Part of the reason some of the banks did this was that they may not have known people were using their savings because people had their savings and current account in a different bank from their mortgage. The only transactional history the bank that holds the mortgage has is that of Katya paying the mortgage or not. They can't see the fact there is nothing coming into her account and that she is paying her mortgage using her savings.

So that meant because they didn't have that information or because even in a situation when they had that information and because they had hundreds of thousands of customers in that situation, it meant that the recognition of the fact-pattern was very late. That is the primary reason why the incurred loss model didn't work in Ireland when it was supposed to.

Katerina R.

On the subject of impairment, IAS 39 states that the loss should be realised based on the available information, you have to be objective. So you need to have objective information on the fact of actual impairment in a first place. But if you didn't try and get that information you obviously wouldn't have it. Then one could say, "well I didn't have objective information", but it would be simply because you didn't try and get it.

Accountant 'A'

Well you may not have the information because you didn't try to get it or because your information system is set up in such a way that you can't get it, even if you did make an attempt to get it. Let's go back to the example of the person who is about to default on their mortgage but they didn't before year end because they used their savings.

The person in question is only a mortgage customer, so it's difficult for the bank holding the mortgage of knowing that the individual is in financial difficulty. There is no register or piece of public information out there that alerts the bank holding the mortgage that you lost your job six months earlier.

Now compare that situation where instead of an individual we are dealing with a business. Say for example Katya is owns a prominent retail business around Dublin. She has a loan with one bank for a piece of commercial real estate. Let's say you own a store on Grafton street and that store closed and it gets written in the paper that the business has gone into liquidation, that it closed down because people are spending less money etc etc. So the bank that has loaned you the money for the real estate investment has other information available to it, if it's keeping an eye on what its customers are doing and the market place in general. The fact they are a business customer they might have a way of that the business has gone bust there as a bank we should be worried that we have an exposure to that customer.

Whereas if you are just talking about an individual and a mortgage, to get back to the retail banking situation, you have no way of knowing if an individual customer has lost their job or not. If you see the distinction between the two, in one instance by making other efforts you might be able to get more information in the commercial real estate example but the in the individual mortgage example you can't.

Katerina R.

But we do have accurate information about rising unemployment; you could use that information to build a risk model. Unemployment is going up and the price of housing is falling. You could, maybe not accurately, but you could model in the exposure to the amount of people losing jobs, e.g. if there is currently 20% unemployment in the country and there are usually 6 or 7%, the difference of over 13% who recently lost their jobs. You could assume if you are very prudent, that they all have mortgages, house prices falling by 40%, so you could model that in too.

Accountant 'A'

Yes, you can model all those things. That is why I made the opening comment that it depends on whether you are interpreting the words “objective evidence” or applying the term “objective evidence” either at an individual account level or are you applying them at a macroeconomic level. If it is applied at a macroeconomic level then I absolutely agree with everything you have said because unemployment increasing, consumer spending decreasing, all those things suggest if you have a population of consumers that there is going to be a portion of that population of consumers who will default over time and that’s what the IBNR portions of impaired loans is all about, incurred but not reported losses. So for example, Katya has lost her job therefore we will incur a loss and this might happen in the general population but it has not been reported to the bank on an individual level yet. The bank does not have enough information on an individual basis. So yes I agree with what you said.

Katerina R.

Can we assume the banks should have done this? Or did they not want to do this or was it not in their best interest to do this? Is there something in the IFRSs stopping them from doing this because it is not seen as objective enough information?

Accountant 'A'

There isn’t anything in IFRSs stopping the banks from doing that. I think pretty much everyone recognises now that in 2005 when the IFRS was applied for the first time that people didn’t think about it enough, we didn’t need to think about it to go back to my earlier comments about having to apply the impairment provision in IAS39 in a global crisis for the first time instead of a smaller crisis. I think the words in IAS39 are relatively clear but nobody had ever needed to apply them in those circumstances.

One of the things you might want to take a look at because I see you have some references from the Central Bank her with you, is the guidance that the Central Bank published on impairment in November or December 2011 about how we should interpret the words “objective evidence”. This was a document that I was involved in writing and it based on IAS39, it is based on research of not only the Irish banks but banks across Europe and some banks in the US as well. So I don’t think there is anything wrong with IAS39 in that specific part if it’s applied in the right way but it wasn’t

Katerina R.

Going back to 2005, actually the end of 2004 when the last piece of IAS39 was adopted and it was only accepted with the cut-outs for fair value and hedging accounting. It seems that there were many disagreements around that standard from the start. And if the cut outs hadn't happened for fair value and hedging would the outcome in 2008 been any different. Fair value is a significant tool in accounting?

Accountant 'A'

I don't think so. In respect of the 2 carve outs, the carve out around macro hedging accounting isn't really something that impacted fair value or impairment provisioning. It was to do with hedge accounting at a portfolio level rather than an individual item level. So I don't think that carve out relating to macro hedging accounting would have any impact on it.

The carve out in relation to fair value, maybe, but the carve out was quite narrow in nature and really the issue here in regards IAS39 and how it amplified the size of the problem is around impairment rules on either Available for Sale category or loan and receivables. So I don't really see that as a major issue. I think the need for the carve out in the first instance in 2004 highlighted the fact that IAS39 was a standard which was written a number of years previous and was quite rules based in nature. It wasn't the best accounting standard in the world and it hadn't been applied by a large number of companies. So are there flaws or were there flaws with IAS39 to start with? Yes there were and I think that is well recognised by not only people who are preparers and auditors but by the international standards board have long recognised IAS39 was wrong.

Katerina R.

Can it be said that in the process to harmonise American and European standards, that too much was taken from American standards, which were more liberal than UK standards for example? It seems that at every step of the way IASs was moving towards American standards, which are fairly liberal. Even the amendment in 2008 which happened within seven days of the EU asking for it. This amendment aligned exactly with American standard FAS157. What I'm getting at is that IASB was leaning towards American standards and we know they weren't adequate either as we can see from Enron, years before and there were also other collapses in 2008 before Lehman,

and at the same time these standards which hadn't been adequate to deal with those crashed were adopted in the EU.

What happened in Ireland with the banks is more than just a limited access to information. Even during the Ireland's banks bailout, Brian Lenihan thought the bailout would be the cheapest in the world at €4.5bn. It has now ended up costing €60bn, where did the other €50bn come from?

Accountant 'A'

I certainly don't think it came from accounting standards or failures of accounting standards. I also wouldn't agree that American standards are more liberal than old UK GAAP. I think American account standards are very rules based. They are perspective more than principle based. The difference between the 2 situations is that in the US accounting standards are seen as a set of rules that one uses to draw up a set of financial statements. They are not the same information by which one regulates the banking sector, there are a whole different set of rules in the US, regulating rules around how one puts together impairment. So in the US they don't use the US GAAP financial statements as the information to regulate the banks. That comes from the FCC and various other boards depending whether you are a state bank or a countrywide bank.

Whereas in Ireland and in Europe the financial statements and annual report is one of the primary tools used by banking supervisors for banking supervision. It shouldn't be. They are not fit for purpose.

An annual report and the information in the annual report and the way in which the report is put together is for a different purpose. They are general purpose financial statements for the purpose of informing shareholders for the most part around the financial performance of the business. They are not supervisory documents and they are not intended to supply information for prudential supervision and that is partly where the problem lies. If you talk to a number of people in the Central Bank here or in other regulatory authorities around Europe they will tend to agree with that comment. So the purpose for what the information is being used is for is wrong to a degree.

Katerina R.

Is it fair to say then that the Central Bank is partially to blame? It's up to them how they regulate banking. They could request a different set of reports, with different information from the banks, according to their needs to monitor and regulate.

Accountant 'A'

They are the regulator so they are entitled to ask for whatever information in whatever format they think is necessary in order to regulate. That's not necessarily the same thing as the annual report so I would agree with you that it's up to the regulator to decide what information needed to regulate.

Katerina R.

There is a point made by Cormac Butler who is very critical of the IFRSs and how they have allowed banks to conceal losses and that in fact IFRSs allow financial statements at least in Ireland to breach company law. Do you agree?

The company law in Ireland states that the accounts must be prepared on a true and fair basis. But who is it up to dispute the opinion of a Director that this is not the fair value for an item. Who is going to disagree and say contrary to that, and to make sure that he/she is presenting the item at a true and fair value?

Accountant 'A'

I think there are a number of questions there in what you have just said.

To deal with them individually, I don't agree with Cormac that the application of IAS39 is in contravention of Irish company law. I think Cormac took that same thought process from Tim Bush, who has been a consumer economist in the UK press. From my perspective Irish law allows financial statements to be prepared in 2 ways, Compact Acts set of financial statements or IFRS set of financial statements.

That's what the law permits so if you prepare a set of IFRS financial statements in compliance with IFRS and you apply IAS39, you are therefore preparing a set of financial statements which the law permits.

Giving a true and fair view as demonstrated by councils in 2006/2007 and 2008 from an IFRS perspective but also in the 1980s/1990s in terms of UK accounting standards, true and fair view means that the financial statements are in compliance with GAAP. It doesn't mean that the fair value ascribed to a particular number is exactly right. So a true and fair view is derived by applying with a set of accounting standards. It is judged on the financial statements taken in totality as a whole. It's not taken by reviewing each individual item. That is to answer your first

question in terms of what Cormac said. I don't agree with him and I don't agree with him for that reason.

In terms of a Director putting a fair value assessment on a particular instrument in a particular set of financial statements, who is there to say he is right or wrong?

Well I think there is a general problem with the use of fair value in financial statements, which is a separate issue which I will return to later. It's up to the directors to provide evidence that the fair value or the number they have ascribed to a particular instrument in a set of financial statements is the true value. You gather all that information in auditing a bank to come to an audit report. Some might say it's up to the auditors, I actually don't think that's true, I think they are there to give a true and fair view and giving a true and fair view is different for the reason I explained in the first part of this question.

What we need is a regulatory system that goes and reviews those financial statements from a preparer's perspective, something like the Financial Review Panel in the UK. Who can go in and do investigations and make sure the application of the accounting standards are correct. So ultimately that's who should be looking over the shoulder of a bank director to determine whether or not the fair value ascribed to a particular instrument is actually its fair value, whether it is an accounting regulator or a providential supervisor.

The third thing to say around that is that fair value is not a very good measure to be used in financial statements because of the fact that many instruments that carry a fair value don't have a market, there is no objective index where you can go and say, the price is X. If you have shares in CRH you can go to the stock market at the end of every day and it will tell you what it is worth. If I own 1 share in a vehicle which is a retail mortgage backed security, I can't go to an index, either on Bloomberg or the back of The Irish Times for some of them at least to be told a value for the security. It just doesn't exist. So we have to use a model to come up with a value and then we are getting away from the true and value. So fair value is an extremely difficult concept to apply in practise and for that reason I would personally suggest that it should be used in limited circumstances.

Katerina R.

There was also a point made by Cormac Butler, I seem to be referring to him a lot but he was well publicised and a bit louder than other people.

Accountant 'A'

Indeed

Katerina R.

He commented, in relation to IFRSs and company law, that back in 2008, around the time of IAS39 amendment, there were legal concerns within the financial industry. Butler states that the board went to get a legal opinion from Martin Moore that by preparing the accounts using IFRS one is following company law. Butler states that to the contrary, legal opinion stated that simply preparing the accounts using IFRSs does not automatically mean you are complying with company law. Butler is publishing articles based on the Irish and UK banks. There were also comments made by The Bank of England during the recent 2012 enquiry that Ireland and the EU had accepted IRFS unconditionally and had most largest banking collapse.

In your view is there a link between the degree to which you follow IFRSs and the level of crisis and loss at the banks? Also, where does it leave Ireland?

Accountant 'A'

So I think there are a couple of comments I would make around that, is there a corollary between accounting standards and the losses the banks suffered? I don't think there is. Accounting standards are a reporting tool, they report what happened. The value of what was lost or made has to be calculated before you report it. I don't think the accounting standards influenced the amount of money a bank made or lost. They are just a reporting tool.

Secondly, I understand Cormac Butler's points, he has made them quite vocally as you said but I have yet to meet a single person who agrees with his point of view.

Thirdly, it is considered that you give a true and fair view by complying with a body of accounting standards, whilst I understand Cormac's comments, I don't see the logically basis for them.

Katerina R.

I suppose he is taking the legal opinion and giving his interpretation of it.

Accountant 'A'

He has read the legal opinion. He has a perspective on it but the basis for this perspective is not quite understandable from my perspective. I don't think there is great logic in the reasoning for his argument.

Katerina R.

Moving away from the legal perspective... Accounting standards provide rules and one prepares accounts based on these rules. So if in the final product, i.e. balance sheet and PL, when we are looking at a set of accounts prepared based on these standards and if these standards allow you no to show impairment through the Profit and Loss account but instead do it through the Balance Sheet, then won't it be distorting the profits?

Accountant 'A'

I understand what you are saying. If an accounting standard allows you to take increases or decreases in the value of an asset through your reserves instead of through the Profit and Loss account, is this allowing you to distort profit in a different manner?

Yes.

Katerina R.

There are many people who actually look at a bank's Balance Sheet or Profit and loss of banks. They don't realise that what they are looking at isn't the actual financial position of the bank. You have to read through 200 pages of notes to get the fair value of X and the fair value of Y. What is BS and PL is good for then?

Accountant 'A'

I don't disagree with you, but I suppose you are trying to address a number of different things. I agree that for the general public who might have decided to buy some shares in for example AIB that the Profit and Loss account or the Balance Sheet or the Reserves are not going to be terribly understanding to them. I would agree with you around that.

But that's why banking as an industry is regulated. That is why there is a regulator, to guard the public interest. The only reasons banks are regulated are because they are in the public interest versus something like CRH which is about making profits or not. It is not systemic to the

economy nor does it take “general public money”, if I may call it that. So the average person that invests his savings into bank shares mightn’t have necessary understanding and that’s why they should be offered some level of protection by the regulator. The regulator does or should have the understanding or they can’t or shouldn’t be in a position to regulate.

To be continued ...

Interview was continued on the 19th July 2013...

Transcript of the Second Interview with Accountant ‘A’

Date: 19th July 2013

Time: 4pm

Place: Dublin

The topic of the interview: The role of IAS 39 in the Irelands Banking Crisis.

Interviewer: Katerina Ryzhenkova

Katerina R.

I would just like to say for the record that it's 19th July and we are continuing from the previous interview.

I first picked on the notion of herding behaviour in the financial market from the Nyberg report where the banks strategies and policies were blamed mostly for banking crisis in Ireland.

He mentioned that herding behaviour of banks managers contributed to the crisis as banks seemed to following the same strategies, making the same mistakes and ending up in the same situation.

And this notion of herding behaviour came up at a different stage during the literature review. Same thing came out to do with managerial behaviour during economic cycles and there were extensive researches done in to this notion and in particular a good one by Diamond and Dubrick, who summarised all the previous researches into herding and there seems to be a lot of herding in financial industry.

So the question is, do you believe there was a herding behaviour going on in Ireland?

Accountant ‘A’

I think it might well have been. To go back to the question around herding, I mean it's not – I haven't read the entirety of the report so it's not something I am very familiar with, but essentially, I guess what we are talking about is people kind of following the same path. And they are following the same path because the person in front of them is, because he doesn't know where the path is leading.

So did lots of people lend to particular people or to a particular developer or because another banker was doing it rather than conducting their own credit analysis as to whether or not that was

a good bankable proposition? Possibly... It's difficult for me to say whether that's the case or not because I guess I wasn't working in a bank at the time, but I do think that bank officials or banks staff's ability to lend and to understand good credit proposition was not ... It was questionable, because I think a lot of people lend money not around whether the reason for lending the money was a good bankable proposition, but rather around whether they get security over it.

Let me give you an example of it. So if I wanted to borrow money to buy a commercial unit or to buy a unit which I would turn in to a retail shop, rather than understanding how many people were going to pass by that shop and how likely were they to come in and spend money and what was the average spend per person, they probably just leant on the basis of well the guy has 20% deposit, we are lending him 80% ratio, property is going up so even if the business fails we will repossess the collateral and sell it to somebody else.

So I think my own sense is that many lending decisions were not based on the viability of the business unit but rather on the value and the resale and saleability of the underlying collateral, and I think that's part of the reason why personal guarantees are such a big culture in banking is it doesn't really matter what you are asking me to lend you money for, or is a banking proposition or not, as long as you give me a guarantee that you will pay me back in so many months.

So, to answer your question, was there a lot of herding? My sense is that there probably was, but I don't know any, I don't have any clear evidence of that and, that is just a sense.

Katerina R.

Can we really call herding, say in terms of the mortgage lending criteria could be seen as herding if one bank is going to issue 90% mortgages, the other banks have to do the same otherwise they will lose the market and it's not because they would like to? For example, the 100% mortgages which is certainly not a great idea, but they all started to do that.

Accountant 'A'

Yeah I think ... well, yes.

I think that kind of behaviour can happen whether it's right to call it herding or not. I'm not sure it's because you know when you are in business you will often make decisions around a particular transaction which are affected by something more than just a viability of the transaction.

So I had a conversation yesterday with somebody who was involved – again actually it’s in banking – who was involved with Bank of America around the time that they bought MBNA, the credit card company, and on a Saturday afternoon what could be a bank were seeking to buy MBNA. It got into the marketplace as a result of a plane crash actually on the Saturday and a company that were thinking MBNA were up for sale and by the following Tuesday, Bank of America had bought it and paid out 12 billion more than the company were going to pay for it, and the primary reason behind that was that they didn’t want that company to buy it. It wasn’t about whether MBNA was a good company to buy, it was about making sure the other competitor didn’t get it. So, decisions are taken for those types of reasons, and if you want to classify that as you know herding ...

Katerina R.

Well, that particular one isn’t really herding, that’s just not letting a competitor to gain a competitive advantage.

Accountant ‘A’

Yeah, but the same is to be said for 100% mortgages. If somebody is in the market – if somebody goes in to the marketplace offering 100% mortgages and your product is only a 90% mortgage, then you are going to lose market share. So it’s protecting your interest but you are kind of putting a different label on it, but it’s ostensibly the same thing.

Somebody does something in the marketplace that changes the dynamic and changes your ability to get business; therefore, you either have to come up with a way of combating that, either by matching their offer, one bank is giving 100%; therefore, I will give 100%, or going the other extreme and saying, ‘Well, I will give you 110% because not only will I bank your house at 100%, I will also bank the fact that you are going to have to pay stamp duty’.

So, you know, I think it’s a form of herding; it’s just to slightly different degrees, but when you do something in the marketplace, that’s driven by the fact that a competitor in the market does something different and you follow suit then that’s herding to a degree, in my view anyway.

Katerina R.

Is it the same with provisioning? Would banks, going back to 2008 talk to each other maybe on executive level? I'm not sure if you can comment on that ... would they monitor each other's activities on how much impairment is done by other banks?

And then they wouldn't do more than the other guy did because, otherwise, you are putting pressure on profits and share price. It appears that in Ireland none of the banks had done the adequate provisioning.

Accountant 'A'

OK, there are two different questions there, so first of all did they monitor each other, yes I think they did and I think, from my knowledge, the monitoring took place based on information which was in the market i.e. what they could get by looking at a press release or a website or self-monitoring, but and I have no idea that one bank rang up another bank and talked about provisioning.

But if you think about the dynamic of the market back in 2008, so you had broadly, Anglo, AIB, Bank of Ireland, EBS and Permanent TSB. Anglo had a September year-end, AIB had a December year-end, Bank of Ireland had a March year-end, so ...

What it did mean though that Bank of Ireland had the availability to wait and look and see what AIB posted in the marketplace around the 2nd or 3rd week of February before they closed their books, so that meant that they could automatically look and see what others were doing and, yes, I think they measured how many basis points did the provision convert to in overall terms of the book.

So, if you had a billion of a book and you had provisions of a hundred million, does that mean you know your book was perfectly provisioned to the hundreds basis points or ten basis points, whatever the numbers worked out at?

So, yeah, I think that they did. They follow each other, but don't forget in that situation you are – what you are doing is you are following bad news in so far as well, and if AIB had their provisions increased, did Bank of Ireland or should Bank of Ireland look at that and automatically say maybe we should be thinking about increasing ours. It's not as straightforward as that because they might have been lending money to different parts of the economy.

In terms of geographical profile, they might have had different concentrations – risk concentrations in terms of AIB might have been very exposed to retail for example. Bank of

Ireland might have been very exposed to corporate or to property lending so it's not – it's not as direct, so there is always going to be a direct correlation.

Katerina R.

It's a very interesting point. I thought when reading about the whole herding theory that it was possible that banks in Ireland could follow each other in terms of provisioning, but the different year-end made it easily available for them...

Accountant 'A'

What I think is: every company that I worked with regardless about what industry they are in, whether they are in banking or something else will generally look at what do their peers in industry do from an accounting policy selection perspective, and most people want to be in the herd, in the middle, nobody wants to be overly conservative and nobody wants to be at the deep end of the spectrum where they are seen as overly aggressive. They do generally want to be among the pack.

Katerina R.

Yes, because should we calculate company's ratios and compare the ratios to industry averages so you want to stay in the middle and as close as possible to the average.

Moving totally in different direction – do you think financial regulator and Central Bank in Ireland was very passive because of the believe in a perfect- market hypothesis? Did they, as the regulators in US and UK believed that? That the market will correct and monitor itself?

Accountant 'A'

I don't think so. My expertise is around how the stock market will correct itself over time or realign itself.

And I don't think the same is to be said in the context of the share price of each of the banks.

I wouldn't say that that really influenced the regulator's behaviour one way or the other. I think the regulator's behaviour is more focused on prudential supervision; it's more focused on how the banks were lending and their capital ratios rather than what their stock prices were doing in the marketplace.

Katerina R.

Gerard Flynn who is a lecturer in DIT issued the paper which Butler referred to stated that IAS rules were to blame for allowing banks to conceal losses, but in this instance he was making reference to Irish banks dropping prudence. As far as I understand since 2010 the prudence concept is not in IAS1 anymore. Was prudence really dropped?

Accountant 'A'

No, it may not be, but I think it's in the stating the principals in the same way that prudence was removed from all Irish GAAP as a fundamental accounting principal when FRS18 in accounting policies replaced what was either - I think it was SAP2 at the time so prudence has not been a fundamental accounting concept in Irish or UK GAAP and onward into FRS since probably somewhere around 2001 or 2002.

If you were to look at FRS18 accounting policies and look at the application date of it, that's the date in which prudence no longer became an accounting concept.

Katerina R.

But to your opinion – is it a right or wrong thing to do?

Accountant 'A'

I think it's the right thing to do, but what I mean by that is I don't think that means – I am not suggesting that means you should not be prudent when preparing a set of financial statements, but I don't think that prudence should be part of the recognition process and what I mean by that is, when you are deciding so there is a yes/no decision to be made to start off with. Let's think about it in the context of provisioning a loan or provisioning any debtor.

Katerina R.

In IAS39?

Accountant 'A'

Yeah in either IS39 or in old UK GAAP if you are a corporate and you're not lending loans but you are lending and selling widgets to a business there are two parts to the process. There is the

stop start decision of do I need to recognise a provision or do I not and that's the recognition part of the criteria. I don't believe that prudence is appropriate at that juncture.

So whether I recognise a provision on a loan or whether I recognise a provision on a bad debt, a corporate debt shouldn't come down to I will recognise it just in case it should be. Yes, there is evidence to suggest I am going to get paid or there is evidence to suggest I am not going to get paid. If you decide that there is evidence to suggest I am not going to get paid and, therefore, you decide it's appropriate to recognise at that stage when you are deciding how much to recognise.

I think it's appropriate to use prudence there so you should be pessimistic in your view having decided there is evidence to suggest I am not going to get paid when you are deciding on the quantum of the provision, you should exercise prudence in that scenario and you should be more pessimistic than optimistic in your outcome.

So, I believe in prudence not as a recognition hurdle but as a part of the measurement aspect of how big or small the provision should be not whether you should have a provision in the first instance or not.

Katerina R.

OK, but then in terms to IS39 which is based on an incurred loss model ... You can't have incurred loss model and be prudent?

Accountant 'A'

I think you can because an incurred loss model means I recognise a provision when there is objective evidence.

No, let's talk about the objective evidence not on an account level but on a market level where we are looking at it in portfolio runs like April portfolio and all mortgages or my mortgage on my house.

Katerina R.

IS39 does not allow group impairment – doesn't it?

Accountant 'A'

It does, yeah. It does allow for collective impairment and, practically speaking, that's how many banks do it. So what they will do is, they will look at individual impairment, just take the

mortgage portfolio again for a minute – they will look at individual terms assessment on mortgages, for example, that are over one million euro but for all of the mortgages that are under a million euro they will look at them collectively as a portfolio using model IAS39.

So again if we look at a portfolio of mortgages and either people in that pool of mortgages have defaulted on their loans or the macroeconomics circumstances suggest that people will default because employment is going up, GDP is going down and debt ratios are going up – that's the decision that helps you – that's the evidence that means you come to a decision that a provision is necessary.

When you are provisioning, then you have a series of inputs in to your provisioning model. One of those inputs might be that if I – one of the inputs of the model would be something called LGD which is Loss Given Default, i.e. when somebody defaults on a loan how much money will I lose. So if I set my loss given fault at 10, which means that I will lose 10% of the value and, therefore, recover 90%, then that might be a very optimistic outcome. Whereas, if I set my loss given default at a larger number being 40%, and I am being prudent in doing so because I have no other evidence to suggest it's going to be 10 so I will go for 40 then I provide a much bigger number but I am exercising prudence in that instance because I am being more pessimistic about the outcome of that situation.

Katerina R.

OK, but would IAS39 not direct you not to do that in terms of not to over provide?

Accountant 'A'

I think there was enough flexibility in IS39 to allow institutions to be pessimistic in their modelling of provisions once they had identified objective evidence to allow them to make the provision in the first place.

Katerina R.

But what is 'objective evidence'? Your objective evidence is different to my objective evidence and basically your objective opinion and someone else's objective opinion is a very, very different thing. And unless there is a clear guidelines banks will not take a pessimistic view. It's not in their interest. Banks will take the best of an optimistic view. I suppose I am going in to reliance on managers' opinions in modelling and in using managers' opinions in those models

will create much variation from one bank to another bank and from one country to another country.

Accountant 'A'

Yes they will. So by its nature and by definition of the word objective it shouldn't be subjective so the objective evidence, just the thing as to how these things get built up. So the objective evidence is the default on a loan where the macroeconomic circumstances would suggest that you should make a provision.

So the macroeconomic circumstances are the same for each bank because they all operate - and that's just talking about the Irish operation - they all operate in the same environment. When you come on to having decided, you need a provision, how you measure a provision and whether your loss given default is a big one or a small one or whether you think when you are - whether your fire sale costs in selling a property should be 5% or whether they should be 8% or whether they should be 10%, those assumptions are subjective because they are made within the bank and they are influenced by where the bank wants to portray itself or what its total market is going to be, its profit etc, etc.

So your question or I think the point you are making is, what's to stop the bank from portraying what it wants to portray rather than what might be an even more truthful situation.

Katerina R.

That's exactly what I think.

Accountant 'A'

And the only thing to stop them in the first instance, I suppose one back stop is the auditor, the second back stop is then the regulator. The difficulty with the first back stop is not every bank in town is audited by the same auditor. So if you have got an audit firm that only has one banking client then how does that auditor know whether the assumptions that the client is using are pessimistic or optimistic?

Katerina R.

Well we know Bank of Ireland's auditors can look at the published accounts of other banks and that information would be disclosed.

Accountant 'A'

Again in the year-ends being different for the banks, that changed so each bank had a different year-end up until 2008 or 2009 when the government changed them all so that became more difficult and again prior to that it didn't really matter what provisions you were making because the environment was such that we were in a bubble and not in a bust.

And the second thing is that the level of detail that we are talking about here isn't always disclosed in the financial statements. So the actual loss given default on a portfolio of specific loans may not be something that banks are required to submit in financial statements. So that then leaves you in a situation where if you are one – if you are an audit firm and you have one audit banking client then it's very difficult for you to say to the chief executive of a particular bank your estimates are too optimistic. Well how are they too optimistic?

Well I don't know because I don't have any other banking clients but I am just telling you I think they are too optimistic so that's why and that's what makes that very difficult whereas if you go to the second back stop which is the regulator, well the regulator regulates all banks in the marketplace, so then the regulator has the authority to collect all that information from each of the banks and line it up and decide well actually this bank is very pessimistic and this bank is very optimistic and therefore we need to get them to increase the provisions and actually the regulator was probably the only person who had the authority and the ability to gather that information to see whether somebody was being overly optimistic or ultimately pessimistic.

Katerina R.

That's what I am saying, can the regulators enforce their opinions on the banks?

Accountant 'A'

The regulator have the ability to enforce it and they even realise the difficulties is that we have had plenty of regulation in this country and plenty of regulation in the bank etc. but we had very little enforcement.

There is a difference between a regulation and enforcement and there were plenty of banking regulations around all the way through the nineties and helped through the crisis but there was probably very little enforcement.

Katerina R.

Is there legal implications for not complying with regulations?

Accountant 'A'

There are, yes.

Katerina R.

And why is no one in prison?

Accountant 'A'

I am certain at that point of time we do not have corporate law written in such a manner that somebody ends up in prison by not complying.

There have been some laws introduced in reference to what they call white-collar crime but it's not and I don't know how far reaching they are and they are not retrospective.

Katerina R.

I also wanted to ask about fair value accounting, a contribution of fair value accounting to Irish banking crisis? Do you think it made an impact?

Accountant 'A'

It had some role, I suppose, but again fair value and the financial statements only report what has happened. You don't use fair value information in the context or information when you are making the decisions today in a bank. So the decision around whether you lend to somebody or not is not really influenced by IFRS; accounts literature is influenced by credit and literature so I think the existence of fair value have an implication around how the banking crisis was reported but I don't think there was a reason for the decision.

I think it had an implication and it created quite a bit of uncertainty and perhaps it could be suggested that the use of fair value masked the situation for a period of time and that's specifically in relation to the available for sale classification and whether an impairment was considered to be prolonged and significant or whether it wasn't. So if that distinction or prolonging significance didn't exist and everybody just had to take fair value gain losses against

the profit and loss account then maybe people might have understood the extent of those losses more clearly.

Which is why fair value is a flawed model because it assumes that you can get a market price for an instrument from a normalised and active and liquid market for every instrument when you can't. So what we actually have is not a fair – we don't – so a fair value presumes you can mark every instrument to market when in actual fact we market most instruments to models.

Models are made up of subjective assumptions.

Katerina R.

Yeah, in 2005 Ernst & Young commented about the impact of IFRS on banks is that the two largest consequences of moving to IFRS is a classification of certain financial instruments from debt to equity and vice versa and the requirement to record them at fair value?

Ernst& Young also seemed to have a problem with fair value for allowing managers to use a lot of assumptions.

Accountant 'A'

I think Ernst and Young as a firm were not in favour of fair value and have not been in favour of fair value since about 1996 long before IFRS was ever considered. EY were never a proponent of fair value in accounting full stop, regardless of whether that was in an IFRS literature or was a UK application.

Katerina R.

But if not a fair value... we know that historical cost is a flawed model as well? What are we left with? Historic cost model was blamed in Japan and the US crises in nineties...

Accountant 'A'

Well I didn't know that. I am not sure I necessarily see what the real flaw with historic cost model is except in a very high inflationary economy, in which case in a high inflationary economy the historic cost model is flawed but that's why we have standards in accounting for higher inflationary economies. Outside of that I don't think it's flawed.

I think actually where the flaws lies is back to – I think we talked a little bit about this the last time – I think primarily where the flaw lies is what are the financial statements used for.

What does the phrase general purpose financial statements mean, is it supposed to report what happened in the past. Is it supposed to report the viability of the company? Is it supposed to report what the value of the company is in today's fair value terms. I think the fundamental flaws more lies with what does a set of financial statements mean or what are they trying to portray or what are they to be used for rather than the model in which they are drawn up.

Katerina R.

OK – that's the exact point about 2010 in chapter 3 of the IaS1 interpretation of financial statement – that's where it originally mentioned prudence and it was replaced by very, very neutral statements of how it should be presented.

It's changed to statement to say that financial statements should not in the slightest way, precise and emphasised, otherwise manipulated to increase the probability of financial information to be received favourably on favourably – that paragraph is where the prudence was before ...

I thought that was very interesting that the prudence concept was deleted altogether.

Accountant 'A'

No, because prudence was removed as a fundamental concept with the introduction of FRS18 so in very old Irish concepts.

Well Irish GAAP is the – Irish GAAP is made up of two parts, it's made up of our law and it's made up of specifically the pieces of company law that relate to financial statements and financial statements preparation and Irish accounting literature which is the literature you should by the literature standard board from the UK so the UK GAAP has changed and evolved over 20 years, but if you go to 2004 and even today but the same would have been said in 2004 which is the period immediately prior to FRS when the bank would have been preparing Irish GAAP accounts.

Prudence was not a fundamental accounting concept in 2004/2005 to my recollection. Because when FRS18 was published to replace SAP2, yeah, it was no longer a fundamental accounting concept. So I'm testing my memory here slightly, so I may get this wrong, but if you go back and look at SAP2 which was published in the 1980s there were four fundamental accounting concepts by which a set of financial statements were to be drawn up. They were to be drawn up on an accrued basis and exercising prudence in a consistent manner from one year to the next in accordance with the going concern concept so four aspects to it. FRS18 changed that and my

recollection is that the accounting policies selected have to be relevant, reliable, understandable and the financial statements have to be prepared on an accrued basis assuming going concern exists but the word prudence isn't there.

So that was – to say that the issue here was that prudence didn't exist well prudence didn't exist in the year immediately prior to FRS18 being implemented.

Katerina R.

OK – In respect to IAS39 its explicitly instructs to only provide for credit risk at the levels that were evident at the balance sheet days so that would imply that if the end of year is 31st December and audit's done in March and you that there was a further impairment needed to the loan you could not adjust provision to show it in the year-end accounts?

Accountant 'A'

That's right.

Katerina R.

And that's not correct?

Accountant 'A'

Well, it's correct in the sense that's what the literature requires.

Is it sensible?

Katerina R.

Is it fair? It's true that the figure at the 31st December would be true at the balance sheet day, but it would not be fair?

Accountant 'A'

I don't agree. It's true but it may no longer be relevant nor may it be reliable so it might and this is – you have to remember that a balance sheet is a statement of position at a point in time it's a snapshot and as soon as something changes it's out of date and irrelevant so the fact that a set of

provisions might have been drawn up on 31st December 2008 for example which was effectively the start of the crisis.

The numbers that were drawn up based on the information available at that date might have been correct but there was a very rapid and this is one of the real issues around this crisis. There was an extremely rapid deterioration in economic circumstances between September 2008 and December 2008 and another very significant change from my memory between December 2008 into January, February and March 2009.

So if you have a December 2008 year-end, you drew up your financial statement based on that date, the information was correct in accordance with accounting standards. It became stale a couple of weeks later because of the pace at which the economy was moving. The question then is should there have been disclosure of a non adjusting post balance sheet event i.e. or provisions at the balance sheet date were x but because of a deterioration in the economy since then if we were recasting based on today's date they would be y.

Katerina R.

And is 'y' there?

Accountant 'A'

I wouldn't think it is.

Katerina R.

But, if an investor can only get his hands on those accounts once they are audited and is published he has information which is three month old and irrelevant.

Accountant 'A'

You know this is where the language becomes very important. He had information which was correct at the time of it being drawn up but it's no longer relevant because the market has moved and that's the imperfection of the market.

Katerina R.

OK – And then I am back to Ernst and Young who in connection with IAS39 permission to do general collective provisions and raised concerns about basically managers exercising their

opinions in doing those collective provisions – we did discuss that already – and that’s my whole thing about herding.

Accountant ‘A’

No I think you have covered a lot of opinions and also probably well thought out leadership in terms of EY and the people’s litigations and the IAS report that you talked about. I think you are looking in all the right places.

I think it’s very difficult to, you know. It’s not straightforward. I a lot of commentary written and a lot of commentators would say that this is a very black and white issue, but it’s not.

But it’s also an issue that’s very difficult to explain either in a very encompassing way and also very difficult to explain to people outside of the industry because it’s quite a complex and quite intricate, and I think some people take that as, being I don’t know if it’s arrogance or whatever or is it you think people won’t understand, and I think many people are very capable of understanding it, but it’s just very detailed and very intricate and it takes quite a period of time. So, I think you are looking in all the right places and you have asked lots of the right questions and, you know, I think it’s difficult to come to a conclusion.

End of interview.

Appendix 6

Transcript of the Interview with Accountant 'B'

Date: 31st July 2013

Time: 9am

Place: Dublin

Interviewer: Katerina Ryzhenkova

The topic of the interview: The role of IAS 39 in the Irelands Banking Crisis.

Katerina R.:

The topic for my thesis is The Role of International Accountant Standards in Irish Banking Crisis. Once I go through a general review of IRFS, I will narrow it down to IAS39 and the role, if any; it played in the banking crisis.

IAS39 provides the requirements how to measure, value, impair loans and how to provide for losses. I will be centring on IAS39 and because two of the categories valuations based on fair value I'll be looking at fair value from a pros and cons point of view and if it had an impact in the crisis.

Accountant 'B'

So under IAS39 there are four classification criteria and each of them has got a different valuation. One: trading or fair value for profit and loss which isn't fair value. Two: loans and receivables which is an amortised cost, not at fair value. Three: AFS, available for sale, which is fair value through OCI, or where impaired is through income. Four, held to maturity which is at amortised cost.

You see fair value would be a factor of a number of different things. It would be a factor of credit risk, liquidity risk and interest rate premium because that's what that instrument would trade at in the market. If you have got something in amortised cost you only have to impair it if there has been deterioration of credit quality. You don't need to fair value if is a liquidity risk for interest premium. It will never be at fair value, because you are not required to value it at fair value. You are required to put it at amortised cost.

If you have an indication that for example you have got a held to maturity instrument that's classified as amortised cost and it's worth a hundred on day one, so you record it as a hundred on day one. Then you look at the mark it to market on that instrument and you find that, let's just assume that it's an Irish government bond that you intend to hold to maturity. At any point in time the market value for that instrument is a factor of the perception of the credit risk to the Irish government, the interest rate that's on the instrument and the liquidity on the instrument itself. If you go along and check and you see that instrument is trading at eighty, the person holding the instrument would be required to do is say, 'OK, I'm holding this to maturity and I know I don't need to mark it to market but I need to consider whether or not it's impaired so when I look at the market value I take into consideration to what extent a deterioration of credit quality. Forget about liquidity and interest rate risk. It's only if deterioration of credit quality that I would be impairing the asset, and it turns out that the credit quality has declined permanently to an extent of ninety as opposed to eighty you impair it down to ninety, but you are not marking it to market, and it's the same with loans and receivables.

If you look at an Irish Bank at the moment with a tracker portfolio, so its tracker mortgages and so the market value of a tracker mortgage portfolio is significantly lower than its book value, and that's because tracker mortgages have got very low interest rates on them. And if the Banks were to mark that to market and put it at market value it would be a completely different answer to what they have on their amortised cost basis and loans and receivables; so the whole premise of loans and receivables are held to maturity is that you're assessing for changes in credit quality and you would impair your assets if you think there's a change in credit quality. You are not marking the assets to market per se.

Katerina R.:

I understand how each category is valued. I understand all that.

Accountant 'B'

If you look at accounts in the banks there is a disclosure under IFRS7 it says – what is your book value for your assets and what is the fair value? For anything that's trading under IFRS those numbers will be the same but for held to maturity and loans and receivables they would differ because there's liquidity premium and interest rate premium with discounts built into the legacy structures that the bank have put into those assets.

As soon as you write a loan, it's no longer on market terms because the market has moved on, so if I've written a loan, take a tracker mortgage in 2004 and 70 basis points or ECB as it would be for a tracker, then someone would come to the market today and say you have got a loan of a hundred, I'm only going to pay you fifty because for me to fund the asset at that return I couldn't do it in today's market so why would I pay you full value so the fair value for that's very different to the book value.

Katerina R.:

OK. I suppose I started saying that I would be concentrating on IAS39 but because there is two of the categories are valued at fair value, I would be looking at fair value model as in pros and cons. I'll have questions so I would like to get your opinion about the fair value.

Accountant 'B'

Of which instruments? If you're talking about the impact of accounting standards on the Irish Banking crisis, fair value model is not the right place to look, in my view, because the assets that caused the issues in the Irish banking crisis were never subject to the fair value category.

Katerina R.:

OK, so the problem is with the loan book?

Accountant 'B'

Yeah. I will deal the Irish domestic markets first, if you look at the banks that have collapsed, so Anglo-Irish Bank which is now IBRC. IBRC didn't have an issue with held to maturity or fair value assets. It had a massive loan portfolio in land development which was lent against the wrong type of exposures, so its assets weren't at fair value. Its assets were being required to be assessed on an amortised cost basis and, in effect, the value of lending that they had put out. They had lent a premium of four hundred million on a glass bottle site in Ring's End and it turned out that site was worth one hundred million and not four hundred million. It lent eight hundred million down in the Dublin Docklands on development land, and it turned out that that land was worth fifty million and not eight hundred million. So, that's kind of bad lending decisions that were irrelevant to the accounting classification.

Katerina R.:

But, was it not worth that when the site was purchased?

Accountant 'B'

Yeah. They would have got valuations to suggest that but, it turned out to be wrong.

Katerina R.:

If you are in the Bank and you are not in the real-estate business and you are not in land trading, how are you supposed to know that the valuations you got from maybe two or three sources are wrong? If valuations say four hundred million, you will accept it.

Accountant 'B'

Yeah, that's the decision they took at that point in time and it turned out to be wrong and they were possibly correct to rely on reports that were provided by renowned property valuers in Ireland. They turned out to be wrong.

Those loans were not capable of being repaid and that's what happened to Anglo, that's what happened to Irish Nationwide, that's what happened to ACC, that's what happened to AIB and that's what happened to Bank of Ireland. It's got nothing to do with the market value of certain assets, it's the fact that they over-lent into property in Ireland in the wrong concentrations to the wrong people.

That's why NAMA was set up. NAMA took all the assets off them that were land development related, over twenty billion and varied by institution, but then the economy started to tighten and the focus then turned to mortgage portfolio as well and the SME portfolios that weren't part of the whole land and development issue that we had.

That predominately drove the collapse of the Irish banks because Anglo for example had thirty billion of loans and receivables from land and development exposure in Ireland, and when the property prices started to slide, they were never going to get it repaid because the whole business model was predicated on if you lend someone four hundred million, they buy the site, they develop it and sell the houses at extortionate prices in two years' time and then they pay your loan in full. That was the business model in too many banks at the same time. And that's what drove the collapse of the Irish banks.

Katerina R.:

In terms of what you just said about banks all doing the same thing. Do you think they all did the same thing knowingly? After doing their appropriate analysis for making their own decisions or did they just do it because everybody else did that? What I am getting at is how much of it was herding and how much was based on business decisions??

Accountant 'B'

Massive, a massive group thing; we all bought into it. Everyone in this country to an extent, one level or another bought into it. The banks were fuelled by cheap money from Europe. And they were able to use that to chase land development exposures and the returns were good whenever they worked. The likes of AIB and Bank of Ireland were looking at Anglo which was doubling its profits from one year to the next, and I suspect the boards of those bank were saying – why can't we get some of that? Why are they getting it all?

They went and chased it. Ulster Bank chased it and Bank of Scotland chased it which is now closed down. Irish Nationwide chased it and it's now closed down. IBRC were leading the pack and it got closed down first. AIB and Bank of Ireland and Permanent TSB, have survived to a lesser extent. One of them is 99.7% state owned and the other is 12% state-owned. Permanent TSB is wholly state-owned now. All of these institutions, predominantly because of their land and development and commercial real estate exposure have been effectively closed down with the exception of the Bank of Ireland which didn't do as much as the others. ACC, the collapse of that Bank, it doesn't lend anymore; it's pretty much because of the exposure to land and development.

So, Ulster Bank which is the embarrassment of the RBS group, pretty much, is largely where it is because its land and development and commercial real estate exposure. So, it was over-concentration in Irish assets by Irish banks with the expectation that building and property boom would continue.

Katerina R.:

Which is completely unreasonable thinking, we had the level of property prices more expensive than it was in London and anywhere in Europe, which it was totally unreasonable to expect this to continue. There were historical precedents before: there was Japan at the end of the nineties and that was a complete property boom related crisis as well. Why didn't people at the top of

the banks, I'm sure they are all educated people, why didn't they see the end of the boom coming. You can't put on the rose tinted glasses and think that there is an unlimited amount of people in Ireland that are going to buy properties and houses forever and we're going to collect those profits?

Accountant 'B'

What happened was people started to question whether or not it's sustainable and then they started to convince themselves that they don't need another 20,000 houses in Ennis, or wherever. "We know that Ulster Bank have lent in Ennis. We know that IBRC have lent in Ennis but you know this site here that we're lending on; Ennis might only need another 1000 houses but we think this one is the one". They all started saying – we think we are in the best sites and if anything is going to be built out and finished, it's ours.

Even when you look at some of the reports that were produced by the IMF and the ESRI back early 2010, they were not predicting the property crash that we had. All the economic commentary, well not all of it, there were always people who had a stronger negative view, but the predominant economic commentary even into 2010 in this country was for a soft landing.

Katerina R.:

How could the reports in 2010 say it was going to be a soft landing after we already nationalised Bank of Ireland and Anglo Irish and AIB? I think it was 2009 that they were still talking about a soft landing.

Accountant 'B'

So, if you think about the assets that were moved under that category and I know you had this in your email. That's not where it's at for the Irish banks.

Katerina R.:

It's not?

Accountant 'B'

It's not a big deal. They moved certain assets out of the trading category into held to maturity. The type of assets that were in there were structured products.

So, if you think about the phases of the crisis globally, it's the structured products that caused the issue. All of the US sub-prime, ABS and RNBS structures and some of the Irish banks would have held those types of structures and, for example, Depfa Bank would have held quite a lot of them, right, but they weren't big investment portfolios for the domestic Irish banks.

Now, they did take the opportunity to reclassify some of those assets to held to maturity. What that meant was they didn't have P&L productivity over the next couple of years, and they would be impairing within held to maturity if there is credit deterioration. But, in the context of the Irish banks, that was only a very small piece of the problem, a tiny piece. It was absolutely dwarfed by their own lending that they had done into land and development.

Katerina R.:

Ok. I suppose the loan book would be valued at amortised cost and fair value and IAS 39 amendment would not affect it.

Accountant 'B'

Like they could have had transfers in from trading into held to maturity, I don't know the numbers, right, maybe of a couple of billion. But you're sitting there with forty billion land and development portfolios, forty billion mortgage book, 25 billion SME portfolios in Ireland. It was pretty much concentrated all on the same thing. So, that's where the issues came from and caused the collapse, not from the reclassification of certain APS structures in the held to maturity.

Katerina R.:

So then, to summarise... in the Irish banking crisis, fair value wasn't an issue and IAS amendments wasn't an issue.

Accountant 'B'

It wasn't the issue. What people tend to focus on in IAS39 is the incurred loss model.

Katerina R.:

Yes. I'm looking in to the incurred loss model and the question is, is it prudent enough because in my view it's not prudent.

Accountant 'B'

That's where I think you should be focused, as opposed to the reclassification. If I was trying to link the crisis to an accounting standard, because the asset class that caused the most problems is loans and receivables, I think the focus of your attention should be around whether or not the incurred loss model is fit for purpose.

Katerina R.:

I am looking at incurred loss model but for the purposes of my thesis I have to review other possible causes and sources. I have to rule in or out the fair value impact and IAS 39 amendment.

Accountant 'B'

If you think about the assets that they have at fair value, derivative, it's not a problem and I'm grossly summarising, some of them were a problem if you had Lehman's, for example as an accounting party. That's a kind of one-off event. And AFS assets were fair value. They classified some of them as held to maturity and impaired them on a credit basis, but they weren't significant. Some of the Banks would have had exposure to US structured products like ABS but not to the same extent as the likes of the global banks which were heavily invested in them.

It's really all around the loans and receivables which were at amortised cost, and the way the incurred loss model works, one would argue, did it recognise the losses in the Irish banks as quickly as it should? Because if you look at 2007 I think they were still showing profits.

The second half it started to turn, and then 2008 losses; one would say, if accounting standards are working correctly, you should get it pretty much as much of your loss as you can in 2008. In 2009 more big losses. 2010 more losses. 2011 more losses. 2012 more losses, so why didn't the accounting standards in 2008 identify all of the losses then is the question.

Katerina R.:

OK, since IFRSs were made mandatory in 2005, it all seems to be about that the financial statements should have represent the fair position of the company at the year-end. One would argue that incurred loss representing fairly at the balance should state the position of that company. The argument is, I am for prudence, but if I was impartial, which I'm struggling with at the moment, I could see how you would say that the argument is they are saying that the

incurred loss model, this is what I'm showing you is fair representation of my financial position at the balance sheet date. You should understand though that it is at the balance sheet date three months ago. And, what I am showing here is as it was and three months later now this will not be anywhere close enough.

Accountant 'B'

I agree with that. Effectively the standards are retrospective to an extent. They require you to assess what has been incurred as a loss on the balance sheet date and then valued. Prior to IAS39 and prior to IFRS, general provisions were allowed and IAS39 said you are not allowed to have general provision anymore.

Katerina R.:

You can have general provisions for economic shocks?

Accountant 'B'

You can have a collective provision, but it has got to be supported by a loss history.

Katerina R.:

OK, but you can say that global crisis in 2008 is an event which will trigger the need for general provision.

Accountant 'B'

In 2008 then you look at the other commentary that you have in the market, right, from the IMF and ESRI and you say, yeah we have a bit of a crisis going on but it's going to be a soft landing.

Katerina R.:

But how can they make a comment like that when in the States the crisis started already. By the year end we had Lehman Brothers say GM Fannie Freddie, and God knows how many of them they had crashes and they had the seven hundred billion rescue package for the industry. That will transfer over to Europe, so we couldn't say that it was a *bit* of a crisis?

Accountant 'B'

That was what the economic commentary was saying at the time for Ireland. No one back in 2008 was saying this country is going to need bailed out. No one in 2008 was going to say that we are going to have 70% decline in property prices. They were saying, you know, we expect 20% decline. No one was saying that unemployment in this country is going to reach 15%.

We were just talking about banking in 2008 and if you look at the economic commentary and it might be worth taking on some of that commentary from them. No one was talking about Irish property prices falling by 70% or 80%. No one was talking about, when I say no one, very few people. There is always someone that will claim that they believe that was going to be the case with the economy.

No one was expecting that unemployment in this country would go to 15% and all the young people emigrating or that Eurozone unemployment for people under 25 would be at 25% or that Spanish people under the age of 25 would be 50% unemployment. Those things were not being predicted at that point in time.

When people were making estimates and this is the bit that is important for what you are doing, when people making estimates of their loans at that point in time they were assuming declines in property prices of 20/30% but they were never assuming that it would get to 50% or 60% or 70%. Then you get to 2009 and it turns out well maybe it will be more than 20 or 30%, maybe it is going to be 40%. Then you get to 2010 and then it is going, well actually, Jesus, is it going to be 50%, 60% and 70% and that is why the losses continued to get higher.

I will show you an example. If you are looking at a loan that a Bank has on its portfolios and the customer has stopped paying, let's say you have given them a loan of one hundred million to buy some commercial real estate. Let's just say you have given it to buy an office block in Dublin. You come along in 2008 and you as the Bank will say, I have got a loan of a hundred, this person has stopped paying so I have got to make an estimate if I was to sell the property, if I was to require them to sell the property and pay me back the loan, how much would I get? At that point in time they could have gone loan, property and they would go to someone like Lisney and say value that office block for me in the Burlington Road or wherever it is. Lisney will come back and say 'Ok when the loan was originally done in 2005, it might have been 150, we think property prices have fallen by 30% so now it is worth 100.' When the Bank has done its sums it has no loss on that loan.

Then you come along to 2009 and you have the same loan of one hundred and actually you go to Lisney and say 'Well actually things have gotten much worse than we expected. That property is

probably only worth 70 now.’ Then suddenly the Bank has to record a loss of 30 and you are saying to yourself ‘Ok I would have preferred to have known about that sooner but I can see that property prices are continuing to fall.’

Then you get to 2010 and you still have a loan of a hundred because they haven’t been able to pay you anything on it. Then you go and get a valuation on the property in 2010 and prices have fallen even further and it is now only worth 50 so now you have got to have a loss of fifty against it. For me right I don’t think, when people talk about the incurred loss model being an issue, I don’t think the incurred loss model would have changed this if we were on a different model because at each point in time we have got to make an assessment of what you think your collateral is worth based on the economic conditions that are in place. As a country we did not realise in 2008/2007 how bad it was. I just don’t think we did. People were saying ‘My house might fall 10%.’ No one in 2007 was saying ‘Actually I think property prices are going to come down.’ In some cases by 90% and in other cases by 50/55% which is around the national average.

Where I live there is certain house prices down by 90%. I don’t think anyone ever expected that would be the case. There was a house sold, I live in a small house at the back and there are big houses at the front of where I live and there was a guy from Westlife used to live in one of the houses. He bought the house in 2006/2007 for €10.1 million and it is now for sale at the moment for €1.0 million.

Katerina R.:

Happy days for the guy who sold it!

Accountant ‘B’

It is for sale at the moment for €1.0 so that house has fallen in value by 90%. If he was selling it in 2007, I think people wouldn’t have been saying ‘Actually that is going to fall by 90%.’ They were saying it might fall by another 10 so I will give you €7.5 million but nobody in their right mind would have sold that house at whatever in 2007 and that is what happened in terms of the Bank’s issues because it only became clear and you could say and this is what I think is a big failing of the crisis being we did not realise it quick enough as an economy. I don’t think, Ireland as a country was too closely involved. The government is too close to the Banks and the Banks were too close to the Central Bank and arguably the accounting standards didn’t help. I

shouldn't say this, people will say did the auditors challenge in the wrong way. People say that we did and other people say we should have done more. We should have said to the Banks 'Guys....'

Katerina R.:

Well you did didn't you?

Accountant 'B'

We should have said 'Guys are you sure that you have valued that correctly?' but they would have come along and said 'Well Lisneys have told us this' or Gunne's or Sherry Fitz have told us that is worth fifty so why would we...?

Katerina R.:

Even if you went and got your own assessors that is what is what they will give you then who are you to question the professional valuers. You can't question everybody.

Accountant 'B'

As an economy I think one of the failings was we didn't realise how bad it was going to be and actually some will argue that we are still only working it out. I would have the personal view that we still haven't solved the SME issue that we have in this country. We are now six or seven years off the peak and the Banks are only starting to deal with the mortgage issues. It is only now they are starting to put solutions on it. From an accountant's standards perspective where the failings have come, you could argue that all loans and receivables, were they required to be fair valued? At each point here you would have had lower numbers, you will have had more losses sooner but that is not the model that they used for loans because they hold them and collect as opposed to trading them.

Katerina R.:

Would you say then that fair value model is the wrong model to have for anything?

Accountant 'B'

I think it is the right model for loans and receivables but the judgements that you put into it have to be prudent.

Katerina R.:

Ok but then we have to limit the discretion and judgement which Banks can apply?

Accountant 'B'

I think what we need to do is ask them to change how they think about it. Are you familiar with IRFS9? It is the replacement standard for IAS39. Back in 2008 in the G20 summit, the G20 requested that an accounting standard was produced that would help reduce the losses so the ISB which are the accounting standards board for international financial reporting standards have been working on IRFS9 which moves away from the IAS39 incurred loss model to a lifetime expectant loss model. What that requires the Bank to do in very simple terms is saying forget about what you think is incurred today. Think about what your lifetime losses are going to be on record and then record that.

That that is going to mean is more provisions so the accounting standard setters and this is relevant to what you are writing, have acknowledged that the IS39 model has shortcomings and weaknesses and have said that they want this new standard which requires people to estimate lifetime losses.

Katerina R.:

That is going to be mandatory from 2015?

Accountant 'B'

I think it is probably more like 2017.

Katerina R.:

I would say Banks are putting up on hell of a fight?

Accountant 'B'

I am not sure they are to be honest because it is going to get done one way or another. There has just been a lack of agreement as to what the model should look like. The common period for

IRFS9 credit provisioning closed on the 05th July and there was a Board meeting by the ISB today or tomorrow to take final views and a standard will be produced in September or October this year. I don't think the Banks are resisting. I know quite a lot of Banks that have started to prepare for it. They have done IRFS impact analysis and that move to an expected lifetime loss model will help secure some of the perceived shortcomings of IAS39.

Katerina R.:

I think I will have to come back because I didn't answer some of the questions.

Accountant 'B'

Do you want to go over it now?

Katerina R.:

I can't because you have that you have time only till 10.

Accountant 'B'

It is fine. We have another ten minutes.

Katerina R.:

That is great. I am reading a lot of Cormac Butler. Are you familiar with Cormac Butler's writings in the Irish Times for the last four years?

Accountant 'B'

Yeah.

Katerina R.:

He believes that the weaknesses in bad accounting standards allowed the Irish Banks to use all the loopholes they could to get around the necessity of doing the proper long provisioning. That the standards in fact helped the banks conceal or understate their impairment.

Accountant 'B'

I am inclined not to agree with that. Let's say the accounting standards were completely different to what they are. You don't even need to say what they are. Just say they are

completely different to IS39. Would that have changed the fact that Anglo Irish Bank lent four hundred million to a developer that will never be paid back? Will that change the fact that AIB lent eight hundred million to the Dublin Docklands that will never be repaid? Will that change the fact that Bank of Ireland lent four hundred million on a development site in Nenagh, Co. Tipperary that will never be repaid. The accounting standards did not in any way cause that. That was bad lending and bad decisions. The question is how does that get reported on and to an extent I agree that there is certain provisions within the accounting standards that could have been written differently to allow that to have been reported sooner. But it would not have changed the outcome.

Katerina R.:

But if Banks have to report prudently on the losses then their lending criteria will be much stricter. In the few years leading up to 2008 it was getting to a stage where mortgages were just getting rubber stamped without proper vetting.

Accountant 'B'

At the time if you think about that. You are in 2006/2007 and you are lending a big volume. Again I am not sure the accounting standards would have changed that. Say you had an accounting standard that says prudently report all your losses in 2006. Because of the expectations of people in that point and time they wouldn't have provided for losses. Who in 2006 was saying....?

Katerina R.:

Not in 2006. 2006 was still a good year. 2007 when the property crisis started to go down you would start too...

Accountant 'B'

They started to provide then but the question is was it enough and what I am saying to you is in my view I don't think the accounting standard would have changed that a whole lot because people weren't expecting the type of falls that we had. If they were on accounting standard that says go and estimate your expected lifetime losses. Your expectation of your lifetime losses would be quite similar. They were saying – Ok I expect I am going to lose 20% of the value of

that one because that probably would decline by 20%. They wouldn't have gone and said – actually I think it is going to decline by 80%.

Katerina R.:

Then you have expected lifetime losses and you have a loan over twenty years you would say ok in ten years' time it will be minus 50% but then in another ten years; twenty years is a long time and it is going to go full circle and it will go up again so then you are saying that the lifetime losses for this might only be 10% because you expect to go down more and come back.

Accountant 'B'

You are right. It is complex. It is not just as simple as saying it will change. What would have changed the outcome for the recorded results of the Banks in any given year is if we as a country had acknowledged the depth of our problems?

Katerina R.:

If the accounting standards required to measure everything at fair value at the balances sheet date, would it give us a better idea about the true financial position of the banks?

Accountant 'B'

I'll challenge you on that so let's say you have a tracker portfolio that is performing, everyone is paying and it's worth 100million. The bank fully expects that will be repaid in full because everybody in that particular portfolio was paying and they continue to pay and they have good jobs. So you go and put a fair value on that because of the liquidity discount on a tracker mortgage and the fair value might be fifty. Do you think that is a fair representation of the value of that portfolio even though you are going to collect a hundred?

Katerina R.:

You collecting 100 somewhere down the line and you may think it is now worth 100 but some years down the line it won't be 100 anymore but at the moment it is.

Accountant 'B'

It shouldn't be fifty because you have such a liquidity premium because fair value is more than just credit is what I am trying to say. Let's say you have got; think of the strongest credit you

can possibly have. Say you got a loan from the IMF or you have a loan to the IMF for a 100million, let me make this simple, and you carry that on an amortised cost basis and that is repayable in four years' time, you could have lent to them at 1% and market rates for a similar loan today could be 10% so the fair value of that loan might only be 50 because another market participant will not pay you low value for such a low yielding asset.

To record that asset at fifty on your balance sheet in my view is wrong because that is not what you are going to collect. I think at all times your value should reflect expectation of what you think you can realise your assets are. You will realise that asset at a hundred whenever the time comes but certain assets you won't realise unless you have been prepared. That doesn't necessarily mean good and fair value because fair value is much more than just credit risk. You have got to understand how the market values loans and how the market values instruments.

If you pick straight Irish government bonds they will change in value based on the credit rating of the Irish government but also because of the interest rate that is attached to them so depending on your classification for bonds under IAS39, I would argue for something like that. You could build a case to have an unfair value or an advertised cost as long as you are recognising the appropriate amount that you expect to be repaid and you haven't overstated that so you are reflecting the credit decline. That way your balance sheet should be representative of what you expect in real life.

Katerina R.:

Ok. There will never be a perfect accounting standard. Now there is a lot of judgement calls and discretion by managers. They are human beings and they are reporting their performances to the market. They'll always be influenced to report their performance is the most positive light possible.

Accountant 'B'

There will always the tendency in any organisation to produce the best results.

Katerina R.:

So should accounting standards be rule based in order to limit judgement as much as possible?

Accountant 'B'

I think you should limit judgements as much as possible and require that they use as many external benchmarks as possible so external evidence to support whatever judgements they have made. Don't tell me as a Bank what you think the property as worth. Go and get external evaluations. Don't think what you think that instrument is worth. Show me what another market participant would value it. That is where I think the accounting standards need to go, have as much external validated benchmarks and judgements so that people are proving against the market at any point in time.

End of the interview.

Appendix 7.

Transcript of the Interview with Accountant 'C'

Date: 31st July 2013

Time: 5pm

Place: Dublin

The topic of the interview: The role of IAS 39 in the Irelands Banking Crisis.

Interviewer: Katerina Ryzhenkova

Katerina R.

Thank you very much for agreeing to meet you, I know it's past your business hours. So the thesis I'm doing is on the role of IAS39 in Irish banking crisis.

So what I'm concentrating on is, because of the nature of IAS39, as I see it, it's the closest thing in accounting standards which influenced banks: financial instruments valuations, loan impairments and provisioning.

Accountant 'C'

Well let's start by analysing the topic of IAS39 and its role in the banking crisis, OK, and let's think about, I suppose, a couple of things, you know. Firstly, we hear this nasty word 'capital' coming around, and you know, provisions, which IAS39 determines, has an impact on those obviously, right, because there's certain deductions, you know, under Basel requirements, which determine capital. There's certain deductions there for your expected losses against where your provisions are, right. You can deduct up to a certain level if one is ahead of the other, right, you deduct it from TR1 capital, or you can add it back to TR1 capital depending on which is greater. But I suppose, you know, this central thesis, if we start off on the central thesis being, was IAS39 adequate, or used properly, or appropriately, to prevent the banking crisis, or indeed could it have prevented the banking crisis. If you were to ask me those questions, what I'd tell you would be that IAS39 is not prescriptive enough, it's too discretionary. It sets out far too much room for interpretation for banks in terms of what impairment is, or what it might be. And why have I introduced in the previous discussion the notion of capital, and I think it's like Basel Rules, well

because there's a comparable concept in Basel, called default. Default and impairment are comparable concepts, default being where somebody can no longer pay what they're liable to pay, or what's due from them, right, or they've defaulted or missed a payment, or a number of payments; and at the start of the banking crisis, we saw that what's classed as impaired was very different from what was classed as defaulted; and the true answer actually was that neither one of those numbers were right, but the trend is important. The impaired number was typically much lower than the defaulted number and banks generally said at the time, 'Oh well a lot of those are down to somebody who's 90 days past due', which is the Basel requirement. 90 days past, you're unlikely to pay is the Basel definition of default, and they said, 'Well, they're only technical defaults', 'they've missed a few payments, but actually they can pay.'

Katerina R.

How do you know that?

Accountant 'C'

From experience from working with banks.

Katerina R.

No, how do the banks know

Accountant 'C'

They claimed at the time through their relationship managers, right, their relationship manager, e.g. John Smith, is dealing with three or four different businesses, or different companies, or different guys - 'Oh, he's just late with the payments, but we're not going to put him into default. He's missed a couple of payments, but he's actually capable of paying.' You know, some of it was rubbish and some of it was down to IT systems where they hadn't flagged - they kind of kept things at a month in advance and a month in arrears. But those technical little details and nuisances aren't the important thing. The important thing is that there's this large difference between 90 days past due, i.e. Basel default and impaired and as we go through into 2011, that's kind of 2006, 2007 time. We go through five years later and we see that actually those technical defaults, a lot of them are real defaults. That trend of impairments being lower than 90 days past due stayed and it was maintained when you look across bank balance sheets, that clearly tells

you that there's a problem. But due to interpretations that are part of IAS - and under IAS39, they did not have to make the two numbers equal, the same amount of loans didn't have to go through and now why is that? Why was the Basel number higher than that? The Basel number itself wasn't necessarily, by a distance, wasn't necessarily sufficient either, but it was still higher than the impaired number. But why is that? Well, one, the triggers for impairment assessment is low and they are discretionary. Two, in terms of the impairment assessments that were performed and they probably weren't performed as rigorously as they should have been, even in respect of things like collateral evaluations. Three, in the accounting context and in the way that these things work, discount factors and emergence periods probably have an effect, or you know, can definitely have an effect of dampening down some of the numbers. Four, the idea of an incurred loss, something was only classed as impaired under incurred loss model when you could definitely trace the loss event to the current accounting period. In that case, you know, if there's a loss event i.e. the loan is impaired then the loss is taken in this financial period. What we don't do is look at any extent, or any idea of expected loss and what we ought to do then is we - we're very conservative in what we call a loss event, or an incurred loss event - and if we go through IAS39, paragraphs 59:63, we see that actually we can impair a loan on the basis of a severe decline in market value on the basis of, market liquidity having dried up. So all of those loans could be impaired much earlier with a conservative application of, or a conservative interpretation of the triggers, and the examined impairment events and the triggers for impairment reviews, that the IAS39 standard sets out. But those were never mandated and those consequently were never taken by institutions.

Katerina R.

Yes, you're - you're going where I want to go. I want to discuss –

Accountant 'C'

Can I just make one other point, please?

Katerina R.

Yeah.

Accountant 'C'

If we look back at, previous standards where you could allow, say, a general reserve. You could have kept a general provision. These same institutions then say, 'Oh well, it's the accountants fault and it's the entire standards fault, because we can't maintain a general provision.' You know, they may not have been able to make a general provision, but what they could still have done was had a higher level of reserves, or provisions, than they do, or than they maintained, if they'd applied the standards conservatively. So, an AIB, or Bank of Ireland will come out and say, you know, 'Our fees weren't high enough, because we weren't able to have a general reserve and we weren't able to have a general reserve, because IAS39 doesn't allow it.' But actually guys, if you just had a conservative view of what an impairment event is, you could probably have got to a similar number under IAS39 as you had under previous accounting standards. So that's a bit of a cop-out.

Its institutions, you know, disguising the fact that, you know, they didn't really want to have in times of plenty - they didn't really want to be raising provisions. You know, and why do we get rid of things like general reserve? Well, for things like foreign, you know, IFSC companies, foreign multi-national companies, or IMC banks, you know, provisions are a nice way to reduce your tax liability. They're a nice way to depress profits and not make sure then hence your taxable profits are lower. So you keep the value on the balance sheet, right, but they're held in reserves. And, you know, IFSC companies have been open to those allegations. I don't know that they've ever been proven, but I certainly do remember a number of those suspicions being, you know, circulating in the market, you know, probably 2004, 2005.

Katerina R.

That's about the time when IASs were become mandatory, isn't it?

Accountant 'C'

Yeah, yeah, that was - I understand and I can't say this categorically - but I understand that's one of the reasons for the IAS39, you know, standards, taking away that general reserve now; because people are just artificially boosting their balance sheet, depressing their profits a little bit and their taxable profits, you know. Particularly companies, say a subsidiary, let's say an Irish down-side subsidiary of a large multi-national firm. You know is a nice way to wash your profits through here, get a good corporate tax rate and held with arbitrage on top by, boosting some of the provisions, or boosting some of the reserves. They'll ultimately be hidden, probably

wash it through in a group consolidation. So, analysts in New York, or London, probably won't see a significant impact, but will gradually build up this reserve over time.

Katerina R.

OK, just - just back to the point about the general provisions are not allowed, but the collective provisions are allowed, isn't it?

Accountant 'C'

Yes. Yeah.

Katerina R.

So that's what they could do. They could look at - they could look at the bunch of loans in general and - I mean, back in 2008 we had an event anyways. I mean the crisis...

Accountant 'C'

Well you could - I mean the credit institutions actually called that, you know, as insufficient as an event of impairment.

Katerina R.

As in global financial crisis, wasn't event enough for them?

Accountant 'C'

No. Because it's not manifest on individual loans, so they say well show me the individual loan where I can impair on the basis of this. Then you'd say, can we go then and - and how would we apply this, here's a loan, I will impair it, or it's one of the loans that are already impaired. So they say well we can't do that, we can't impair it, because we can't relate that event directly to the loan, nor can we relate it directly to individual loans that are already impaired.

So you say, right can you relate that to a pool of loans that are not impaired i.e. the collective or IBNR approaches where you're, you know, giving a kind of a statistical model based assessment of a provision level, or an impairment level that's inherent within a portfolio, but not manifest on an individual loan level. So you believe there's a level of loss in there, a level of latent loss that will emerge at some point, but it's not immediately emerging, but you're making kind of

provision for that. Could you relate that 2008 event? Everybody would argue no. If you went and, you know, looked at IAS39, you know, **58:63**, if you looked at those again you'd probably find you could, you know, and probably find you should. You know, there's market - there's a credit crunch, there's market liquidity problems. By the time you get into 2009 on a real estate side, we're seeing values plummet like hell. You can't sell anything. Under those circumstances and in some respects under a nuclear interpretation, these are impairment events. These are events that should knock the seven shades out of your provisions numbers. If you've got a portfolio of real estate, commercial real estate mortgages, they're not worth anything and as soon as they stop servicing anything, they're worthless; and we get into that peculiar zone if, because if we think about now, kind of residential mortgages and we think of arrears levels and we think of negative equity levels, you know, you probably find you get a lot of the arrears mortgage are attracting higher provisions, but a lot of negative equity homes are still performing. They could still be impaired on the basis of there being negative equity, but yet they're still performing. People are servicing them. They haven't fallen behind their schedules. So it is a judgement call. There's definite judgement here. When you take an IAS39 trigger, you take the idea of here is - here is a criteria, decline in market value. That's a trigger for impairment. We have to be careful what we mean. Is it a trigger for impairment assessment, or is it a trigger by which something is automatically impaired? And when we talk, collective models it's very easy to interpret that as that's a trigger, it's automatically impaired. All these things should be triggers and the way that the IAS39 process should have been set up by banks and wasn't - and this is, from my, in my view why all those subtlety and nuisance was missed - is we needed to have a process where those mortgages are subject to an impairment assessment, OK, and your impairment assessment might be even statistical, or taking three or four criteria. Right, here's my - is it servicing? Has there been a decline in market value, or is it of negative equity, right? Take both of those together. Any ones that don't meet both of those criteria, yeah, right, or that fall short on both of those criteria, we're calling impaired. If they fall short on only one, or only the property value - it's being impairment assessed, because it's still performing we've no problem with it, we're not going to impair it.

Katerina R.

But in collective provisioning, though, in Ireland in particular, we have, say we, regarding unemployment, of nearly about 20%, 15%?

Accountant 'C'

15%, 14.8%.

Katerina R.

Which is at least 7% over the normal - the normal, say, 2004, or 2005 level. So that in itself can be used in the modelling.

Accountant 'C'

For 2004 the level is full employment level, it was 4% and 4% is classed officially in most economics texts as full employment. If the 4% is down to virtual and seasonal unemployment i.e. people who are changing jobs, people who have just -

Katerina R.

We don't count that, yes.

Accountant 'C'

Yeah, people who have just come into the workforce and getting jobs, so it's actually full employment level, right. So when we get into 14 %, yeah -

Katerina R.

We can assume that 10% of the country lost their jobs, the houses went down by nine to 30% -

Accountant 'C'

Yeah, and more, yeah.

Katerina R.

So you can collectively say OK, my mortgage book is that much, it's - I should provide for the increase in unemployment.

Accountant 'C'

Yeah. Like and I totally agree with you. I mean, like in all of these macroeconomic events are

again a potential trigger in IAS39, I mean the - we get to this situation where what banks use provisions as, and all my detailed discussion previously in terms of kind of how you organise an impairment, what's a trigger for a review and what's a definition of impairment. You know, it's all coming together to say something very simple. You use IAS39 in the best sense, in the most conservative sense; you use it as a proactive tool rather than a reactive tool. You say these are the events that are happening and this is what could happen to my portfolio, so, you know, these are my impairment events, these are all impaired because there's only negative equity and there is unemployment, etc. It doesn't mean to say that that's what's actually going to happen, but it does mean to say that that's what could happen; and that's using it in a proactive way. None of the banks really did this very well. They used it in a reactive way. And I, you know - there was recognition that this happened, because people started talking about impairment forecasting to try and get an idea and a view, using the unemployment, using interest rates, trying to correlate that with things like arrears rates, what would impairment look like in the future; and a lot of banks did that, but again –

Katerina R.

But they didn't do it - they didn't do it conservative enough.

Accountant 'C'

They didn't and again, I think you know, sometimes you get overtaken by events. In fairness to some of the institutions, I know one in particular tried to do this and tried to do it as conservatively as possible, but they based it on historical trends and what they'd observed and tried to put a level of conservatism on top of it. What actually transpired and what actually happened out paced their expectations. So they went, they tried to go about things in a rigorous way, but things got so much worse than they anticipated; and I agree with the hypothesis that banks didn't use this appropriately. I agree with the hypothesis that banks, you know, didn't have the correct triggers for impairment. I agree with all of that, but what I do want to make a point, and I think it's important, that events moved so quickly and so severely, it was very difficult to anticipate them; and people who, anybody even who lived through it, looking back at it, sometimes forgets that; and it is easily forgotten, but it shouldn't be forgotten. I mean I remember looking at portfolios and looking at Black Rock estimations that they did for the

Central Bank as part of the PCAR exercise and you'll remember this yourself - everybody talking about how this was a doomsday scenario, their numbers were crazy. Their numbers were mad. Irish banks could not lose this amount. Now that's not an impairment number, but it's very close to an impairment number. It was a lifetime loss, so a loss over a particular period. So it's not a million miles away from an impairment number. Your question as an accountant is to say well, OK, some of that are defaults that they expect in a future time periods that we can't account for under current accounting models today, but some of its actually related to the stuff that's going on today. Right, so why our provisions aren't at least directionally or even in the same ball park and why aren't they in that ball-park?

Katerina R.

You can't justify that.

Accountant 'C'

And, you know, you could have used all the same assumptions and probably got to a - not a million miles from that number, but bear in mind that within kind of a year and a half of that number, there was a number and a stress number - most of the banks would be on the stress number. When that number was published in March '11, everybody said that's a crazy number. So forget about whether its capital or provisions, you could have got there on provisions probably as well, if you'd been a bit more conservative on your triggers - but people were saying that that number's mad. That's crazy, that's a nuts number. They'll never get there. The stress number was even worse. You know, nobody expected things to move so quickly, nobody expected to be sitting there a year and a half beyond that and with people from the Department of Finance, who made this one of the business products and saying, you know, well for such a bank, this is - they're already beyond the PCAR stress case. Nobody expected things to move that quickly or that badly. You know, historical relationships that we'd only observed, we'd observed through a limited period in history that was actually dominated by really positive events by, a very weak relationship between interest rates and default rates. A very low level of defaults anyway - was never going to give us the answer to what's going to happen when you take a load of income out of the economy through taxation, Taxes go massively up. People's disposable income falls to hell, unemployment on top of it just increases massively; and government expenditure actually decreases as well. So when you have all those effects, they fundamentally

change the game and they fundamentally accelerate the downward spirals in a way that, as somebody committed to statistical modelling and who has done it for many, many years, I can tell you that they changed the game in a way that's very difficult to capture, in any collective provisions model; and it's not to say that things are perfect, but it's to say that there are - I suppose, almost the opposite - there are fundamental imperfections in everything that we do, because there are black swan events. There are things that we can't possibly anticipate, and we never know what we don't know.

Accountant 'C'

Am I giving you what you need?

Katerina R.

You are giving me the correct information and what I want to know, but there are certain questions I have to ask everybody for continuity to analyse their answers.

Accountant 'C'

And if you - and if there are questions you don't get a chance to ask me now, I can meet you again - I'm happy to do it, to meet again - so that you do get a chance to ask them, OK?

Katerina R.

OK, cool, cool. So, there are a few things I want to discuss. It's the fair value model, because two categories of financial instruments are measured at fair value. But I want to look at it from Irish banking perspective.

Accountant 'C'

So what's the question?

Katerina R.

Well the question is. Have fair value cause the problem for Irish banking system during crisis?

Accountant 'C'

No, not really. I mean, the - I don't believe - like, what's caused the problem for Irish banking

crisis, are poor loans, fair valuation, hit some of the notes of the accounts. It's not the fundamental driver of provisions. Looking back on it, it's certainly easy to say that provisions weren't adequate and the capital wasn't adequate. So that wasn't driven by fair value.

If assets were valued at fair value, you know, truly fair value, fair, fair value, honest fair value - the provisions probably would have been driven lower. So, a correct application of fair value probably would have helped. With the fair value model as it was, I don't believe it's - in any way had much of an impact on it, to be honest with you. I certainly don't think it's helped by provisions too far up, I think that's down to other practices.

Katerina R.

In Ireland most of the financial instruments on banks' balance sheets were loans, property related loans. I am assuming that fair value as a model, has nothing to do with this Irish banking crisis.

Accountant 'C'

Most of them are accounted for at amortised cost. They didn't have to be necessarily be accounted for at fair value, so like this - that's my point. I mean, what matters now is whether your accounts or loans were impaired or not. If you're going to do a fair value calculation that comes into, what, note 26 in the financial statements. I mean it's - the loans themselves are accounted for at amortised cost, unless they're held in a wacky portfolio. So if you were to do a fair valuation and I've done fair valuations of portfolios of two of the large banks as part of a potential merger and while, you get a different number and you'll be saying maybe the portfolios are worth 75 cents in the euro, the euro being what the banks say they're worth, right. So they'd say they're worth 100%, you're saying you'd probably need to haircut that by 25%; but I mean, what would that lead you to think? I mean you could do that sort of approach if you wanted to calculate provisions, right, but that's doing it properly, doing it correctly. That's first of all. It's not saying that the fair value model, as it was practised, was a problem for it. It's saying that if you practised the fair value model correctly, it might have influenced your decision on provisions. Do you understand?

Katerina R.

Yes.

Accountant 'C'

It's a subtle difference.

Katerina R.

Yes. So then going back to the loan book, which was while you're at amortised cost, do you think the standard itself is at fault? As in valuing the loan book at amortised cost?

Accountant 'C'

Loans, like, financial statements are a point in time valuation, you know. I mean people have to understand that a point in time valuation is actually out of date as soon as it's done. By the time the accounts are published there is a view of a company's financial picture over a period in history.

Katerina R.

No, it's actually at the balance sheet date, isn't it?

Accountant 'C'

Yeah, but that's - by the time they're published there's, you know -

Katerina R.

Its three months later.

Accountant 'C'

Yeah. That's a period in history. The world has moved on in those three months. It's a period in history. It's - the 2012 accounts come out, you know, 30th of March 2013. You know, it can take six weeks to complete a merger transaction. These are out three months later. So it's a period in history, things can move on. And they're probably - they're the best indicator of financial reliability yes, but they're not the only one - portfolio degradation can occur, credit events can occur, individual counter-parties can default in that time period, which yes of course you have to denote significant post balance sheet events, absolutely, but the world moves on and you know, genuinely what do I think was the biggest, or the biggest problem with banks here? I think that banks didn't want to be as conservative as they needed to be. I don't think banks

realised how concentrated they were. I don't think they realised how highly leveraged and geared they were and the funding issues that they were building up and I don't think they realised how, I suppose, how fraught a lot of that property lending was.

Katerina R.

But that's their business.

Accountant 'C'

It is their business.

Katerina R.

They have to know that 60% of their business is in the property?

Accountant 'C'

I totally agree with you, I totally - I couldn't agree more with you. It doesn't change my view that they didn't know. It doesn't change my view that they were badly run. It doesn't change my view that they were badly regulated and it doesn't change my view that the people were stupid. People signed up for mortgages, people did everything they could to get the most money out of a bank. The bank did everything it could to get them there, because both of them thought it was in their interests. The person thought well, you know, I can tell the guy down the road look at the big house I'm going to get and he can look at me and say, you know, Jesus, you know, that guy is rich and he's doing really well for himself. The bank is thinking, you know what, there's a lot of money to be made in interest on this one. So, like there's no appropriate checks and balances in that. And that guy comes back when his loan goes into default and blames the bank and says you guys gave me the money, you should have looked after me. The bank is a money making institution. They wouldn't have given the guy the loan if it didn't think it was going to make money. It just got greedy, the same way he did. The regulator was just asleep at the wheel. Auditors go and they give their view at a point in time. I mean, auditors, they have to give a view of going concern and that's actually very challenging for an auditor. It's hugely challenging for them, because ultimately most of what they're asked to do is relies on management - is this particular item treated correctly according to accounting rules. It's actually very difficult and in my view, can I be sure to stand on my reputation and say, yes this company is going to live for

the next year. It should be considered as a going concern. No, I wouldn't be comfortable with that. I genuinely wouldn't be comfortable with that. I think what's being asked of accountants and the requirements that have been placed on them to achieve that, there's a world - a huge difference between those two things.

Katerina R.

OK, and we did mention incurred model, which is IAS39 and it's the way it's limited, I'd say, to report events at the balance sheet date. So in terms of incurred model in general, do you think it's the right model? It's a good model?

Accountant 'C'

No. As you know, we're moving towards, IFRS9, which talked about expected loss, and I don't think that's perfect either. The good thing about that is that it will allow you to sort of say, look this is a portfolio and while it looks okay today, it has vulnerabilities that we need to think about. So it could degrade very quickly, so if we take an expected loss calculation, we can actually make provisions for that now rather than waiting; and that helps in terms of avoiding a situation like we had in the current crisis. Do I think it's perfect? No, because I think that, you get that variability through the profit and loss. So you've potentially got massive, and year on year, variability and year on year restatement.

Katerina R.

But that's the market, it is volatile -

Accountant 'C'

Well it is and it isn't the market. I mean the market is volatile, yes, but you know, when we talked about those accounts and we talked about variability, we talked about expected loss - actually you know what, what happens if next year my expectations proved invalid, do I have to restate my previous year provision, or my previous year calculations? Under IFRS9, you know, if I give three year forecast and three year expected loss minimum, do I have to restate that then going back to last year? Is that going to cause confusion? Is that going to cause transparency issues? Absolutely, it will. So that's where we get into the year on year restatement, or constant changes as a result of changing expectations and changing parameters; and we get a huge level

of variability and that invites transparency and it impacts certainty. So it's not - it's not a perfect solution. Is it better than the current model? If used correctly the current model mightn't actually, certainly in theory, mightn't actually be a million miles from it, if used correctly. I'd probably be inclined from a stats point to say yes, it is better. It genuinely is, but it's not without risks, you know. It's not without risks for people artificially buying up the provisions that you had, it's not without risks of having silly year on year movements that exaggerate P&L [profit and loss] swings and provision swings, that introduce again transparency issues for investors, you know, and customers alike. So it's certainly not without risk.

Katerina R.

One of the other people that I interviewed mentioned that banks will deliberately go out of their way to get around accounting rules. They will create a product, which are not covered by accounting standards.

Accountant 'C'

Well like we've seen secularisation transactions, we've seen what people deliberately move things off balance sheet, they circumvent capital relations, or they circumvent all kinds of different regulations, you know. So we've seen that. Can people get around the IFRS9 rules? Is that the question? Could people invent products to get around them? I'm sure they could. I can't think of a product right now, but most people, if they want to manipulate accounts - and there are a lot of people that do, they would sit down and look for the loophole. I mean there's a very famous lady in credit modelling, called Janet Tavakoli, and Jan had a number of positions in investment banking and is a very very good modeller and has written a number of books on the topic; and in one of her books she said in her job in a bank, when the capital will come out, one of her jobs is to sit down and figure out how she can get around it, you know. Is there a way she can get around it? And banks and accountants aren't massively different in that respect, you know. They want to find out how they can make the rules work to their advantage.

Katerina R.

OK and one particular product, might be the roll-up loan, whereby definition a customer can never default on it.

Accountant 'C'

Yeah, yeah

Katerina R.

Because it's a roll-up.

Accountant 'C'

Yeah, yeah. And this was a problem during the crisis as well

Katerina R.

But that was more - that was property related.

Accountant 'C'

Yeah, like you should still have a risk management infrastructure such that you can detect impairment in that situation, because what you don't have is the typical and traditional indicators of payment.

Katerina R.

Or default - they can't have a default.

Accountant 'C'

No, you can't. I mean, I dealt with one bank who's nearly 90% of their portfolio - in 2009 I dealt with them - and nearly 90% of the portfolio was interest in capital roll-ups.

Katerina R.

Seriously?

Accountant 'C'

Yeah, yeah, yeah, yeah. Everything was rolled-up, everything was bullet repayment, bullet repayment, bullet repayment; and so you say to yourself, well like if that's the case you don't have any data to do anything systematic and say take 100 loans and run four criteria on them and

filter that way to identify the loans who are at greatest risk, like who was a late payer, or who was a non-payer. What you do have is an ability still to look at, collateral value, if you look at it honestly. So that might be one indicator that you could use to identify loans that are - or to differentiate between loans of risk level.

Katerina R.

But if you don't have evidence that the customer going to fail, you don't have to - you don't have to look at the credit risk of the loan.

Accountant 'C'

Why, who said that? Who said if you don't have outlets, you don't have to look? I mean if you're going to run a bank integrally and honestly, you do have to look. You always have to look. You know, if you want to design a product to get around it, so you don't have to look, yeah fine, design that. The regulator should still kick your arse for having a weak risk management function, because that's just, that's designing a product and carrying no oversight on the customers and their performance, right? So any regulator that's in any way lively should be saying well what's your risk management function here? How do you monitor the risk? Irrespective of the fact that the product you've offered means the traditional indicators of declining credit quality are not available to you, OK. Traditional indicators like, you know, have you paid on time, have you not. They're not available to you now. You need to find a way as a company to still detect whether this loan has gone bad, that's what having a risk management function is. So yes, you can design a product, but if the regulator has anything at all about them when they look at those products, they're still going to want to know why and how you plan to manage and monitor the risk; because all of that just amounts to designing a product for which you can mount a theoretical argument to say I can't monitor the risk - can't monitor it, it's not possible. It is always possible. You just have to be as creative with the means to monitor it, as you are with the product you design.

Katerina R.

OK, and on the subject of regulation in the period of, say, 2007, 2008, 2009, what is your opinion on the banking regulation in Ireland?

Accountant 'C'

I think it was weak. I think it was incredibly weak.

Katerina R.

That's very nice of you to say that. Weak is a nice way.

I think it was weak. I think there was an agenda where people were trying to sell a story of Ireland Inc... Great place to invest, great place, great place. Not a lot was actually happening outside property, being quite honest, in terms of property values. They're the only thing that was happening in this country. We weren't growing indigenous exports, anything like that. Property was the only thing that was happening. So the regulator - I know they had concerns and had mounted some exercises in various different institutions to investigate concentrations and things, but I don't think they were invasive enough, I don't think they were strong enough in telling banks what - that they could and couldn't do things. And I don't think they were a real regulator in that sense. I think they tried to work in partnership with banks rather than reminding them they were a f**king regulator and regulate, you know. I think the supply of credit, an interesting stat, that's worth looking at is looking at the different definitions of the money supply and how it just went off the charts, in the early 2000s. One of those is kind of credit cards and things like that. That's one component to M3, the money supply; and it's quite interesting to see how it grew. Loans in advance to customers.

Katerina R.

Yes, there is quite a bit of growth between 2002 and 2007 in loans volume. I think it was something astonishing from maybe 200 billion to like 700, 800 billion

Accountant 'C'

And then you compare that with where this is funded from and from October 2001, I mean a lot of this money has been borrowed from international markets. So the banks are just leveraging international markets and they were delighted to lend to us. German banks couldn't lend enough. French banks couldn't lend enough. Great place to lend into! And I mean property value's going up left, right and centre. A nasty shock for you, because you're soon going to realise how much of European money was actually tied up in this little country, that it wasn't all along - that we borrowed it from somewhere. Like you're saying that, the motivation that's shit, you know,

Germany is going to lose a shed load of money and so is France, unless they come in here and provide support. It's kind of part of what the story of what happened.

Katerina R.

So, if you had to summarise Irish banking crisis and pin it down to one, or minimum of things, what would you say?

Accountant 'C'

I think weak management in banks, absolutely. You know, I think there's weak credit risk management and I think that impacted things like capital calculation and things like provision estimation. Because I don't think people were cognisant of the, genuinely the real risks inherent in our banks. I mean I had discussions with one bank where I told them in 2006, 2007 that it wouldn't take a lot to push them over and I was nearly hounded out of the building; and I could see the numbers and nobody in the bank believed me. People even in my own workplace didn't believe me.

Katerina R.

Well, they just didn't want to know, but from the Anglo tapes, we know that they knew.

Accountant 'C'

Well, like you know. I'd say it from the Anglo tapes we know - I mean, none of us have heard the full Anglo tapes, so I don't draw any conclusions from those. We heard excerpts and snippets and, you know, I'm too long in the tooth to make my mind up on excerpts and snippets. I've been around - I've been around the game for a long, long time and I know how people can use these to sell a story and to start a story and make no odds about it, I'm no fan of David Drumm, or Sean Fitzpatrick, or any of those guys. I mean, you know, I've no time for these people, or for what they did after - how I believe they lied in a number of circumstances.

But that said, I think we're all too intelligent to buy into the idea that we can make a view, or make a judgement based on excerpts of a small set of documents. I mean, it's - to hear the arrogance, to hear all of that, you know, it's pretty annoying. And even in a smidgen, even in an excerpt, that's not acceptable. But beyond that, I wouldn't make a view. I genuinely wouldn't

make a view. And I heard - I heard plenty of loose talk around places that were in trouble and it didn't mean to say that those people took it lightly, far from it; but some of them were in such a state of desperation, that actually you know what, their loose talk like that betrayed really the fact that they felt, well, it doesn't really matter what the number is, we're so screwed. What are we going to do? The only way we can cope is laughing at it.

And I heard, you know, it wasn't just that institution, I've heard a load of people, you know, say things like '10 - 10 billion, or 20 billion, it doesn't matter at this stage, you know - we're under, we're dead.' You know, 'I know, but sure go on, we'll do the weekly shopping and away we go', and if you take that excerpt - and I heard that conversation in one institution - if you took that on its own without knowing the people involved, you would think, you know, obnoxious, arrogant so-and-so's. But knowing the people involved, you know, I know - I knew at the time that there was a different interpretation, that they meant something very different. So I don't base things on just on excerpts, I don't base a view on excerpts. I already knew that the guys were arrogant, I already knew that they guys were aggressive. I don't agree with saying things like 'stick the fingers up and take the money, sod 'em.' I don't agree with saying things like, 'get them to invest and just get them in and, you know, let them follow their money', you know, and I think it's - there is a case to answer about whether they deceived the regulator. I think that there's a very - there's prima facie evidence to suggest they did and that prima facie case needs to be examined, but you know, I don't think I can adjudicate on it.

Katerina R.

OK, and in terms of accounting standards, if you had to pin one thing down that added to the crisis, what would that be?

Accountant 'C'

If I had to pin it, I think people weren't, and I still think people haven't been conservative with their provisions. Genuinely, I think people haven't gone and said, you know, you need to be conservative about how you apply it and how it matures. It comes down to weak regulation, weak management and as a consequence you get poor, weak and inconsistent interpretations of capital requirements and of provisions. Bear in mind that provisions being what they are if the capital requirements are robustly estimated, the institution will remain solid, irrespective of

provisions. Now yeah, they're linked, but - and they are absolutely linked - but you could go and estimate a capital requirement, say on average, all your portfolio is much than it actually is, but not in default - and estimate a capital requirement and hold it. You could say my provisions are much better than they actually are and you'd still be solvent, even though those numbers would be very different. So it's not just about the provisions. It's about the capital.

This crisis - this is about a liquidity crisis that became a credit crisis that became a liquidity crisis again. It's about people who couldn't pay what was due, that called out their worthiness into question, that became a self-fulfilling hypothesis and so far it's again, made it further difficult for them to pay what was due, because they're all highly leveraged. Individually, you see drip, drip, drip, one after the other because of that. So for me, I mean, it's also about that liquidity management, it's also about that leverage.

Could the impairment standards improve, could you look at those and say, do you know what, you know, could I have an unlikely to pay indicator as being the level of leverage a company has, yeah absolutely you could. It's not - I don't think it's explicitly called out, but if people were rigorous and rigorous in how they apply the impairment standards and maybe if they applied the Basel requirements as well, they would have been in a better place. Hard to say that they ever would have stopped it, you know. I can't tell you how unanticipated any of this was, even from a conservative view. Even from, like, a renowned and notorious pessimist likes me. In my world, the - at best, the world is going to end in seven days, at worst it's probably three. You know, this would have - and I would have felt that a lot of the banks around town were in trouble as it was, or should have been in trouble, but I wouldn't have seen it to this extent. I definitely wouldn't have seen it. I would have thought that they would have recovered, but in kind of two, two and a half years, you know. So I think it is preventative, yes. Do I think the impairment standards could probably have prevented it? I think it would have helped, I don't think it would have perfectly got you there. I think a better application of the Basel requirements and a better specification of those requirements would have got you much, much closer; but I think all of those require - they require having better management in banks and better supervision.

Katerina R.

Not crazy people!

Accountant 'C'

Yeah. Yeah, and you know, more humility to be honest with you and then a bit more humility; and a lot of these people thought, proclaimed, that they knew things that they simply didn't.

Katerina R.

And then it's pride. It's easier to continue with the lie than to ask for help.

Accountant 'C'

You know and everybody - like, everybody bought into this. It's an unpopular thing to say, but for example there's a guy who's and he's an every man's guy, I mean he's a guy I know and, you know, he bought a two million property with his uncle. I said, 'But you earn like 35,000 a year.' 'Oh, I broke into HR, the HR offices in our place, and I stole some headed paper. I re-wrote - I wrote a salary certification for myself stating that I earned 70,000.'

Katerina R.

But you have to repay the loan and eventually...

Accountant 'C'

What is that great phrase, you know, the great Dublin phrase, 'Getting it it's grand, it's repaying it that's the problem.' I mean I got this, I got my mortgage in 2006 high to the ground. But I heard that three, four, five different times a week. Not, like in obviously terms - a week. You know, people buy into this and they're the same people that come around and, you know, say, 'Hey, you know, this isn't my fault.' It is. I mean, it's your fault, because you were ignorant to the risks you took. You mightn't have known what risks were there, but then it's your responsibility to educate yourself on those risks. It's a bank's responsibility to make sure that you know what risks you're taking on and for them to make sure they know what risks you're taking on. And it's regulated to make these responsibilities, to make sure that the bank knows what risks it's taking on and to make sure the regulator knows what risks the sector is taking on. All of those things failed, individually and collectively, all of those things failed. You haven't got a hope; all you've got is an inevitable outcome over an undetermined period of time when those things happen. That's all you've got.

Katerina R.

And here we are.

Accountant 'C'

There you go. Is the interview over?

Katerina R.

Yes, I think I actually got a lot.

End of the interview.

Appendix 8.

Transcript of the Interview with Accountant ‘D’

Date: 19st July 2013

Time: 2pm

Place: Dublin

Interviewer: Katerina Ryzhenkova

The topic of the interview: The role of IAS 39 in the Irelands Banking Crisis.

Katerina R.

To start with, the Irish banking crisis and the main reports which came out after it and the main points for all the three reports prepared by Patrick Honahan, Nyberg and stated that it was a home grown crisis, and that the practices and strategies of the banks were to blame. Do you agree?

Accountant ‘D’:

Well, there are two elements I suppose, there are commercial loans and then there are private sector loans, we all know about the private sector loans, your mortgage used to be two and half plus the site plus one. Then they went to lending four or five times, we know from anecdotal evidence that Anglo Irish Bank on commercial loans were done on the strength of a handshake, they didn't get the security in place, they didn't test the business plan. So I think that, when they're saying it was home grown, that's what they mean it was home grown. We had very good compliance procedures in place and we just ignored them all. We were playing catch-up with the likes of Halifax who came into the market, they were able to lend loads of money and the shareholders of other banks were saying why can you not compete with Halifax. Instead of sticking to their guns, what they did was they just threw the rule book out the door and just, they were throwing money out the door.

Katerina R.

I suppose Anglo was growing very rapidly at the same time as well and may have been very aggressive in the market.

Accountant 'D':

The Anglo shareholders, same as everybody else, would have been putting the board under pressure too, here's Halifax coming into the market place, we're supposed to be the aggressive company building up market share. Halifax came in and Royal Bank of Scotland and they just took a huge amount of the market and it was down to shareholder pressure, the boards just caved in and started lending and they didn't apply the principals they have done in the past.

Katerina R.

The thing about the practices, I would expect that you, may be allowed to practice wherever you think appropriate, but regards the presentation of accounts, if the banks are compliant with all the accounting standards and auditors are there to check it so we know that banks were compliant with all the standards, otherwise auditors will be highlighting that why they aren't. We know that after 2008 the crisis happened and we didn't know extent of the losses and extent of the crisis in the banks, would you say that the accounting rules, even if they didn't cause this, they at least didn't prevent it, they could have facilitated more disclosure to let the stakeholders into the real state of affairs in the bank, do you know what I mean?

Accountant 'D':

It's back to this point about fair value which is a lot of your questions cover as well, see if you apply fair value to all of those loans, the fair value at that point in time, up to whatever date it was in August 2008, all those loans would have been in excess of their book value. You had no other way and you've had a huge swing, so I know what you're trying to, what you're getting at, but I don't know what the solution is, so I think what the IFRS accounting framework is the best solution. Fair value accounting I think just doesn't work, it's too erratic and then no one will have an idea of the underlying value.

Katerina R.

But it is a fair value at the point in time. There has been research done on the pros and cons of fair value, most of them do prove that fair value didn't cause the crisis.

Accountant 'D':

No, fair value didn't cause the crisis, because they wouldn't have fair value.

Katerina R.

So we can't say that, it was fair value that caused it?

Accountant 'D':

The crisis would have happened whether or not you had fair value. The underlying banking is the problem, not the accounting treatment. The fact that they were giving out too much money, don't know how big your mortgage is, mine's way too big!!

Katerina R.

It is, it's big. I'd prefer to pay what it cost now rather than what I bought it at!!

Accountant 'D':

It's true and fair on a going concern basis not on a breakup basis. But if you had to sell everything in the morning that's the value you'd realise for it.

Well it can just lead to a downward spiral because people then with the money will know that if they wait that bit longer the market will suppress and value will keep going down, and you just have vultures with the capital that just come in and pick up the assets at the end for next to nothing. So it doesn't work, it wouldn't work either.

The key point is that the accounting, the accounting treatment didn't lead to the crisis, what lead to the crisis was the operations both in the construction and in the banking, financial accounting only reports on historical fact, you come along after it and say, what happened. So it can't be the cause for a recession, you might argue that it contributed because people didn't have sufficient information, but the information is twelve months old anyway.

I think it's very important that people understand what true and fair is. It doesn't mean fair value, it means going concern on a true and fair basis. And you have to understand then that for a bank that might mean the discounted cash flows at the amortised cost, rather than the actual mark to market valuation.

But that's the key, if you, if you can say where to begin at mark to market but I mean, if there isn't an active market, you have to try and simulate the models, assume there's an active market, you can discount it by anything up to 90% and you just end up with ridiculous figures that only confuse the reader, in my mind.

Katerina R.

Yes, and the fact that it's allowed per accounting standards, and I suppose, the whole point of harmonisation of accounting in EU, while we allow for so much management discretion. Different managers even in the same country in different banks would think differently and do something differently. So then at the same time the banks follow the same rules but when you look at it, there are too many variations.

Accountant 'D':

We follow the same principals, the key distinction between here and the United States is, the states is rules based, so they have a rule for everything. With principals based in the EU, and the people can interpret the principals, separately or differently I should say. Whereas if there's a rule and everyone has to play by the rule, like the offside rule in soccer, everyone knows what the rule is, everyone has to play by it. Soccer is a bad analogy now but if it was just a principle and then people would interpret it differently, so in America it's more defined because it's rules based, Europe is principles based. The experts would argue that technical accountants can pick holes in all of the rules because there's just so many of them, each one you can pick a hole in, whereas if it's principles based, you're down to principles and everyone agrees the principles. Our financial statements in Ireland and throughout all of Europe should be more aligned than they are in the states, the fifty states could all be very different. That's just one of the views. Which would be more aligned, rules based or principles based? In Europe we think principles based are more aligned, the states obviously believe the rules base is more aligned.

Katerina R.

But then it's not, from the investors point of view, we're not comparing financial statements like for like.

Accountant 'D':

Until we can get it to a situation where were we can key it into a computer and the computer does it all and it's consistent all the time, once you've got human intervention you'll never get like for like. You never will. I think you'll get it within a band, you'll get it broadly the same, you'll never get it 100% the same.

Katerina R.

But do you think there should be so much reliance on the discretion of management?

Accountant 'D':

In relation to judgemental issues, estimates, there's a lot, it's not an exact science, if it was an exact science all you'd do is you'd account for on a cash receipts basis, you'd do everything to a fair value, and then it actually wouldn't be worth anything because you wouldn't be able to see what the underlying value is.

A business is a lot more complicated than just saying, it's fair value today. You have to look at the discounted cash flows; you have to look at can you continue to hold that portfolio of assets for the next twelve months after the day of the signing. What's happening in the environment, can you hedge against that and risks, there's all of those things are at play.

Katerina R.

In IAS39, it allows incurred loss it works on an incurred loss basis, but it doesn't allow you provisions and discount for a future impairment.

Accountant 'D':

You can have macro-economic figures though.

Katerina R.

But you have to produce the evidence

Accountant 'D':

Demonstrate that it's incurred. But that's what the banks are doing now, they're saying that the macro-economic trigger is recession, so now they're booking provisions. You couldn't book the provisions until the recession was here. IAS8 is going to allow you to have expected losses but yeah, historically it was all under incurred loss basis but the distinction for the banks, or not just banks, anyone, you can look at macro-economic triggers, you don't to have to look at the specific assets, you can look at the portfolio of assets, so overall the bank might say that, given that we're in a recession, that's incurred, the recession has happened so it's an incurred loss.

Some percentage of these will default then you'll be relying off historical data or comparing to other economies. That's where they're at.

Katerina R.

Apart from the global financial crisis, if that didn't happen, would our banks still be in trouble?

Accountant 'D':

Yeah, because we were lending too much, the price of our property here in Ireland was dearer than Japan and New York at one stage, by square foot, I think what Sean Dunne paid for the site in Ballsbridge, it was the most expensive piece of land in the whole world.

Katerina R.

Really?

Accountant 'D':

Sure Dublin it's not that good! You know, New York or Japan or London you could say maybe because it's a financial service centre, but it just got ridiculous, and there's a bit of ego thing, who could spend the most money. The banks were just throwing money at them, and had they been allowed to continue, it would have all come good. It's like if Nick Gleeson was allowed to continue with his back office trading, it would have come good. Or if you're in a casino and you keep gambling and doubling up you bet, eventually you'll win.

Katerina R.

No, the house always wins!

Accountant 'D':

Problem is the house doesn't run out of money, you run out of money. If you didn't run out of money, you'd win eventually. You just keep doubling up but because you run out of money. Well it depends what game you played, if you're playing roulette, the odds are slightly in the house's favour because they get zero and then you've got black and red. But if you had sufficient

money, if you had unlimited flow of cash, you went into a casino and just went, black and red on roulette

Eventually you'll win. You might be there for ten years, but eventually you'd win. And if you're doubling up each time, or double up plus a bit, you'd get your money back and you'd win. Once you have sufficient funds, the house does win because people don't have unlimited cash.

Katerina R.

But it doesn't make sense because everybody have the same chance.

Accountant 'D':

Everybody has the same chance?

Katerina R.

If the house and the person have the same amount of money and they don't run out of money, the odds are fifty-fifty.

Accountant 'D':

Yeah if people prepared to sit there and keep gambling.

Katerina R.

So you can say in the same conditions, two people with the same odds and the same everything, the odds can't go in ones' favour.

Accountant 'D':

No, the rule of probability is that it'll be fifty-fifty, if you played for a year you should end up both with the same amount of money that you started off with. What will happen is, in the casino example, the person going into the casino will have a run of bad luck, the casino will also have a run of bad luck but they just go and get more cash out of the safe. When the individual has a run of bad luck, he has to go home and tell his wife he was a fool!

But it's the same with the banking, it was a gamble, it was speculation, had Sean Dunne been allowed to go and develop that site in Ballsbridge, he'd have sold that on and made a fortune and

then he'd have gone on and paid a ridiculous amount of money somewhere else. Eventually it had to stop.

Katerina R.

But the bubble will have to burst at some stage anyway.

Accountant 'D':

Well you'd have been to hyper-inflation because the prices were just going out of control.

Katerina R.

There are only so many people to buy second and third houses, it had to stop eventually.

Accountant 'D':

There is still a lot of demand in Dublin. But yeah, eventually they would have saturated the market. They had to stop at some stage.

Katerina R.

Do you think that conversion to IAS4 for all the companies, for all the listed companies in Ireland affected the quality of their financial reports?

Accountant 'D':

So when the banks first applied IRFS compared to Irish GAAP?

Katerina R.

Yes.

Accountant 'D':

So historically, under Irish GAAP, they would have accounted for on the discounted cash flow basis, it wasn't fair value so it's a similar basis. What IFRS brought in was IFRS8 you had to put in your fair value basis, your interest sensitivity analysis, your final exchange exposure analysis, so there's actually more information in the financial statements now than there was historically.

If you get a set of financials, just go onto a website, go back ten years or whatever it is, it's probably more now, fifteen years, all the financials are up there, and print off a copy of financials today, your financial statements are nearly twice as big. Just the financial statements, I'm not talking about the annual report just the financial statements for financial disclosure. There's way more under IFRS a lot more work to do in their IFRS.

Katerina R.

But there is more disclosure for fair value now, but previously everything was assessed, the impairments and provisions on the prudential concept and this was pretty much dropped because IASs are based on incurred loss.

Accountant 'D':

Well you weren't allowed, IFRS12 was the first standard where you weren't allowed to have expected loss provisions. Now they are going to change it, at the moment we are on an incurred loss basis, people weren't taking account of macro-economic triggers. It's back to principles, about how you look at it.

Katerina R.

So you could then say that if we didn't have IASs banks would have to exercise prudence, they would be better off going into the crisis, they would start provisions, those provisions would be visible and reflected in the profit or loss of the banks and that would be a signal to the market that something was up.

Accountant 'D':

It's not down to GAAP or IFRS, in either situation, if the bank was lending out, say it was a mortgage broker, and they were lending out a thousand mortgages, of a hundred thousand each we'll say, for argument's sake, you would know from history that one of them, two of them is going to default. Under the incurred loss, we were doing it on a line by line basis so you couldn't provide for it until Mr X came along and said, I can't, well, you'd see that he wasn't making his mortgage repayments, you call him in, have a meeting with him and you find out that he's lost his job, he's got nothing, no collateral, the collateral he said he has is long gone, so you had to provide against that, the mortgage. But that's under the incurred loss method, under the expected

loss method, what they're going to do now is that if you have a portfolio of a thousand mortgages; you'll know that 3% on average default and you'll book your provision up front. The bit in the middle is that once the recession comes, you know that more people are going to default on their mortgage and you can under the IFRS's book provisions on macro-economic triggers, the banks didn't do this They didn't want to show that their balance sheet was weak, they're all looking at each other seeing have they provided yet, because obviously there's a lot of people investing in banks on the strength of their balance sheet, so there's a lot of political things at play as well.

Katerina R.

I was under the impression that we could not make a provision for something which did not happen.

Accountant 'D':

But what happened? The recession happened, we all know that.

Katerina R.

OK, but going back, going back in 2008, could they actually provision more?

Accountant 'D':

Back in 2008 or whenever the date was, before IFRS12 came in you could have general provisions and everything. I don't know what date that was, but it led into the international financial statements that there were no more general provisions. We used to be allowed TO have general provisions, people just kept money to the side for a rainy day.

Katerina R.

That was before IASs in general?

Accountant 'D':

Yeah.

Katerina R.

IAS39 I think looks at the loss credit loss provisioning and loans provisioning for, loss impairment provisions and all that.

Accountant 'D':

They have but the thing is IFRS8 or whatever number is coming in, is going to allow you to have loss from expected loss model, it hasn't come in yet.

Katerina R.

I'm looking back in what banks could and could not do in 2009.

Accountant 'D':

So ignoring FS12, just around 2008, 2009, when they went from GAAP to IFRS, there were fewer provisions in the IFRS.

Katerina R.

It was they just they weren't allowed because of IFRS?

Accountant 'D':

Yeah, you weren't allowed.

Katerina R.

In relation to Irish banks public, published annual reports do you think that stakeholder looking at the banks' balance sheet and P&L would have a true and fair picture about the banks position?

Accountant 'D':

Well you would if you knew what you were reading and if as I said if they had done their job properly. If I was looking at Anglo's P&L balance sheet just before the crash, I would have thought it was worth investing in; it was worth a lot of money. Turned out Anglo was worth nothing.

Katerina R.

Would you as a qualified accountant look at the banks P&L and you would think it's worth investing in?

Accountant 'D':

The P&L, the return on capital employed the history of dividend payments, that's what you'd be looking at, yeah.

Katerina R.

In 2008 those accounts were prepared under IFRSs and if we assume that everything was done per IFRSs which we know they were. Then I would agree that it's true but can we say that's also fair?

Accountant 'D':

Yeah, why not?

Katerina R.

Well true means the figures are correct but the fair implies that they have been assessed...

Accountant 'D':

...on a going Concern basis or discount and cash flow or whatever. You're back to fair value again, aren't you?

Katerina R.

I think it's my favourite subject!

Accountant 'D':

So if you don't think it's fair, what would make it fair value?

Katerina R.

Prudence would make it fair. You would look at that loan and if you'd know that in the next three months something would happen and if you see it coming and you know it might be impaired, a fair for me is to provide for that. But you can't under IFRS back in 2009.

Accountant 'D':

I think you can if you take the macroeconomic view. But what triggered the loss, something after the balance sheet date?

Katerina R.

Yes.

Accountant 'D':

So the recession happened just the day after you signed the balance sheet?

Katerina R.

Yes because we have the balance sheet dated 31st of December, the audit is conducted in say, March, April, so we know in March, April that a lot has happened, a lot of impairments, more information came out about the state of economy, but because it's against incurred loss basis, you couldn't discount those figures and you'd couldn't impair and provide for losses, at the end of the year.

Accountant 'D':

They were looking at it on a line by line basis; they could have looked at it on a portfolio basis.

Katerina R.

But they couldn't.

Accountant 'D':

There's something I think in IAS39 whatever it is, but you can look at macro-economic triggers, you don't have to look at each individual line of the portfolio.

If you have to look at it on a line by line basis, well then customer X, his loan hasn't defaulted until after the year end, then you can't provide for it. But you can you look at macro-economic triggers. They are only getting to grips with this now, trying to work out what to do.

Katerina R.

Taking long enough, isn't it?

Accountant 'D':

Nobody expected us to fall off the cliff. The soft landing never materialised.

Katerina R.

There was an interesting question about amendment of IAS in 2008?

Accountant 'D':

This is when the French government intervened?

Katerina R.

It was following the report by the French.

Accountant 'D':

The EU banks were showing a less favourable position than the American banks because the Americans could position their balance sheets the way they wanted so, that was under political pressure, really shouldn't have happened but it did and that's we are.

Katerina R.

But, I can see some fairness in doing so, of course there are pros and cons to do that, but one could say that it is, it is fair that if you know that you're not going to sell an instrument and it was for trading but it's not anymore because you can't sell it, you can't afford to sell it, then this price is, you should move it to held to maturity, then value it in that category. So while it can be seen that banks took advantage of the amendment, it can also be seen as a way of dealing with the crisis.

Accountant 'D':

I think the banks did that. If anything was in doubt it went to health and maturity at amortised cost rather than mark to market.

Katerina R.

And that's how I suppose the amendment happened in October 2008 and then all the published reports came out for that year and ...

Accountant 'D':

There was political pressure from the French and the English.

Katerina R.

A lot of instruments went into the health and maturity category at amortised costs, would you agree?

Accountant 'D':

Absolutely

Katerina R.

Then surely the fair value again is questionable in balance sheet of those assets, even if there is a rule.

Accountant 'D':

Well that's why I said, it's OK doing that if you can afford to keep them as health and maturity. But it depends on some of the other things on your balance sheet, if some of them have to be available for sale, because you have to realise the cash to pay back whatever, because banks have obviously borrowed from other people around the central bank or the EU. So if, again if they had have been allowed to play it out, without any intervention, they could have left them in health and maturity. But that's not taking account of the other factors they're playing the market with. I think they were looking for a simple solution, if I leave it here at mark to market, the value's plummeting, it's going to wipe out the value of my balance sheet. I'll put it into health and maturity and it'll prop up my balance sheet value.

Katerina R.

Yes true but then at the same time, this is the standards they followed, and this is the market price now. So how can they just to switch it over to health and maturity category.

Accountant 'D':

We have to go through the, it's either twenty-six or twenty-nine when you determine whether you have an asset or a liability and which category it falls into and then how you are going account for it. And there's certain steps that you have to go through, you can't just decide, OK, suits me to go to health and maturity category.

Katerina R.

Well you have to prove that market is inductive for this. You basically show that there is no value to it, that can also show at the same time, you're not planning to sell it anymore, so is that how you just put it to, on those basis you put it to health and maturity.

Accountant 'D':

Well that would nearly bring it to trade and receivables but yeah, it's along those lines

Katerina R.

But if the banks didn't do that though, we'd see a lot of value being lost from the bank's balance sheets.

Accountant 'D':

That's what they did.

Katerina R.

Oh I know, no, I said if we wouldn't do it, the banks' balance sheet would just be discounted so much.

Accountant 'D':

Absolutely, there'd be a huge internal provision.

Katerina R.

And that's why they probably did it in the first place.

Accountant 'D':

Protecting their Shareholders and interests, otherwise the shareholders would have gone mad, people would have been selling their shares and then it spirals down.

That can be it though, it's a self-fulfilling prophecy if you start to write down your balance sheet, people get nervous, they start to sell their shares, your balance sheet goes down in value even further. Next thing, other people start to sell their shares, next thing you're worth nothing.

Katerina R.

Cormac Butler is the man who got me into this topic in the first place. He ascertains that IAS39 is a tool for Irish banks to conceal losses ever since 2005 up to now.

Accountant 'D':

He was in The Times recently.

Katerina R.

He was saying pretty much the same thing the other week. That the banks are still concealing losses and loopholes still exist.

Accountant 'D':

Losses are still concealed because the central bank, if you look at their website, we have addressed the commercial loan books but we haven't looked at the private individual mortgages yet, there are a lot of people defaulting on their mortgages and the banks and building societies haven't provided any disclosure. The same in the banks, the individual banks and building societies haven't really gone through the process thoroughly.

Katerina R.

But do they have to? How much authority would central bank have if they want to change something over from IASs because if the banks by law and by EU law and local law have to follow IASs and they can interpret them whatever way they have interpreted it and that is how

the accounts were produced. So even though the central bank is issuing all these guidelines is it going to make changes to how banks are doing these impairments?

Accountant 'D':

I'm not sure what the role of the central bank is in relation to enforcement, if they can go into a bank and say you need to book the provision of X, I don't think they can, I think all they can do is suggest that you need to book a bigger provision.

Katerina R.

So it's all really suggestions.

Accountant 'D':

Yeah

Katerina R.

That's interesting. The central guidelines in a paper last December, about the provisioning for mortgages and loans or something along those lines. Then they commented that we're not happy with how banks are complying with those guidelines. But they are only guidelines.

Accountant 'D':

That's it, they can shout about it as much as they wanted, they're only guidelines, and they can't enforce them.

Katerina R.

So what would need to be done for the central bank to be able to enforce their guidelines?

Accountant 'D':

I think there'd have to be a change in legislation.

Katerina R.

But can they really change the legislation?

Accountant 'D':

Well you've got this expected loss model coming anyway. The international standards board are trying to address the issues. I'm not sure when it's coming out, it should be any day.

Katerina R.

Well it probably won't be until 2015.

Accountant 'D':

The next one's coming out, where are we now, seventeen? Yeah, I don't know what they can do, their hands are tied.

Katerina R.

I was reading the company law on this topic and it specifically states that the appropriate regulation in adopting IASs supersedes everything else. You have to follow it. I think there are 3 or 4 different Company Acts even in Ireland. They are amendments everywhere to say that you have to follow IAS.

Accountant 'D':

What do you mean there's different companies acts?

Katerina R.

Well there's Company Act 2003 which covers accounting, there is well then there is Company Act 2005 and then there is Company Act in 1993. I always thought there were ones Company Act, and then they do amendments to it but there are apparently numerous Company Acts.

Accountant 'D':

No, in Ireland the way it works is from 1963 through to 2012 and we keep adding onto the Companies Act and you have amendments, and you have to know all of the various acts. In the UK what you have is the 2006 Act, so they just bring everything, make a couple of changes to it and then bring the whole lot forward and that'll be the 2010 Act. There's one act. Whereas what we do is keep adding a little bit, which is how the UK used to do it and we can go that way, next year or the year after, we'll just have one act so the 2014 Act.

Katerina R.

That will be very convenient because it took me about half an hour to read everything.

Accountant 'D':

That Act was enacted in 1963 and then you don't know which bits have changed later on, it's a pain.

Katerina R.

Yes and when they change something, they don't recall the whole point, we just say, change that after that word to this, and cancel number four and replace it with this word!

Accountant 'D':

I know, you feel like going, in a couple of years' time we'll just have one act, so we'll bring everything together and then that'll be the current act and everything will be there in one place.

Katerina R.

But the main point I gathered from my research is that IFRS supersedes everything. As long as you follow IFRS and as long as auditors confirm that you follow that IFRS, you're fine. So there, no one can really blame auditors or accountants or the banks for following IFRSs company law.

Katerina R.

The Bank of England, like The Central bank in Ireland, is very, very vocal about IAS39. They use similar language as Cormac Butler and they are saying that banks are heavily under provisioned because of IS39. They believe the banks in the UK and Ireland are still concealing losses. Andrew Hyland who is the director of financial stability in the UK, in the Bank of England, he made a speech there last year and he went into the history of the whole fair value versus mark to market and he was making a point that, when it's convenient the banks will value assets according to fair value and then when it's convenient they go back to mark to market. That's the whole point is, accounting should be consistent.

Accountant 'D':

Accounting should be consistent. You can't just pick and choose, you can't just go from one day, I want to be mark to market and the next day I want to be held and maturity. I don't know if they're doing it while wholesale. I think some of them might be doing it to a certain degree.

Katerina R.

Even though it's reasonable to move away from mark to market?

Accountant 'D':

Once you can show that you can afford to.

Katerina R.

It seems to be unfair that from this year to this year a bank can do A and this year to this year a bank can do B, the markets go up again and the banks use market value instead of fair value.

Accountant 'D':

Yeah, you can't just keep changing.

Katerina R.

So I suppose the point Andrew Hyland was making is that the amendment to IAS39 allows this inconsistency.

Accountant 'D':

No, certainly you could say that the, that amendment allowed people to move from mark to market to held and maturity and it didn't give as true a reflection as it would have done historically, but it's not the reason for the recession or the credit crunch.

Katerina R.

Not it's not, definitely not the reason but it didn't give us consistent, clear picture, because how many investors would know that suddenly in 2008 in October 2008 this rule was changed?

Accountant 'D':

The role of the big investors, like, the pension funds obviously would have done, but individuals wouldn't have known.

Katerina R.

If investors knew that was going on, it would make sense not to invest in any Ireland banks shares, but then even directors of the banks were buying shares up to the last moment in 2008.

Accountant 'D':

That's because nobody saw it all plummeting; everyone thought it was going to go for this soft landing.

Katerina R.

But they must have seen their own figures. We know from the Anglo tapes that they more than they let on!

Accountant 'D':

But they thought that, even Anglo thought that they were going to be able to get away with it, they'd get the three billion and the government would just keep drip feeding into them. They thought they were just going to keep lying to the government and get funding, in Anglo's case, in the other banks I think they thought that the markets would return.

Katerina R.

But then if we assume that Anglo executives knew that they required more than the €3.5 billion that they asked for but needed at least seven and a half billion and more, as the tapes revealed, we can assume that the other banks knew more information than we had more information than they revealed about the state of funding which they would need. If you look at it was €7 billion for Anglo originally, another €7 billion between AIB and Bank of Ireland, but since then it has increased to over €60 billion. It's a lot higher than the originally thought and we can assume that if Anglo knew they would need more than €3 billion that the other banks knew more than they originally disclosed.

Accountant 'D':

If it had been just the small recession and it was all the worldwide recession didn't last for the last five years and everything picked up after six months and we were all back trading, well then we wouldn't need any of the provisions because you'd have traded your way out of it.

End of the interview.

Transcript of the Interview with Accountant ‘E’

Date: 25st July 2013

Time: 11am

Place: Dublin through a Skype phone call

Interviewer: Katerina Ryzhenkova

The topic of the interview: The role of IAS 39 in the Irelands Banking Crisis.

Katerina R.

You started saying about interest roll up loans. It's a very simple instrument but for reporting purposes it is impossible to determine that borrower is able to repay it and how are those assessed for impairment?

Accountant ‘E’

You have to ask the question if they even checked if the borrower was capable to repay the loan or did the banks assume because there was no indication of default on payment. There can't be default on payment because by definition there is no payment due.

Did the banks go out and see if the site is finished or nearly finished or what was the condition of the site, because a lot of these may have been sites that may not been started. They may have been green fields.

Katerina R.

Yeah, but what I want to say is that the banks are obliged to present true and fair view, they have to do their best to determine that they are reporting correct information and there isn't impairment or loss in the future on a particular loan. But if there is nothing in the accounting standards or rules to make the banks do that, why would they bother?

Accountant ‘E’

That is the point. They structured certain loan types in a way to avoid the requirements of IAS39.

Katerina R.

But we have a financial regulator. Surely the regulator should be aware of all instruments being used and they should review the risk of those instruments?

Accountant 'E'

If you look at the Credit Unions, it is a very good example of where the regulator has gone in and defined what sort of provisioning needs to be done. Have a look at the registrar of Credit Unions. It is on the Central Bank website. You will see they have quite a detailed schedule of when loans are provided for and when they are not. The regulator could have done that in relation to commercial banks but didn't do it.

Katerina R.

But could they though? Credit Unions are not publically traded organisations the way banks are.

Accountant 'E'

Yes but the banks have to follow the law.

Katerina R.

Banks have to produce accounts in accordance with company law.

Accountant 'E'

No, banks do accounts in accordance with company law and securities law for the Central Bank. The Central Bank could have at any time imposed any requirement they wished and had the powers to do that. They have done it with the Credit Unions.

Katerina R.

I know but didn't the EU regulations at the time of adoption of IFRSs, didn't they say that on a national level that governments and central banks could not interfere with the International Standards once they were adopted?

Accountant 'E'

I don't know and I don't recollect reading that they weren't allowed interfere. I know certain countries didn't implement IFRSs fully anyway. They have adopted them but they have

nominally adopted them. If you go to some countries and talk to accountants they will tell you there are some sections that they don't implement.

Katerina R.

That is very interesting.

Accountant 'E'

But that is not the issue, if you go to pwcglobal.com or iasplus.com, one of those has a list of countries that have implemented IFRS and you will see that for banking some haven't implemented parts of it.

The Central Bank can enforce any prudential requirements they like. The financial statements are not the way you regulate a bank. A bank is regulated by its prudential returns. The prudential returns are done quarterly to the Central Bank and they can be done any way the Central Bank determines they should be done.

The Central Bank could have gotten the information they wanted, we do not know if they did or not because those prudential returns are not public documents. But they Central Bank could gotten any information it needed to determine whether the banks were lending recklessly or not.

Katerina R.

The reports could have been requested in any standard or format they wanted?

Accountant 'E'

Yes, in fact if you look at the insurance companies. They use to have completely different prudential reporting requirements compared to their accounting requirements. They did align the two, but the point is that the Central Bank could have insisted on any type of provisioning they wished to have. They didn't appear to do so.

Katerina R.

The fault of the regulator is undisputed. The 3 official reports issues on the crisis in Ireland all cantered around the fact that the Central Bank and Regulator didn't do their job properly.

Accountant 'E'

Yes, they were the policeman and you can blame the policeman for not capturing the crooks but you also have to blame the crooks.

Katerina R.

Yes, but there are always loopholes and always moral hazard. If management wanted to do certain things they always find a way. It's the whole greed thing.

Accountant 'E'

Yes it is the greed thing. But I still don't think IAS39 should be the culprit for everything. IAS39 certainly didn't help but it certainly didn't cause the crisis.

Katerina R.

Yes I agree it didn't cause the crisis. It is just an instrument used to compile reports.

Can I move onto something else? There is a literature review that I am doing on fair value accounting as a model that is now widely used opposed to historical cost accounting. Since adoption of IFRS fair value accounting has been heavily promoted and throughout the IASs it is fair value and mark to market. I suppose the question is that, was it fair to tell financial institutions that they had to value products at mark to market?

Accountant 'E'

They had to do that because financial institutions were producing products at no cost but carried huge liabilities. So they have to implement fair values. Bankers were producing products that were so complex that the cost of production was not relevant so they had to bring in fair values. You might argue that they didn't bring in a very good model for calculating fair values and IFRS13 is an attempt to remedy that. Fair Value had to be done, there is no doubt you couldn't continue with cost accounting because it was nonsense. It was removing a lot of liabilities and assets from the balance sheet. Fair value had to happen but perhaps a better model for calculating fair value should have been thought about.

Katerina R.

It was implemented in 2005 but even before that companies were following IFRSs. It was the good times and the models and assumptions were not really questioned or tested. There was no chance to test them until the crisis.

Accountant 'E'

If you look at when we swapped in 2005 from UK GAAP to IFRS across UK and Ireland, most companies took the opportunity that was afforded in the conversion to cease using fair value for valuing their buildings. The only companies that continued using fair value for buildings were insurance companies and the banks. They did that because they wanted the capital on the balance sheet.

So you have to question whether it was good or bad to have fair value. Well most companies didn't want to use it necessarily. It was used by companies that had a capital adequacy issue and it was an attempt to get over the capital adequacy issue.

Did fair value flatter balance sheets? Well they only flattered balance sheets of banks and insurances companies, the rest were more concerned about their own earning ability. When you think about the banks, the only reason they had a capital adequacy issue was because the Central Bank required them to have a capital adequacy issue. The Central Bank could have addressed the capital adequacy issue more effectively with prudential requirements more than financial reporting requirements. I wouldn't accept that fair value was convenient for most companies; it added cost to the preparation of financial statements.

Katerina R.

The criticism toward financial instruments which were held for trading and which had to be valued at mark to market, was that in 2008 when the crisis hit and those instruments were devaluing at a staggering rate the banks were forced to still value them at mark to market but mark to market value was arguably not fair value of those instruments.

Accountant 'E'

Yes I would agree with that and that is why IFRS13 has been written. They are trying to tweak the valuation methodology. I think IAS39 is too simplistic in its approach to fair value. When

the market is dysfunctional there should be some other method, obviously the other methods they use need to be looked at very carefully. But I agree that the IAS39 model when the market went into free fall and when the market became dysfunctional produced the wrong answers and produced business decisions that weren't optimal because it was based on the wrong answer.

Katerina R.

The banks engaged in a fire sale to get something instead of just watching the products fall in value.

Accountant 'E'

The point is that if they fall in value it leads to a capital adequacy problem and a capital adequacy problem requires more liquidity to solve it. The only way to get liquidity is to sell and the act of selling only forces the market down even further. It was a dysfunctional market and it was accounting standards forcing activity on the market that wasn't optimal. I am not sure that IFRS13 will make much of a difference. If there is an active market in a product, yes you designate it as held to maturity.

At the end of the day the banks took too much risk. When that risk crystallised they all complained that IAS39 caused the problem. The problem was that they took too much risk. They bought products that didn't have an inherent underlining value.

Katerina R.

Do you think the amendment in 2008 which allowed the banks to move assets held for trading to held for maturity was the right decision?

Accountant 'E'

Was it the right decision? I think it was the only decision. It has to be done to save the market place. But at the end of the day the market was in trouble because of the investment decisions of the banks.

Katerina R.

Do you think that decision was a political one on an EU level?

Accountant ‘E’

Maybe it was a political one but they couldn't let anymore banks go bust, so it was a practical decision. It doesn't matter if it was a political decision, it was the only decision. It was the only thing that could be done at the time.

Katerina R.

Why do you think there wasn't the option to do the reclassification in the first place? The US standards which preceded IAS originally had this option and the banks in the US were using it. When 2008 came the US banks were in a position to say that certain products weren't for trading anymore and could be moved in the held to maturity category. That option was not available in Ireland.

Accountant ‘E’

It was open to abuse. You will see in my written email answer, the more management discretion you allow the more potential there is for abuse. The more options there are, the more options you have for changing half way through. I can see the arguments for and against allowing for movement in and out of categories. In the case of IAS39, they had to make that choice because they couldn't allow anymore banks to go bust.

Katerina R.

There is something interesting that I picked up on and I am not sure if I mentioned it to you yesterday. It's about "herding". Through my literature review I picked up this notion of herding in the insurance and banking markets. There are dozens of articles written on the subject to see if herding was the reason a bank made a decision of was the decisions based on what was correct or practical for the bank.

Accountant ‘E’

I can't really comment, I haven't read about herding activities in banks. I would concur based on my knowledge that there does seem to be a herd activity. If one bank lowered its lending criteria other banks did tend to follow. If one bank moved into a particular area, other banks tended to follow as well. I think there is some attempt to try and differentiate from each other and stop doing that because there is more money to be made if you are running against the herd rather

than running with the herd. I don't think there will be as much in the future but there certainly was a lot in the past.

Katerina R.

Have you read articles by Cormac Butler? He has been in the Irish Times a few times over the last number of years. He is very critical of IASs and his general view is that it allowed banks to conceal losses from regulators and shareholders.

Accountant 'E'

Look he is entitled to his opinion.

Katerina R.

It is not so clear though.

Accountant 'E'

A lot of people have said that. It is not an uncommon opinion. Everyone is entitled to their opinion. I don't think he is right, but he is entitled to his opinion. IAS39 didn't force people to make stupid loans and it probably didn't measure them properly when they did make them.

The fundamental cause of the crisis was absorbed lending and you can't get away from that. It was the cause of the financial crisis. The regulator didn't catch it, IAS didn't catch it but the underlining problem was that bankers didn't do their job. That was the reason we had a crash. If they had given out proper loans, IAS39 and the regulator wouldn't have mattered. The cause was the bad loans.

Katerina R.

There could be an argument that valuing loans at amortised costs could potentially hide or conceal losses or under provide for losses.

Accountant 'E'

You should regulate a bank based on financial statements. I keep going back to these prudential returns. Measuring bad loans at amortised cost or fair value, doesn't matter. If it is a bad loan it

is a bad loan. The only difference is the day the recognition is made. If it is a bad loan IAS39 might recognise it after 18 months, IFRS13 might recognise it after 8 months but the regulator should have recognised it after 3 months. That is the issue, the loan was still bad when it was recognised for purposes of regulation.

Obviously from a shareholder perspective you would want to recognise it as early as possible, but at the end of the day shareholders get information so late that to a certain extent it is not relevant. The primary person who should stop bad loans after they are made is the regulator through the prudential returns.

Katerina R.

In terms of shareholders, banks are trading companies, those published accounts are for shareholders information.

Accountant 'E'

Yes, but no shareholders read them.

Katerina R.

Especially if they contain 200 pages of notes.

Accountant 'E'

I have read the Bank of Ireland reports prior to 2008 and saw a table of loan defaults. I did my own maths on these defaults and I stressed tested them as best I could. What I didn't know at the time was that most of the loans weren't in default because they were interest only or interest roll ups.

Katerina R.

Was that information disclosed anywhere?

Accountant 'E'

The IAS39 and fair value tables were all in the BOI reports both pre and post 2008, it was all there, all the information is there but what wasn't disclosed to me as a shareholder was that the loans weren't in default because they were interest roll ups.

Katerina R.

That is very interesting. The accounting for banks is so complex that unless you specialise...

Accountant 'E'

Hold on for a minute. It is not the accounting for banks that is specialised it's the complex products the banks have developed.

Katerina R.

Yes, that is what I meant. It is complex to account for these products properly. How an investor meant to make sense of them? The institutional investors must understand them?

Accountant 'E'

Why do you say "must"?

Katerina R.

They are professional whose business is in investments so they must understand the products.

Accountant 'E'

I would argue that some understand and most don't. Even Sir David Tweedy who wrote IAS39 has said on numerous occasions that 1% of accountants understand it. He has also said that he who claims to understand it hasn't read it.

So if the person who wrote it thinks it's too complex then the chances are that investment analysts who are probably not accountants, are taking their information from management discussions documents, conference calls or presentations rather than from the financial statements themselves. I would argue that very few if any shareholders were misled by the reporting under IAS39 and probably relied too much on the regulator having done their job properly which they didn't do.

End of the interview.