

House of COMMONS
TREASURY COMMITTEE
BANKING CRISIS - AUDITORS AND CREDIT RATING AGENCIES

Wednesday 28 January 2009

MR ROBERT HODGKINSON, MS HELEN BRAND, PAUL BOYLE,
PROFESSOR PREM SIKKA and PROFESSOR MICHAEL POWER

MR JOHN HITCHINS, MR BRENDAN NELSON and MR JONATHAN HAYWARD

MR MICHEL MADELAIN, MR FREDERIC DREVON, MR BARRY HANCOCK,
MR IAN BELL, MR STEPHEN W JOYNT and MR CHARLES PRESCOTT

Oral Evidence

Taken before the Treasury Committee

on Wednesday 28 January 2009

Members present

John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Jim Cousins

Mr Michael Fallon

Ms Sally Keeble

Mr George Mudie

Mr Mark Todd

Sir Peter Viggers

Witnesses: Mr Robert Hodgkinson, Executive Director of Technical Strategy, Institute of Chartered Accountants in England & Wales, Ms Helen Brand, Chief Executive, Association of Chartered Certified Accountants, Mr Paul Boyle, Chief Executive, Financial Reporting Council, Professor Prem Sikka, Professor of Accounting, University of Essex and Professor Michael Power, Professor of Accounting, London School of Economics, gave evidence.

Q409 Chairman: Welcome to this session on auditors and credit rating agencies. Can you introduce yourselves, starting with Professor Sikka.

Professor Sikka: Prem Sikka, Professor of Accounting, Essex Business School, University of Essex.

Professor Power: Michael Power, Professor of Accounting, London School of Economics.

Mr Boyle: Paul Boyle, Chief Executive, Financial Reporting Council.

Ms Brand: Helen Brand, Chief Executive, ACCA.

Mr Hodgkinson: Robert Hodgkinson, Executive Director at the Institute of Chartered Accountants in England and Wales.

Q410 Chairman: You are all welcome. We have three sessions this afternoon of three-quarters of an hour each and we want the maximum out of each session so we are going to ask short question and we want short precise answers and we will get that information on the record. Can I start then. Do you think auditors asked the right questions of bank finance directors over the past few years? Professor Power?

Professor Power: I think we have to backtrack and ask ourselves what the purpose of an audit is. An audit is to determine and evaluate the quality of the financial statements. Whether the right questions have been asked of finance directors should be seen in that broad context. That is to say, it may not be reasonable to expect that auditors would be challenging business models directly and raising strategic issues with finance directors, that is not their job and if we want it to be their job then things would have to change quite substantially.

Q411 Chairman: Does an auditor have a duty of care other than to the bank, to other interested parties: the FSA, the lender, suppliers, customers, the general public?

Mr Hodgkinson: The purpose of an audit in statute is clearly addressed to the shareholders as a whole and in some of the work that my Institute has been involved in bringing stakeholders together to talk about audits, through the Audit Quality Forum, focusing on that essential purpose of the statutory audit is something which auditors have been encouraged to do over the past six or seven years because exercising their responsibility to make sure the numbers are right is something which is central to the purpose and everything else relies on that. There is perhaps a feeling that six or seven years ago they had lost sight of that.

Q412 Chairman: If they have lost sight, what can we do, Mr Boyle?

Mr Boyle: In his answer Mr Hodgkinson was saying that six or seven years ago they had lost sight of that, but as a result of the reforms put in place a few years ago, following the Enron scandal

which this Committee investigated six or seven years ago, there has been a significant refocusing within the audit firms on the importance of audit quality. In part that has come from the existence now of an independent regulatory agency, the FRC, which is focusing on the auditors' attention to audit quality and the attention has improved in recent years. That does not deal with the fundamental questions about whether the audit is focused on the right things. Auditors are currently focusing on what Parliament has asked them to focus on. It is possible to change that role, but that really is a second question which we might come to.

Q413 Chairman: It seems to me the answer is, Professor Sikka, that auditors are doing the right thing focusing on it, but meanwhile we have banks going down the sink and if that is the case what do we need to do? Do we need to throw the auditors out or keep the auditors and bring other new people in? If everybody has done their job, why are we in this situation?

Professor Sikka: My feeling is we need a fundamental change in accounting and auditing. If you look at bank accounts, not a single bank has given us any figures at all about any company's specific assets, liability, income, expenses, credit default exposure, derivative exposure, information is simply not there at all. The auditors are too close to companies. They get their fees from the companies, therefore they cannot really bite the hand that feeds them. If the FSA is to liaise with auditors that creates too many problems. The auditors claim confidentiality on their working papers and the FSA has basically been operating blind, assuming that the auditors would alert would anybody to any risks, any problems. Our system has really fallen apart and the underlying idea that commercialised accounting firms, as I put it bluntly, one bunch of commercial entrepreneurs, can somehow regulate another bunch of commercial entrepreneurs, that is company directors, that kind of model is broken, it cannot work. It has not worked because what we have seen in the current crisis is within days of getting a clean bill of health from auditors many banks have simply collapsed. We are often told that the market has taken note of audit reports. What we have seen here for the first time is markets saying, "We do not believe a word the auditors have told us because all the assets, liability, numbers are unbelievable". Audit reports have been totally discounted, financial statements have been totally ignored, which has generated a run on Northern Rock and many other banks.

Q414 Mr Fallon: A year ago, Mr Boyle, we drew attention to the fact that the auditors of Northern Rock had been paid substantial sums for providing comfort letters for the securitisations off the balance sheet that they themselves were auditing and we urged you to do something about it swiftly. What are you doing?

Mr Boyle: We have indeed taken note of your report and we are nearly complete with our review of the ethical standards for auditors. In five or six weeks we will be publishing some proposals to amend the standards. We do not think the standards were fundamentally inappropriate but there are a couple of respects in which they could be clarified, specifically in relation to securitisations.

Q415 Mr Fallon: Would it still be possible after this review for a bank's auditor to be paid for providing comfort letters for securitisations off the balance sheet that itself has been paid to audit?

Mr Boyle: It will still be possible, yes.

Q416 Mr Fallon: Why is that?

Mr Boyle: Because we do not judge that this fundamentally impairs the independence of the auditor.

Q417 Mr Fallon: You are quite happy that the same firm can be paid for the off balance sheet stuff as is auditing the balance sheet itself, because we are not?

Mr Boyle: In the case of the vehicles that were used by Northern Rock, the Granite vehicles, they were in fact consolidated on to the Northern Rock balance sheet. They were on balance sheet in the group accounts of Northern Rock.

Q418 Mr Fallon: Is it the case with the five major banks that the auditors of those banks have also been paid for non-audit work of this kind?

Mr Boyle: I cannot say in detail what each of the firms have been paid but, yes, each firm receives a variety of services. The proportion of non-audit services has been steadily declining in the last six years. It was the case that in 2000 around 38% on average of the income of an audit firm came from non-audit services to audit clients, that percentage is now down around 14%.

Q419 Mr Fallon: You are avoiding my question. It is perfectly possible for there to be some non-audit services that are, in fact, quite closely related to the audit.

Mr Boyle: That is correct.

Q420 Mr Fallon: What we have been asking for and recommending is a clear distinction between audit work and comfort and securitisation work that is off the balance sheet. You are telling us that is continuing and you are happy for it to continue.

Mr Boyle: The view we have taken at present is that is not inconsistent with the independence of the auditor.

Q421 Mr Todd: I am just digesting that exchange which I must admit has left me alarmed. Can I just pursue it a little further because I noted some apparent dissent on this panel at your remarks, Mr Boyle. I think you are dissenting, Professor Sikka, is that right?

Professor Sikka: Yes.

Q422 Mr Todd: Would you like to expand on your dissent?

Professor Sikka: My view is very simple: we have many kinds of audits in the world we live in, whether it is at airports through the passport controls or health and safety or food hygiene, and in no case are the auditors allowed to act as consultants or advisors to the auditees, the financial audit is here out on a limb. These kinds of problems you are raising have been documented since the 1970s.

Q423 Mr Todd: Can I just check whether Mr Boyle is on his own here or that you share his views or that of Professor Sikka?

Mr Hodgkinson: Can I offer the views of the Institute. We think that the issue of independence is one which naturally causes concern. It is the first port of call. I think we need to recognise that having looked at this as the first issue which was discussed back in 2002/03, it was very thoroughly examined as to whether there should be the kind of blanket bans of the sort that are talked about, and the very firm conclusion, for example, out of the co-ordinated group on accounting and auditing matters was that blanket bans were not appropriate. We wholly support the approach on threats and safeguards that is now embodied in the Auditing Practices Board's independently set standards.

Q424 Mr Todd: Let me just move on to what I was going to ask about which was whether people have unrealistic expectations of auditors. I think this conversation has possibly indicated that one of the expectations of auditors is that they should make the best money out of a particular client that they can selling whatever services they might. Is that fair?

Mr Boyle: I think that is an unfair statement. There are prohibitions on services that the auditors may or may not provide and they have a fundamental obligation and, indeed, incentive to retain their independence from their clients because the whole value of an audit comes from it being an independent expression of opinion. If it is an expression of opinion which merely rubber stamps ---

Q425 Mr Todd: I understand that, but if we are going to address the issues that I think concern the public here about how risks that have since crystallised appear not to be identified by audit activity, one of the assumptions that many members of the public might make is that the intimacy of that audit group to the management of that company prevented proper critical analysis and engagement.

Ms Brand: The problem around expectations might lie more in the expectations of what information an audit is actually going to deliver to the market and I think that is where the expectations gap that has been talked about is really the issue. It is the clear understanding of what an information audit will and will not deliver to the market. Where we might make improvements, going back to an initial question from the Chairman, I think that the whole issue of risk management is one that could be improved upon for all aspects, including the auditor, and the analysis of risk around the low likelihood/high impact risks that are on all our registers but are not articulated fully is an issue and that is something that the auditor, and all the other stakeholders involved in the risk management of an enterprise, need to take a closer look at.

Mr Hodgkinson: Can I just make an observation about your comment that of course independence is an important driver of quality in what the public would expect, but a lot of work has been done, again since 2002/03, to consider quality. There is an Audit Quality Forum which I have referred to, but the FRC has developed an audit quality framework after exhaustive consultation which says you have to look at the culture of a firm, you have to look at the quality of the audit partners and the staff, you have to look at the processes they adopt, you have to look at the quality of their reporting and other factors, for example related to the governance of the entities they are auditing, which all drive quality. So although independence is an important aspect of many of those aspects and drivers of quality, I think it is a little bit disheartening for those who are committed to quality in the firms and the regulatory structure that everything seems to focus on independence. If you are independent that does not enable you on its own to deliver a great audit.

Q426 Mr Todd: I think one of you has already remarked about the legal framework within which you operate. Is there room for policy-makers to review how this operates, the relationship between audit and the customer?

Mr Boyle: There absolutely is scope for that review.

Q427 Mr Todd: Because clearly you are not looking at it with great sharpness so maybe policy-makers should?

Mr Boyle: We are operating within the framework that is currently set out in the law but if you look at the role of the auditor it is worth looking at it in the context of the broader picture of the financial crisis. I think the most thoughtful and comprehensive analysis that I have seen of the crisis was that set out by Lord Turner in his recent speech. If you look at the range of forces that he identifies that have been building up over a number of years, he admits there that no-one, neither the regulators

nor the government, put the whole picture together so it is not surprising that the auditors did not spot the problem. It is not their responsibility to do that.

Mr Hodgkinson: Can I just make an observation about the quality review. This reaffirmation of the directors' responsibility to shareholders having regard to other stakeholders is something that occupied us from 1998 to 2006 in the Company Law Review, so it has recently been exhaustively discussed and the auditors' duties just follow from that model of how directors owe duties.

Q428 Chairman: Do you want to make a point before we move on?

Professor Sikka: I am very sceptical of what the institutions are saying here. The FRC has been basically asleep on the job. Northern Rock was the warning, that did not result in FRC scrutinising banks' accounts and so on. Bear Sterns and Lehman Brothers went bust with a gearing ratio of 30 or 33:1, Lloyds TSB as at June last year had a gearing ratio of 34.1 which meant just a 3% change in its assets which means it is bankrupt. I do not recall the FRC taking any initiative to scrutinise bank accounts or anything else. We heard about ethical codes. The last ethical statement issued by the Auditing Practices Board was drafted by a committee consisting entirely of the big four accounting firm representatives and nobody else and the whole thing is a charade, it has very little to say about ethics at all. At best these statements merely regularise the relationship between the accountancy firm and their clients, there is little that is ethical in it.

Q429 Chairman: Okay. Professor Power, do you want to say anything?

Professor Power: I think there are some serious issues, Chairman, about ethics and independence but I think that issue is a complete red herring. I would be disappointed if one of the conclusions of this Committee was to tinker with those arrangements. I think the real action is elsewhere and it is down to the operational side of the audit process: what is it that auditors know, what is it they do, what is it they are capable of doing, who do they rely on in order to carry out their work. I think if we open the black box and have a look at that, there are some very interesting questions to be asked. I think the independence issue is a soft target.

Q430 John Mann: How significant a problem is going concern status for auditors and for banks, Mr Boyle?

Mr Boyle: I think it is a very significant issue and it is one that I know is getting a lot of attention both in bank boardrooms and amongst audit firms at the moment. If I may, Chairman, while I have got the floor, I should just correct there is a factual inaccuracy ---

Q431 Chairman: Do not go on too long because we are taking evidence from different people. This is not a debate between yourself and Prem Sikka.

Mr Boyle: There were some factual inaccuracies in his statement about whether or not we are looking at bank financial statements. It is a very important issue and it is an issue on which both directors and auditors are going to have to exercise judgments. I do not think there is anyone in the country who can say with certainty that all of the banks will still be trading in 12 months' time. No-one can know with certainty. We understand now that the range of possible outcomes is much wider than we previously understood, so judgments have to be made on the basis of such evidence that is available.

Q432 John Mann: What is your judgment about the potential impact of adverse audit opinion on the banking sector?

Mr Boyle: I think it would be potentially very serious but, on the other, hand there was at one time a belief that no-one should talk about the going concern issue on the basis of the self-fulfilling prophecy, that if it was talked about then disaster would certainly follow. I do not think anyone would be surprised now if in a bank's financial statements the directors say, "As you will all be aware, there is a credit crunch at the moment and our funding position is less certain than it has been in previous years but we are working diligently, taking into account all the actions that the Government is taking in this country and in other countries to address the position". I think it is far better now that people in their financial statements disclose the fact that there are uncertainties but nonetheless, having made a judgment, they feel comfortable that they are a going concern and the auditors then have to make a judgment about whether the disclosures made by the banks are satisfactory or not and if they are not satisfactory they have to pipe up.

Q433 John Mann: Are you comfortable that your approach to this is sufficiently clear to auditors?

Mr Boyle: I am very comfortable that the approach is sufficiently clear. I think bank directors and auditors all understand their obligations in relation to this. Of course, we at the FRC are not party to the discussions that are currently taking place between auditors and their banks but in the course of our audit inspection work during 2009 we will certainly be looking at this issue.

Professor Power: I think we should distinguish clearly between the current period when everyone is on red alert and the going concern qualification is expected and the past where, indeed, it would have had these self-fulfilling prospects. Are we talking about the past or are we talking about the future?

Mr Hodgkinson: Can I just make a comment there in relation to the present circumstances because there are two aspects of the banks and going concern. First of all, there are the banks' own financial statements but then there is the potential role the banks play in using the financial statements of the rest of the economy. The Institute has been trying to draw a lot of attention to the issue of how banks themselves respond to references to going concern in their clients and their customers' accounts which is crucial and they play a role in this in both providing information to help directors prepare their financial statements and then responding. There needs to be awareness within banks that they are people who give information which helps people prepare financial statements and we are trying to avoid a disaster which would arise if banks themselves were not aware of their crucial role in the going concern basis being applied throughout the economy.

Q434 John Mann: One final question, Helen Brand. You said a few moments ago that auditors had a duty to the market. Is there a duty to the consumer and the general public equally?

Ms Brand: In statute the duty is to the corporate entity and that is to the shareholders.

Q435 John Mann: That is not the market.

Ms Brand: I do not think I said there was a duty of care to the market.

Q436 John Mann: You did, yes, and I wondered why.

Professor Sikka: There is a real issue here about what exactly an audit is for. What we are hearing is that auditors might know that a bank has financial problems but they do not want to tell anybody. We came across this scenario after the BCCI collapse and the US Senate Report noted that the auditors' silence was directly responsible for losses to about 1.4 million depositors. Auditors are

paid a lot of money to make judgments and if they find something they have to tell, simple as that, there is no point in keeping quiet, that does not forewarn the regulators or the public, that is their duty. They are simply hiding behind the fact, I think, that they do not want to upset their clients.

Q437 Nick Ainger: In response to earlier questions from Mr Fallon and Mr Todd, following reports of the run on the Rock you basically indicated that there had been very little progress at all in addressing the conflict of interest issue. In the same paragraph we made another recommendation and that was that further assurance should be given by auditors to shareholders in respect of risk management processes of a company, particularly where a company is regarded as an outlier. Has any progress been made in responding to that recommendation?

Mr Boyle: That is a recommendation which would dramatically extend the scope of auditors' responsibilities. It is a change which could only be made by statute and the legislators would have to give very careful consideration to the law of unintended consequences in making a change of that sort. It is not the role of the auditors to report to the shareholders on the quality of risk management practices in a firm, that is simply not what they are asked to do. It is not clear to me that they are well-placed to do that, competent to do that, and it would have a significant impact. We would also have to be careful if we chose to extend that responsibility to auditors in the UK, which would be a radically different practice to that adopted in other major international centres, what the impact of that would be on Britain's position, so that would be a very significant change and it is not within the power of the FRC to make that change, that would be a statutory change.

Mr Hodgkinson: Could I supplement that answer by saying that in 2004/05 the ICA supported the FRC in doing a review of the requirements for listed companies and internal control, the so-called Turnbull Guidance and at that time there was a question as to whether the UK should follow the United States in having auditors reporting on the effectiveness of internal control over financial reporting. At that point there was a resounding "no" from across the UK. I think you might say in present circumstances should we revisit that? We might, but I think it is important to note that in the US where those requirements have been in place then the quality of financial reporting has held up, there have been very few restatements or withdrawn sets of accounts, as in the UK, but it has not prevented financial institutions and corporates in the States from getting into trouble because the focus of that reporting was entirely on accounting controls. If you start to get into a far wider field of all the risk related to strategy, it is, as Paul said, transformational in terms of the role of the auditors and the costs.

Ms Brand: I do think - this is not talking about external - there is a role for internal audit here where that could come more to the forefront. I think the conversations between the internal audit function and external auditors could be more comprehensive in seeking to look at the risks which have been identified within an organisation, so you are more likely to get useful information from that type of conversation.

Q438 Nick Ainger: Professors, have you got a view on this?

Professor Power: Yes, I have. Like the other witnesses, I would be very sad to see a Sarbanes-Oxley type system come into play. I think the questions are quite simple for me. What additional roles are needed to tackle the causes of what happened? Should auditors be doing them? I think my answer is there are some additional roles around risk and risk management. I think the whole question of how boards of directors have oversight over 20 year old PhDs in maths who, three of them on a desk, can take us to where we are now, how you have oversight over that kind of specialism is a very specific kind of management and audit or assurance task. I am not convinced that audit, as it is currently constituted, is fit for that task but it is one that we need to visit in some sense.

Q439 Nick Ainger: You are accepting that there is a real issue here that has to be addressed.

Professor Power: Absolutely.

Q440 Nick Ainger: But you are saying perhaps it is not the actual auditors who should be doing it. Who should be doing it, the FSA?

Mr Boyle: I think we have to re-think what that role would be, what the nature of oversight is and what kinds of skills would be appropriate for passing judgment on that. The opportunity here is to do what you rarely have a chance to do and that is start again.

Mr Boyle: I have to say that without starting again there is already a regime, section 166, which can be used by the FSA to trigger work on areas of systems and controls that might concern them, so there is a mechanism.

Professor Bower: I still think we should start again.

Professor Sikka: One of the problems is that the financial regulators like the FSA do not have access to the organisations and their management in the same way and on the same regular basis as the current financial auditors do. This was one reason why I was suggesting that the audits of banks really need to be conducted by the regulators on a continuous basis, with complete access to everything, so that they themselves can weigh up the risks. If audit firms were to do that kind of task their profit motive would always intervene and that motive would always stop them from asking certain questions and reporting certain matters. My feeling is that accountancy firms are a barrier; they themselves are part of the problem in this particular function and they really need to be removed from this role. This role has to be taken by the regulators - that was one of the original proposals when the SEC itself was being formed in the 1930s, recognition that you cannot get private business to regulate another private business.

Q441 Nick Ainger: Coming back to your point very shortly, Chairman, what you are saying is in the States auditors do have this function but it has not really changed anything. Professor Sikka is saying that this should be a responsibility of the regulatory authorities; would you agree first of all that there is a significant issue that has to be addressed and that if it is not auditors then it should be the regulatory authorities?

Mr Hodgkinson: Thank you for the chance to just clarify briefly. In the States there is a responsibility in relation to financial reporting. I am not saying it has had no effect but financial reporting and the reliability of the numbers does not seem to be the issue here. We are talking about wider risk management that is not addressed in public reporting in the States or here, but I am saying that in these wider aspects of risk there are mechanisms for reporting to the regulator now, for commissioning special work, and it might be worthwhile looking at whether that possibility has been used as fully as it might have been and whether there is some benefit of reviewing how that has been working.

Q442 Mr Mudie: Just continuing the same theme, it is clear from the papers that have been put in by yourself, by KPMG, that the role or relationship between auditors and regulators has changed. There is reference to a different relationship with the Bank of England when they were the regulator and a different way of operating. I pick up from your evidence where it refers to "an ad hoc arrangement with the FSA". What was put on the record for us, what was the situation in the old days with the Bank of England and what has happened since? Then I would like to just pull you

forward to try and reconcile different views on what should happen. What was the old arrangement that might have prevented this debacle?

Mr Hodgkinson: It is worth recognising that the whole risk assessment approach of the FSA is different from the Bank of England which had those responsibilities before, but my understanding is that under what was referred to as section 39 of the Banking Act there would regularly be tripartite meetings between banks, their auditors and the Bank of England to talk about work they had commissioned under section 39, the management letter, the financial statements and so on and, under a different regime that now exists, those meetings are not quite the same and there is a different focus and emphasis. We are not saying there is a magic solution, it was just something to look at as to whether we can learn from recent experience.

Q443 Mr Mudie: Professor Power, would you like to speak on that?

Professor Power: These are private exchanges if they take place so the first thing we - whoever we are - have to do is find out how those exchanges have happened.

Q444 Mr Mudie: What did happen in the past where there seems to have been a better relationship between auditors and regulators?

Professor Power: I am not in a position to answer that question.

Q445 Mr Mudie: What is happening now then? You refer specifically to it: "The question of when an auditor might report directly to regulators on matters of concern has been widely debated and remains a source of tension." Can you explain what you mean by that?

Professor Power: It is the tension between client confidentiality and the public interest, and the exchange of information with a regulator which cuts across the grain of that client relationship. If I may say, I think it is time to revisit that relationship between regulators and auditors to see whether a richer set of arrangements can be put in place for information exchange, not just between regulators and auditors but maybe even between the Big Four themselves.

Q446 Mr Mudie: Do you not think in terms of banks with system risk we should perhaps think of special arrangements that link the regulators to the auditors as a matter of course so that even if there is the happy relationship where the auditor is doing other jobs and there is all this concern, the fact that they would have to automatically involve the regulator would answer that question to some extent?

Professor Power: I personally think that should be explored; the regulators would have to raise their game to make that relationship work.

Q447 Mr Mudie: I got your paper and as I am reading an important sentence I realise my staff have not photocopied the end of it, they have left a page out.

Professor Power: It probably does not matter.

Q448 Mr Mudie: You say: "The Basel Committee (2002) developed some general principles ..." What did you say after that because it is an important point on the relationship with banking supervisors?

Professor Power: The others can help me here. There is high-level guidance about how that relationship can be conducted.

Q449 Mr Mudie: When you were both speaking to Nick about it you said you would be in favour of taking a starting point as section 166 or something and you said you would start with a blank piece of paper. Is that irreconcilable?

Professor Power: I am social scientist; I just want to find out what happened.

Q450 Mr Mudie: That is in terms of investigating but in terms of the way forward; you would like reform and you see the basis of reform starting from this clause, you felt you would like to rewrite the whole thing.

Professor Power: No, that is not what I said.

Q451 Mr Mudie: What did you say then?

Mr Hodgkinson: I was saying we start from where we are and see whether we can improve it.

Mr Mudie: Tell me what you said then, as I misunderstood you.

Chairman: I think you said you would start again.

Q452 Mr Mudie: Start with a clean piece of paper you said, a blank piece of paper.

Professor Power: On the question of providing assurance about risk management arrangements and oversight I would start again, not so much in terms of the relationships that you are talking about but in terms of what is oversight and what is it to have confidence that it is operating successfully.

Q453 Mr Mudie: Lastly, you suggested we should look at the lessons after examining the period of the financial crisis and how the relationships worked. This is a politician's way of doing it; in the field is anyone or any organisation actually doing a study of what has been happening between the auditors and the regulators through this period?

Mr Boyle: Probably not, yet, but it could be done. There is already a statutory gateway which exists which allows the auditors to breach their normal rules on client confidentiality to talk to the regulator, and those conversations between the auditor and the regulator take place in private because both of them are bound to operate in private. There is a factual question, which I do not think any of us has the benefit of knowing the answer to, as to how many of those conversations are taking place, but in the end we will come back to the fundamental question that if you want to change the behaviour of banks you need to ask the FSA to do that because they are the banking regulator and the role of the auditor is to report on the truth and fairness of the financial statements. Those roles are complimentary, but they are fundamentally different.

Q454 Chairman: Just finishing up here, Professor Power, you said in response to a comment from Prem Sikka that independence is a red herring and we need to delve into the black box; can you delve into that black box for us in the next minute?

Professor Power: Very quickly it gets to the heart of the expectation issue. Auditors are reliant on a number of external sources in order to be able to function. They are reliant on market prices for assets, credit rating agencies and so on and so forth and, very importantly, they rely on

management, and if management is not doing its job or misleads the auditor or does not know what is going on in the bowels of the organisation it is very, very difficult to expect the auditor to do better. The direction of my comment is that we might be expecting too much from this black box in terms of what it actually delivers. It delivers assurance in conjunction with a whole series of other things working well at the same time.

Q455 Chairman: Do you want to add to that?

Mr Hodgkinson: Before saying it is a complete black box it is worth saying that over the past six years we have introduced a fundamentally different inspection regime of audits, so the actual conduct of the audit is now rigorously assessed by the Audit Inspection Unit and their reporting last December was that UK audit was fundamentally sound and at least when they were looking at the early stages of the credit crunch the audit firms' responses had been appropriate and timely. There is a lot of looking in the black box and if you are somebody in an audit firm you are very much aware of the Audit Inspection Unit that operates under the FRC.

Chairman: It sounds like the declaration of innocence the hedge funds managers gave us yesterday, but there we are. Graham.

Q456 Mr Brady: Just taking a step backwards, is it a problem that so much audit is conducted by four big firms?

Professor Sikka: There is a related issue: I do not think the Big Four accounting firms are fit to conduct public watchdog functions. In my submission I have highlighted how they have been involved in running cartels, tax evasion, bribery, corruption, many other things; it is difficult to see how such entities can actually deliver the public interest function. Maybe that is one of the reasons why people in the market chose not to believe the unqualified audit report when auditors were saying all is well and the marketplace were saying "We do not believe you because you have a particular kind of a track record." The domination of the firms is also important in other ways, they dominate the regulatory functions. When you look at the setting of auditing standards, domestic or international, internationally the International Audit Assurance Standards Board is the creature of the Big Four firms - it is funded by them. You can look at any auditing standard and one thing you will not find in there is anything about the accountability of the firms themselves, that has been organised off the agenda, and FRC acts more as a cheerleader rather than a regulator for the big firms. It has really failed.

Q457 Mr Brady: Without starting a debate, FRC, Paul Boyle, you wanted to comment as well.

Mr Boyle: If I may. The answer to your question is yes, it is a concern and it is a concern that we have been speaking out about for the last three years. There are risks that we are all exposed to because we have only got four firms capable of auditing the largest global companies. These firms are fragile economically and you could have a very serious situation; that is why it is important that legislators carefully review the rules that get in the way of new entrants of scale entering the market. This is a serious problem and at some point there could be a difficulty. I do not want anyone to say we were asleep on the job because we have been talking publicly about this for the last three years, including with the European Commissioner, who has responsibility for the relevant law. This is an important issue which we should not lose sight of.

Ms Brand: We support that view and we have welcomed the proposals of the FRC as they have come forward.

Q458 Chairman: Professor Power, your point about PhDs in the banking industry reminds us of the financial products that we were examining when we asked the chief executive of an investment bank when he came here if he could explain a CDO and he said it was not his job to come and explain it. That was left to the smart people with the PhDs, just a small number of people in the bank, on that issue. That is the aspect that worries us and the theme is coming out here today. You said in your report to us that "financial auditing may only work as designed in an orderly and non-stressed world." If you know a non-stressed household tell me that but a non-stressed world; please expand on that for me.

Professor Power: There is a band width of states of the world, if I can call them that, where audit works very comfortably, that is to say it can rely on management representations, it can rely on management accounts, it is confident that management is on top of its own organisation, that is the world where auditors are able to do their job most comfortably and where the incremental assurance that society demands is provided. We are not in that world.

Q459 Chairman: Are we blaming the auditors too much or are the auditors being blamed - we do not do that, we are just taking evidence on this. It maybe begs the question from what I have heard, just as a last question, what are auditors for and what is the future? Robert Hodgkinson, would you start?

Mr Hodgkinson: We are very much concerned with the future and the solutions. I have referred to the Audit Quality Forum that the Institute hosts and some of the issues that we are looking to take forward on our agenda there relate to the potential role auditors have in systemic risk issues and also making sure that there is wider understanding of the independence framework. So we as an Institute are very keen to make sure that questions about what the auditors are for are addressed and that we are not seen as being marginalised.

Q460 Chairman: Any comment, Helen?

Ms Brand: As the Professor said there is limited impact that the external audit is going to have in this kind of crisis, stressed situation, but there is room for improvement within the audit function which auditors are now starting to address.

Mr Boyle: Chairman, audit is a hugely valuable activity and you would really miss it if it was not there. The value of an audit is not in the beauty and the elegance of the financial statements that you see, it is the difference between those financial statements and what would be produced if management were not subject to independent review, either for over-optimism or simple error. I had the opportunity to work in an environment a few years ago where there was no auditing; the difference is huge and we would seriously miss it if it was not there. That is why issues to do with the continued availability of audit are so important that someone needs to pay attention to that issue.

Professor Power: Auditing is one part of a very wide and complex network of institutions which produce trust and stability in an economic system, and I do not think we understand well the inter-connectiveness that supports this system of trust and assurance.

Q461 Chairman: Robert made the point that there is a potential role in systemic risk issues; Prem Sikka, how can we firm that role up and why did no one blow the whistle, or is that an unfair question?

Professor Sikka: I do not think so. Auditors have unprecedented rights; they have more rights than the police. Without any warrant they can examine any document, interview anybody in a company;

they have increasingly been given more and more rights, they also have been shielded from lawsuits and basically they have failed to deliver, so the question is how do we reinvent the audit function. My argument is that in the end it is only the regulators who themselves have to directly take on the responsibility for auditing at least financial institutions. That way they are not relying on external parties to alert them or to make them aware. That is the way forward.

Chairman: The final question is from George.

Q462 Mr Mudie: Where there is a systemic risk - the banks - is there not a case for a parallel relationship so that the auditor does automatically report, with the knowledge of the bank, to the regulator? Whether it costs the FSA money or not, they put it in and they ask different questions for a deeper audit or a deeper investigation than you get with the normal financial audit. Would that not be very, very useful for at least going further to alert us to a possible crisis in the present arrangements that clearly do not work?

Mr Boyle: It is, if I may say so, a promising line for further study. It needs to start with the factual examination of what communications are presently taking place and then we must remember that the auditors are not currently responsible for changing the behaviour of the banks, but improving that communication would be a good thing.

Chairman: This continues from our inquiry into Northern Rock which Michael made a point to you on in that with Northern Rock, when I spoke to people in the market people were saying "Look, if you had come to see us we would have told you the problems of Northern Rock". The business model there was the problem but nobody blew the whistle, and it is that issue that we are interested in today and taking that up. Can I say I am both surprised and delighted to get such an animated discussion with accountants, so thank you for that.

Memoranda submitted by PwC and KPMG

Examination of Witnesses

Witnesses: Mr John Hitchins, Partner, PwC, Mr Brendan Nelson, Vice-Chairman, KPMG, and Mr Jonathan Hayward, CEO, Independent Audit, gave evidence.

Q463 Chairman: Welcome and good afternoon. Can you introduce yourselves, please, for the shorthand writer?

Mr Hitchins: I am John Hitchins, I am the leader of PricewaterhouseCoopers UK banking practice and I am a banking audit partner.

Mr Nelson: I am Brendan Nelson, I am a Vice-Chairman of KPMG in the UK and I am a bank audit partner.

Mr Hayward: I am Jonathan Hayward, I am the Chief Executive of Independent Audit Limited, which is an advisory firm providing corporate governance advice to organisations including banks.

Q464 Chairman: First question, how culpable are the auditors and are we being too hard on the poor old auditors?

Mr Nelson: You will not be surprised, Chairman, if I say that I think the auditors have actually discharged their responsibilities diligently in the context of what the statutory audit responsibility represents. The last audited financial statements of major financial institutions were to the end of 2007 and of course we are currently doing the audits of financial institutions for the year ended 2008. As has been discussed in the evidence given to you just before we sat down, the audit is around expressing an opinion on the truth and fairness of the financial statements and, in the context of the statutory audit responsibilities for 2007, auditors we believe discharged their responsibilities professionally and with care and diligence. They were subject to review by the Audit Inspection Unit who expressed the overall opinion that auditing in the United Kingdom was fundamentally sound. The financial statements of those institutions were also subject to detailed scrutiny by the Financial Reporting Review Panel and as a result of that scrutiny there have been no restatements of those financial statements.

Q465 Chairman: Okay. Jonathan.

Mr Hayward: I agree with what Mr Nelson has said.

Q466 Chairman: We have not got you here to agree.

Mr Hayward: I know; but I am afraid in this case I have to. I am always ready to criticise the Big Four if they need to be criticised, but in this particular case it is correct, there is no evidence to suggest that the auditors have failed to do that which they are obliged by duty to do, the issue is around whether they should have been doing something else.

Q467 Mr Fallon: Mr Hitchins, the Financial Reporting Council did an audit report on PricewaterhouseCoopers last year and one of the points that they picked out was that you specifically allow your key audit partners to be rewarded for selling non-audit services and they suggest that this is actually in conflict with the ethical standards. How do you respond to that?

Mr Hitchins: First of all, Mr Fallon, I would like just to correct that. They made a point that we did not prohibit non-audit partners working on the audit - so these are tax specialists for example - from selling non-audit services.

Q468 Mr Fallon: But that does not prohibit the audit partner.

Mr Hitchins: We do prohibit all of the audit partners on the assignment from doing that. Ethical standards only prohibit audit partners from selling non-audit services so we believe we fully comply with the ethical standards.

Q469 Mr Fallon: So this is factually wrong is it, that your firm's policy and guidance specifically permit key audit partners to be rewarded for non-audit services.

Mr Hitchins: We disagree with the findings of the Audit Inspection Unit on that point.

Q470 Mr Fallon: I see. Why should a key audit partner be rewarded for selling non-audit services like providing comfort letters for securitisations?

Mr Hitchins: The key audit partners who are audit partners are not rewarded for selling non-audit services. Specialists are brought into the audit at a partner level to provide advice to the audit team; they are not prohibited under ethical standards from selling non-audit services.

Q471 Mr Fallon: Okay, but the key audit partner is part of the audit team is he not?

Mr Hitchins: The question of who is a key audit partner is a matter for judgment on each audit and it depends on the role on the audit.

Q472 Chairman: Thank you. Just to ask a quick question, The Sunday Times of 25 January spoke about Deloitte and was saying, firstly, that in 2000, the first year that Deloitte took the RBS account it received £4 million for management consultancy, tax and other advisory work, in addition to £5 million in audit fees. Then the fee climbed to £7 million the next year and for the 2007 financial year Deloitte's fees reached £31.4 million, having more than tripled in the seven years. If rumours in the accountancy world prove correct, this year's bill will top £40 million. Now that RBS has been forced to surrender a 70% stake to the government, investors are beginning to question whether the auditors should have spotted problems some time ago. The same is being asked of KPMG, which audited HBOS, and PwC which audited Lloyds TSB. That same Sunday Times article said that "the accounting firms are all trembling in the corner, just waiting for someone to start asking these very awkward questions," according to an unnamed City law-firm partner. Why were the accounts of all the banks signed off without any problems last year? Without trembling, can you answer the question?

Mr Nelson: I will do my very best and I can only, obviously, comment on the financial statements that were the subject of an audit opinion by KPMG. You have to go back into the history of this. At the end of 2006 the world was a very different place to what it is today. Markets were liquid, economies were growing, there was a mood of optimism everywhere and nobody saw any clouds on the horizon, and that situation effectively prevailed well into 2007. It was only in the latter part of 2007 that the world started to look a very different place so in fact everybody was put on notice, with effect from August 2007 that things were beginning to change and change quite rapidly. When we came to the close of 2007 both the boards of financial institutions, their management, the regulators, auditors and indeed other interested parties were all aware that the world was starting to change and so that provided additional focus and additional emphasis on the audits of 2007. Nevertheless, audits are effectively a snapshot in time and they record events that have already occurred, they do not record events that are still to occur, so the auditors' responsibility at the end of 2007 in terms of looking forward is to be satisfied that those financial statements can be prepared on a going concern basis. That is the primary responsibility of the boards of those financial institutions, and of course at that time there still was enough evidence to suggest that the crisis that was going to occur in October would not materialise within the period that is covered by the going concern assumption, which is 12 months from the date of the audit report of the financial statements in question. So the evidence available to auditors, and indeed to boards, at the end of 2007 did not anticipate the crisis that was going to occur at the end of September/beginning of October.

Q473 Chairman: Jonathan, the point has been made that the world looks different, but should not the auditors have a professional consistency which is essential? Given Mr Nelson's point about it just being a snapshot, is that not the best get out of jail card you can find?

Mr Hayward: It is a very good get out of jail card, but that does not stop it being correct, it is a point in time snapshot and from the perspective of the responsibility that those auditors have they seem to have done a good job. The reason you are finding these answers unsatisfactory is because you wish they were asking a different question, as was touched on with the earlier group of witnesses, which is around the role of auditors possibly in relation to the wider risk picture. Auditors are required only to report on the statement of account given by directors; the problem you have with this expectation here is that a lot of people would like auditors to play a much wider role in terms of

protecting the interests of investors and of the public at large, wider than that actual specific role of reporting.

Q474 Chairman: But if auditors get £40 million from one company you would think quite a lot is expected of them.

Mr Hayward: Indeed, a lot is expected of them and actually it is a difficult job to give an opinion on the financial statements of a very large bank. It is an incredibly complex exercise that takes a lot of resource.

Q475 Chairman: Could you read Royal Bank of Scotland's or HBOS's accounts last year comfortably?

Mr Hayward: No, that is an entirely different question and our profession is culpable in that, that we have headed for compliance rather than communication. We are producing telephone directories of data ---

Chairman: God help us if you cannot read it. Nick.

Q476 Nick Ainger: Can we return to the theme of Michael Fallon's question because I am a bit puzzled. Here we have the Audit Inspection Unit, which is part of your industry's regulatory framework as I understand it, making a clear judgment on conflicts of interest, certainly in relation to Northern Rock but generally, and in the case of Northern Rock out of £1.8 million fees charged by PricewaterhouseCoopers £700,000 were fees relating to assurance services in connection with the bank's actions in raising finance, not to do with the audit service. Could I ask you, Mr Hayward, what do you think of one of our major auditing companies basically challenging a judgment of the regulator? What does it do for the reputation of the audit industry?

Mr Hayward: I agree it makes poor headlines and I actually think it reflects well on the regulator that they were prepared to stand up for their own ground and publicise a finding when such an influential and powerful firm disagreed with them. It is a healthier sign than having everybody reaching behind doors in acquiescence.

Q477 Nick Ainger: In terms that now you are basically saying they came to the right judgment ---

Mr Hayward: I have no view on that. I have no information that would enable me to comment on it.

Q478 Nick Ainger: What is your view of PricewaterhouseCoopers actually challenging that decision and has the Audit Inspection Unit got any sanctions that it can use against PricewaterhouseCoopers if they continue to challenge their judgment?

Mr Hayward: I have no idea.

Q479 Nick Ainger: Mr Hitchins, it is your company; what sanctions are you risking?

Mr Hitchins: May I just read what we actually said in our response which has been published in the AIU report. "We do not believe that your comments on the remuneration of key audit partners are consistent with ethical or auditing standards and we remain completely satisfied that we observed the principles involved. If it is the considered view of the AIU that existing standards or rules need to change then these matters should be referred to the Auditing Practices Board [in this case the relevant body] for review and, if necessary, the amendment of the standard." We are saying that we

disagree with their interpretation of the standard; that the standard is in our view clear but clearly does not say what they think it says and so it should be referred to and I believe is part of the review of the ethical standards that is currently being conducted by the Auditing Practices Board.

Q480 Nick Ainger: Mr Hayward, do you want to come back?

Mr Hayward: I would just like to add that I do think this is one of those angels dancing on the head of a pin question. We are all getting very exercised over this little technical detail of who may do what among a large number of people. Independence is not the same as objectivity; objectivity is what you want in your auditors and these technical issues of independence might or might not support it. One of the poorest audits that I have observed in practice was done by an audit firm that had no non-audit work because the price for having no non-audit work is a considerable level of ignorance about the client's activities. This is a much more complex issue than is made out by these little technical, rule-based details.

Q481 Nick Ainger: Do you not understand that this type of refusal to acknowledge a regulator's judgment brings the whole industry into disrepute? People out there say is it right that an auditor of a bank which subsequently failed and had to be bailed out by the British taxpayer not only took fees for the audit but also took £700,000 off that bank for other types of advice. Do you not understand that people out there, now that we are bailing out these banks, actually say "What on earth is going on?" and do not consider it counting the number of angels dancing on the head of a pin.

Mr Hayward: I can understand the politics of it, yes, as a practical matter in terms of ---

Q482 Nick Ainger: It is not politics, Mr Hayward, it is reality. Your industry, along with other parts of the financial services industry - as John Lawton told us a few weeks ago people would like to see some public hanging, that is the attitude that an awful lot of people out there have. We want to see confidence restored in your industry; do you not think that if regulators make rulings then the industry should follow them?

Mr Hayward: In general, yes, I agree with you. My observation though was that I do not actually believe these rules really serve the further purpose that we are trying to advance here.

Nick Ainger: Thank you.

Q483 Mr Todd: It does make us all think of the value of self-regulation in that this is not a regulatory function carried out by a government agency, it is carried out by the industry itself, and if it does not appear to deliver any obvious leverage and indeed appears to be greeted as a sort of rulebook exercise by yourself then it does not necessarily give great confidence to the regulatory framework within which you operate.

Mr Hitchins: We take our independence extremely seriously. In this particular instance our reading of the rules is - and the rules are still to our mind clear - that they do not prohibit the point that the AIU picked up. It may be that they should prohibit it which is why we said to the AIU this should be referred to the rule-maker and if necessary the rules can be amended.

Q484 Mr Todd: You have possibly not grasped the implication of what I was saying which is that you are regulating yourselves, you are disputing with your own regulator who you essentially resource. To the outside world this seems a perverse circumstance but you are obviously comfortable with it. Can I ask about the relationship with the regulator of auditors? In this banking

crisis, in the preparation of the 2007 accounts, was there any communication with the regulator over any aspects that were raised during the audits?

Mr Nelson: Yes, there was a meeting prior to the end of 2007 which was convened at the initiation of the Big Four with the regulator, the Financial Services Authority, at which the Financial Services Authority were present - in fact the big six accounting firms in the UK were present, a representative from the Bank of England was there, representatives from the Financial Reporting Council, including the Financial Reporting Review Panel, were there but that was a fairly high-level discussion. At that point nobody got into the detail of the impact of this on individual institutions ---

Q485 Mr Todd: What was it, some sort of rhetorical encounter?

Mr Nelson: To some extent it was the FSA explaining to us some of the work that they had been doing of a generic nature in the industry, particularly with respect to market risk, there was an opportunity for the firms to talk about some of the issues around valuation of financial instruments, which was going to be extremely challenging at that year end. There were some observations made by the Financial Reporting Council then that issues like going concern obviously would be pertinent in the context of closing and I think there was a general discussion around the additional disclosures that would be required in the 2007 financial statements for the first time following the introduction of IFRS7 in that IFRS7 required financial institutions to actually provide much more detailed quantitative and qualitative disclosures around their exposures to credit risk and market risk ---

Q486 Mr Todd: I have interpreted this as the FSA was delivering a series of messages to yourselves, it was not seen as an opportunity for you to flag up any particular queries or concerns that you might have about the task in hand working for your clients.

Mr Nelson: Maybe I am not making myself clear. I think it was; everybody was well aware as to what the major challenge was going to be in the context of 2007 and the major challenge in 2007 was going to be the valuation of financial instruments that were held at fair value in the balance sheets of financial institutions.

Q487 Mr Todd: You obviously had opinions on those and communicated those to the FSA.

Mr Nelson: No. As I have said, it was a very high-level discussion and we could not discuss individual instruments, it was just that that was going to be a challenging issue.

Q488 Mr Todd: Fair enough. In your evidence both of you two have said that you would have wished for more interaction with regulator at various times.

Mr Nelson: Yes.

Q489 Mr Todd: On what sort of terms would that interaction take place?

Mr Hitchins: If you go back to what used to happen under the old Banking Act there was an annual meeting which started off as between regulator, client and auditor on each individual institution. Then it developed from there into bilateral meetings so we had a meeting with the regulator by ourselves, without the client present. Those meetings have become - ad hoc is probably the best way to describe them. They are occasionally called but they vary from institution to institution and we believe there is some value in increasing the frequency of those in future.

Q490 Mr Todd: To give us some examples if you can among your clients, did you have meetings about any of the institutions that were your clients with the FSA using that sort of mechanism?

Mr Hitchins: There would have been meetings on some and not on others.

Q491 Mr Todd: Ad hoc arrangements.

Mr Hitchins: Yes. The protocol is such that they are convened by the FSA.

Q492 Mr Todd: Do they pay you for those meetings?

Mr Hitchins: Sorry, does who pay us?

Q493 Mr Todd: Do they pay you for those meetings?

Mr Hitchins: The cost of us attending those meetings is part of the audit fee for the institution, the FSA do not pay us.

Q494 Mr Todd: I am relieved to hear that. Do you think that one of the outcomes of this that may be valuable is a formalisation of the relationship between auditor and the regulator and how that is to square with the client relationship, which I think we have all learnt is your first concern?

Mr Nelson: We would certainly support that. If you go back to what was being discussed at the previous session, the relationship that existed between the auditor and the regulators prior to the introduction of the Financial Services Authority was a much closer one and our involvement in the regulatory process was much clearer. Nowadays it is very ad hoc, it is not a particularly close relationship and the focus of the work that we do in addition to the audit work now is very much detective in the sense that section 166 reports are generally only convened when the FSA has suspicion or evidence that an institution is failing in some respect to meet particular regulatory requirements, so it tends to be that you go in to try and find the evidence to present to the FSA of the scale of perhaps this failure to meet requirements. In the previous regime it was very much a preventative type regime, i.e. there were more regular examinations in order to impose if you will a certain discipline on financial institutions to ensure that they constantly maintained the requirements in terms of records controls and so on as imposed upon them by the regulator. That role that we had has now gone and so the only role we have is as and when we are required to go in and do a review under section 166, but that tends to be after the event.

Q495 Mr Brady: In the current financial crisis how significant a problem is the greater uncertainty over the going concern status of banks, both for auditors and banks?

Mr Hitchins: It is of considerable concern for this set of year ends. The basic business model of a bank always has a funding gap in it because banks take in short term deposits and lend it long, it is a function in the economy. In normal markets and normal circumstances you can have considerable confidence that the banks can meet that funding in the market. Since the collapse of Lehman's that has not been the case and all banks have had to depend on facilities, largely from the Bank of England but also partly from the Government. For this year end we basically have to assess the projections that management have done in forming their own opinion on their funding needs, examine those and consider whether the funding needs shown in those forecasts can be met by the facilities that are available in the market which will, in the short term, largely be from the Bank of England. If we are able to reach a conclusion that it can be met from the existing facilities, then it is appropriate for management to conclude that the going concern basis is appropriate and it is

appropriate for us to sign off on that. If it appears there is a problem, the first step is actually to go and talk to the FSA and the tripartite authorities about what is the best thing to do with that situation rather than simply publish accounts and wait and see what happens.

Q496 Mr Brady: Is there anything you would like to add to that?

Mr Nelson: I absolutely agree with John; boards, audit committees and auditors will see going concern as probably the biggest issue of judgment this year end. There will be a lot more disclosure in bank financial statements about the uncertainties of the future, but if they become material in the context of the Board's decision they will have to make that clear in the financial statements. If that happens then the auditors would be required to add what is called this "emphasis of matter" paragraph but if there was fundamental disagreement between the auditor and the institution then the auditor would have to consider a qualification. As John said, the reality is that we are under this statutory duty to go to the FSA if we are minded to issue a modified or a qualified opinion, so the FSA has the opportunity to take whatever steps it may feel are appropriate in the context of that institution before the audit certificate is published.

Q497 Mr Brady: It is unlikely that it would reach the point of giving qualified accounts to a bank.

Mr Nelson: Absolutely.

Q498 Mr Brady: There has been a lot of debate recently about auditors' approach to wider issues of going concern for the imminent round of financial results. How much comfort do you take from the fact that this is now being discussed and that audit opinions might not be met with as much panic as might otherwise be the case?

Mr Hitchins: It is very important that it is discussed because it is very important that the expectation gap, that an audit opinion somehow guarantees the future of a company, is corrected, that people actually understand what we are doing and what the audit opinion is saying.

Q499 Mr Brady: Is there more that you can do to improve understanding of that or to promote that further?

Mr Nelson: The Financial Reporting Council has issued guidance to directors on matters to consider when determining the going concern assumption, and I think that just helps give the correct perspective to some of the issues that have to be considered by boards so you can be more assured that boards are approaching this in a consistent way.

Mr Hitchins: That does carry authority because, to correct something that was said earlier, the FRC is independent of the Big Four, we are not self-regulating; as our regulator it is independent. We pick up most of the bill because that is the way the legislation that established it deemed it to be, but that is about the extent of our input.

Q500 Sir Peter Viggers: When an audit is undertaken the auditors produce a disclaimer document usually running to several pages; it is usually pretty impenetrable and leaves the reader wondering what the auditor is responsible for, it having been made very clear what the auditor is not responsible for. The bank then produces a report running to several hundred pages and the auditor either qualifies it or does not qualify it. Have you undertaken any research to discover what the user of the accounts would like to see and whether the user feels that this is a helpful framework that currently exists?

Mr Nelson: That is a very interesting question. There is constant dialogue with users of financial statements but the trouble is the user community is so wide that it is quite a challenge to see if every user expectation can be met. We are in a situation now, as you rightly point out, that bank financial statements are now running to some hundreds of pages and indeed in some cases some many hundreds of pages and the trend is likely to be that there will be more pages added in the context of this year because, again, the response by a number of regulatory agencies to the crisis is to require banks to disclose more information about the nature of the instruments they are holding and the degree of risk inherent in those instruments, so you are going to see this getting progressively longer. There are initiatives being taken by the ISB in terms of looking at the complexity in financial statements and seeing to what extent financial statements need to be restructured to make them perhaps easier to understand. The other confusing aspect of financial statements is that financial statements basically now sit in two halves: the front half which is management's commentary on the performance of the business throughout the year and the second half, which is the audited piece, which is the actual pure financial statements themselves. The trouble is that some of the audit information relating to these additional disclosures ends up in the front half of the financial statements, and therefore it can be quite confusing for readers to actually understand what exactly is audited and what is not audited. I think perhaps it is worth looking at financial statements to see if you can be slightly clearer between what is audited and therefore subject to the audit opinion and what is not, because if it is listed as unaudited people tend to draw the wrong conclusion and think that as it is part of the financial statements it must be covered by the opinion.

Q501 Sir Peter Viggers: Just as doctors are pushed into defensive medicine so I think accountants are pushed into defensive accountancy. Does the Companies Act 2006 help by producing a regime where auditors can agree a limitation of your liability, does this help provide a way ahead to simpler, more transparent accounts?

Mr Hitchens: First of all it remains to be seen what the impact of that legislation is because as yet no company has put forward to its shareholders a proposal to limit liability, so we do not yet know what impact that will have. However, all that legislation really does is provide catastrophe insurance for the profession; it is there to try and limit sizeable claims and it does not really impact the quality of the audit because we are not driven by the threat of litigation, we are driven by a desire to get the quality right.

Q502 Mr Mudie: After all this year or the 18 months will you be changing your instructions to your auditors who audit the banks for this year's audit?

Mr Nelson: I would like to get across the clear understanding that auditing is dynamic, it is not static. We have to adapt to changing market environments, changing market conditions, changing standards, changing regulation, and therefore the whole audit process continues to be a dynamic process. We - and I am sure it is the same with other auditing firms - have a process of ensuring that all audit partners who are involved in financial institution audits are kept regularly abreast of what we are seeing in the marketplace and how we need to respond to that in the context of our audit. Going back to the issue around complex financial instruments and how these are valued, we do not do that on an individual basis so that one partner is out there making the decision on his own, we look at the collective knowledge of the firm in terms of what do we see across the marketplace as a whole, what is the collective view of the partners engaged in the industry who understand the nature of these instruments and the risks inherent in that, and then we seek to benchmark to make sure that there is a consistent view emerging, but recognising that in the context of illiquid markets you end up with a wider range of what people would deem to be acceptable outcomes because the pricing widens as the market becomes more illiquid, and that creates the real problem in terms of trying to get a true comparison between institution and institution.

Q503 Mr Mudie: I struggle with that because the consistent line up to now is you are not corrupt, you have not done this for these additional fees, you are not incompetent, you are doing it within strict lines and we the public and we the politicians just do not understand how limited your role is. Now you tell me you are dynamic; how does that square with what is happening because I asked the last panel what changes and they have not got round to even thinking about it, discussing it, analysing it. Maybe you are ahead of them; tell me how dynamic you are going to be with this year's audit. What have you learnt, what will you be looking out for, will you be broadening these lines that you have consistently told us are fixed and if only we understood how fixed they were we would sympathise with you, so which is it? I will tell you why, Brendan. We have had such an august figure as the Bank of England Governor, we have had the FSA tell us if only people in the banking industry and people like yourself had read our speeches, for the last two or three years we have been warning about this with speeches in Bristol and speeches here. You have no excuse; the Governor made his speech, if you are dynamic you should have picked it up. Why did you not? You have now picked it up because it has crashed around you, but what are you going to do this year? Is your audit going to be wider than you have done to earn these fees in the past few years?

Mr Nelson: The audit is dynamic in the context of the statutory responsibility that we have under law; it is not dynamic in the sense that ----

Q504 Mr Mudie: So it is not dynamic at all, it is fixed by the law.

Mr Nelson: We have no remit to extend it.

Q505 Mr Mudie: You lectured me for five minutes on dynamism and how of course you were going to change, but when I say "Tell me the change" you say it is fixed by the law.

Mr Nelson: The impression I gained from your question was that we audit in a very static environment and did not in the context of our audit work adapt to the changing environment. That was the reason I answered the question in the way I did.

Q506 Mr Mudie: Brendan, if you were watching this on television and you had lost your job, you were going to lose your house, you would be pretty bloody angry at the auditors for allowing the banks to get away with all the off balance sheet derivatives, the lot. As you go in and audit them the ordinary person would say "Why the hell didn't the auditor pick it up?" In an intelligent discussion you are saying to me "Well, it is not our business." Will it be your business in future or will there need to be discussions and changes, maybe even changes in the law? Have you started those?

Mr Nelson: Those discussions clearly will take place with the Auditing Practices Board, the International Accounting Standards Board, the Financial Reporting Council in terms of the role of the auditor going forward, but I really do want to come back to this point about the fact ----

Q507 Mr Mudie: There is a cold shiver going up my spine. That does not sound very good to me.

Mr Nelson: I really do not mean to leave you with that impression. The responsibility for financial statements is the board's; there is a huge number of initiatives that are taking place to require boards to disclose more and more information about the nature of the risks that they are taking within that institution. It is not an automatic process that that additional information is subject to audit and it may be that going forward there needs to be a dialogue to discuss with the auditing profession to what extent this additional information, which is now deemed to be very important to ensure that users of the financial statements truly understand the nature of the risks that these institutions are

incurring, and if these additional disclosures are to be provided then maybe they should be subject to audit. Let me give you one example. One of the key measures of a bank's strength is its capital ratio, the regulatory ratio. The one often quoted is tier one and now in the current climate the core tier one ratio. That ratio is not audited; that is not part of the audit opinion or the audit comfort and yet that is seen as one of the key determinants of a bank's strength. I think there is a case that we need to look at some of these additional disclosures. Another point I would make is that for the first time this year banks will have to publish what are called "Pillar Three disclosures" which will either be published on their website or maybe incorporated in their financial statements. Again, these provide much greater detail about the nature of the risks that the banks are running, both in terms of credit risk, market risk and operational risk and, more importantly, it gives some sensitivity analysis. Again, these disclosures are not subject to audit but it is out there for all users of financial institutions to see and form their own assessment.

Q508 Mr Mudie: Do you think the four major institutions could provide the Committee with a list of such things so that we can consider putting them in our report because it is obviously urgent that we get the thing moved on so that we can look people in the eye and say that in terms of audit, in terms of regulation et cetera et cetera we moved as quickly as possible to make sure this does not happen again. You have given two very good examples, do you think it would be possible for the four institutions to put specific points up to us so that we could have a look at putting them in the report? John, you are permitted to speak.

Mr Hitchins: We can certainly take that away and come back to you with something.

Q509 Mr Mudie: Does that mean you are going to do it?

Mr Hitchins: Yes.

Mr Mudie: Good.

Q510 Jim Cousins: Do you actually think you are capable of working out whether one of our major banks is a going concern?

Mr Hitchins: Yes.

Q511 Jim Cousins: You are absolutely sure about that.

Mr Nelson: Yes, in the context of the going concern assumption.

Q512 Jim Cousins: Ah.

Mr Nelson: Which is a 12-month view; it is not that we are saying the institution is going to be thriving in five years, four years or three years, it essentially is a 12-month view from the date of the accounts and the audit opinion, not the date of the balance sheet. If you sign off at the end of February it is 12 months to the following February.

Q513 Jim Cousins: You see the balance sheet of a major British bank is likely to be bigger than Britain's GDP. The underlying assets - if in fact there are any underlying assets because, as we are discovering, in some cases there are not any underlying assets - are spread all around the world and they have been packaged and repackaged into hundreds of thousands of complex products which are parked very often in tax havens. Do you actually think the audit process as we understand it

now, and as it has been built up in British legislation, is at all capable of coming to terms with that and working out whether the institutions we have got are actually going concerns?

Mr Nelson: Yes.

Mr Hayward: I would be less confident; I share your question mark over it because to come to that conclusion requires one to make assumptions about the behaviour of markets which over the last year or two have not been predictable or rational. We just do not know how things are going to shape up; my feeling is that the audit profession though is trying its best to work within what it has got to do and is trying to be helpful in saying yes to that.

Q514 Jim Cousins: Okay. Is the problem we have got here in wrestling with this huge construct that has emerged legal powers or is it simply that the task is so immensely complicated that for an institution even like a Big Four accountancy firm it is just beyond them?

Mr Hayward: It is a combination of the complexity of the task and the fact that you are having to look forward into the future in times when nobody really knows what is going to happen.

Q515 Jim Cousins: If I was a member of an audit committee of one of these major banks I think I would be tempted to do what the Danish politician suggested he would do if he was attacked by the Russians which is simply send a telegram saying "I surrender". The task is enormous, the institutions we have - and this is not a question of individual competence or individual ill-will - are just not capable of getting the measure of the situation. Do you not even have a hint of that?

Mr Nelson: Let us be clear, the responsibility for determining whether the financial statements should be prepared on a going concern basis rests with the board. If the board have a material uncertainty over any significant aspect of that then they are required to make a disclosure of that in the financial statements so a reader knows what the level of that material uncertainty is. As I explained earlier on, in those circumstances the auditor would issue a modified but not qualified opinion and the modified opinion would be the emphasis of matter to make sure the reader of the financial statements was drawn to the disclosure regarding the material uncertainty. That judgment has not been arrived at.

Q516 Jim Cousins: That is a very carefully worded and I have no doubt entirely accurate point, but by the end of February the British taxpayer will be supporting trillions of pounds of complex financial instruments, more than half of which are outside the UK, something that I think very few people have spotted. More than half of the things that will be guaranteed are outside British jurisdiction, and in some cases we do not even know if the underlying assets are even there. Do you really think any of the Big Four accountancy firms, or even the Big Four working as a cartel together, are capable of giving British taxpayers the assurance they will require from somebody in such a situation?

Mr Nelson: If the boards cannot convince us that they are able to prepare financial statements on a going concern basis then we would qualify. If the boards produce adequate disclosure around any material uncertainty then we will issue an emphasis of matter. If the boards convince us to the standards required under auditing standards that they can continue as a going concern then we will issue an unqualified and unmodified opinion.

Q517 Jim Cousins: In the end, therefore, we rely not on you, not on the audit process, but on the competence and capacity of boards of directors of banks who plainly have already failed us. That is your view.

Mr Nelson: The responsibility for preparing financial statements rests with the board, it does not rest with the auditor, but if we disagree with the board then our duty is clear.

Q518 Chairman: Okay, very sobering. Jonathan, we are over time but just addressing a few points to you do you think that audit committees of banks have performed well in the run-up to the current crisis?

Mr Hayward: Audit committees of banks generally have two roles, sometimes split between two committees but very often in one; part is the audit side, which is around the integrity of the financial statements, and that is the side that has had so much attention in the years since Enron and that side seems to have worked pretty well. The other part of the responsibility is around the oversight of the risk management in these organisations and self-evidently that has not been so successful.

Q519 Chairman: The composition of bank audit committees: are they sufficiently expert in their understanding of modern banking generally, do you think?

Mr Hayward: Sometimes, but sometimes not.

Q520 Chairman: If it is sometimes not is it some big banks that are not?

Mr Hayward: The role of these committees is not to go in and audit the detail of what is being done, it is to oversee to try and maintain a check that the management is doing its job properly.

Q521 Chairman: Is it to oversee risk?

Mr Hayward: To oversee the management of risk. Overseeing the absolute amount of risk that is taken by a company is a job for a board really, not a committee, and it is an area where in our experience it is often a bit fuzzy. It is a difficult thing to do and there have been too many attempts to try and make it scientific.

Q522 Chairman: You have left us with quite a bit of food for thought on this issue, but if I could just sum up what I think you have said there, it is that auditors have done a decent job of fulfilling the duties expected of them in statute, but for us is the code appropriate. Is that a legitimate area to be looking at?

Mr Nelson: Yes.

Q523 Chairman: There are some concerns over the fact that only four audit firms dominate the market, and indeed I well remember - as maybe some of my colleagues will - when Howard Davies as chairman and chief executive combined of the FSA came before us he was saying that for some audit work there are only two audit firms. That indicates that maybe the stability of the market could be affected and is an issue for policy-makers to look at, is that correct?

Mr Nelson: Yes.

Q524 Chairman: Also, it is maybe an opportunity to look at the independence of auditors.

Mr Nelson: You will not be surprised if I say ---

Q525 Chairman: You would not disagree.

Mr Nelson: We would not disagree. If people want to look at our independence then we are perfectly happy for that to be done.

Q526 Chairman: Maybe the bigger issue for us is for policy-makers to say we could make better use of the skills and experience of audit firms to prevent problems in the financial sector, because the question that haunts us here is that all the banks' accounts were signed off, seemingly without problems. If auditors are doing their work and everybody else is doing their work and we still end up with a black hole, how do we prevent the black hole in the future?

Mr Hayward: May I say that I think the present system is geared towards achieving compliance. This situation we are in now is not a failure of compliance. What you are asking for is something that goes beyond compliance and to get there we will require a system that goes beyond the audit system that we have.

Q527 Chairman: Do you think there is an opportunity for us to explore that?

Mr Hayward: I think there is a great opportunity to do that and to start with a clean sheet.

Q528 Chairman: From what we heard in the first session here there is a need for an immense improvement in the depth of interaction between auditors and the FSA.

Mr Hitchins: I would say there is a need for that to be at an individual institution level. There is very good interaction between firms and the FSA at a firm-wide level on policy, but there is room for improvement at an individual level.

Q529 Chairman: We think there is an opportunity for a review and a reflective approach.

Mr Hayward: Can I just go back on the question of there only being four firms? That is in part a reflection of the issues that Mr Cousins was raising; it is the complexity of these banks which is why there are only four firms with the skills and capability to do them. Part of the barrier to entry of a new firm joining that market is the cost of building up that expertise.

Q530 Chairman: There is a great opportunity to reform here at this time, looking at that, is that fair enough?

Mr Hayward: Yes.

Chairman: Lastly, Mr Nelson, given your expertise, from what I am told the report and accounts of HSBC last year were almost 500 pages. Could you with a good malt whisky sit down at the fireside one night and fully understand it, looking at that report?

Q531 Mr Mudie: Do not say you do not drink whisky; you will offend the Chairman.

Mr Nelson: It is not a book that you would read cover to cover - it is not a book - but if you have an interest in particular aspects it is quite a good dictionary to look in.

Q532 Chairman: You think there is maybe a good chance of getting drunk before you understood it. Thank you very much.

Mr Nelson: That is your comment, Chairman.

Memorandum submitted by Standard & Poor's

Examination of Witnesses

Witnesses: Mr Michel Madelain, Executive Vice President, Moody's, Mr Frederic Drevon, Senior Managing Director, Moody's, Mr Barry Hancock, Managing Director and Head of European Corporate and Government Services, Standard & Poor's, Mr Ian Bell, Standard & Poor's, Mr Stephen W Joynt, President and Chief Executive Officer, Fitch Ratings, and Mr Charles Prescott, Group Managing Director, Financial Institutions, Fitch Ratings, gave evidence.

Q533 Chairman: Welcome to the Committee. We saw you en masse in November 2007 so welcome back the usual suspects, but you obviously do not have any draw appeal with the exit to the door. I cannot do anything about that, but could you introduce yourselves, please, for the shorthand writer?

Mr Hancock: Certainly. Barry Hancock from Standard & Poor's; I run our corporate and government ratings business in Europe.

Mr Bell: Ian Bell, I run our structured finance business in Europe.

Mr Drevon: Frederic Drevon, Moody's, I am the Head of European Operations.

Mr Madelain: Michel Madelain, the Chief Operating Officer of Moody's.

Mr Prescott: Charles Prescott, Fitch Ratings, running financial institutions.

Mr Joynt: Stephen Joynt, I am the President and CEO of Fitch Ratings.

Q534 Chairman: Okay, thank you, and thanks for coming. The European Commission has stated, "It is commonly agreed that credit rating agencies contributed significantly to recent market turbulence." The charge levelled at you, at least in the press, is that you issued over-optimistic ratings and did not respond quickly enough to market developments. Is there legitimacy in that charge?

Mr Bell: We have all kind of acknowledged - certainly at S&P and I think my colleagues from the other firms would not disagree - that when you look at the ratings of the US sub-prime residential mortgage-backed securities and some of the CDOs that were backed out of the sub-prime, undoubtedly the assumptions we made about how those would perform in the future turned out not to be correct. There is no doubt about that.

Mr Madelain: I would just comment by saying that if I look at the financial institutions we rate about 2500 of those and if I look back over the last two years we had 18 defaults and 35 institutions that moved from investment grade to non-investment grade. I would like just to put those facts in front of you just to give some balance to the perception that may have been created by the sub-prime events in the United States.

Q535 Mr Todd: You probably have also read of people saying that you were attempting to rate instruments that you did not fully understand yourselves and that you went beyond your

capabilities, so it was not just that you got things wrong, you actually were not able to get it right because you did not have the ability to do so. Is that a criticism that you also buy?

Mr Bell: Personally and speaking for the structured finance group of S&P absolutely not. I personally was in structured finance since 1988, I used to in a previous life put these instruments together, I used to create these instruments in a law firm. I think you will find that my staff and myself have had decades of experience of this so, no, we do not believe that these instruments were themselves too complex in their structure to rate. That there is an inherent uncertainty about predicting how anything is going to behave in the future is undoubted, but in terms of the structures that we were rating, no, I do not believe that they were inherently too complex.

Q536 Mr Todd: So people like Willem Buiter who certainly said exactly that are wrong.

Mr Bell: I would have to disagree with Mr Buiter.

Q537 Mr Todd: I think when you were last here some of you certainly were keen to emphasise that a credit rating was only one piece of information which someone should use in understanding the risk of a particular business or product. Do you think that those who used your ratings grasped that?

Mr Joynt: Maybe I could address that. The ratings in many ways are reflective of the relative credit risk and not other risks that might be important to investors. The most notable ones today are liquidity risk, price volatility and price itself so our ratings can contribute to investors analysing that, they are not designed to precisely provide that information, certainly not alone, and it is very difficult to think about how those can be helpful in this volatile environment.

Q538 Mr Todd: My question was slightly different to that which was what do you think the users thought. I understand what you think they were for, but what do you think the users thought?

Mr Joynt: There are many types of users and it is quite complicated to answer that question. Many large, sophisticated institutional investors that we would meet would tell us that ratings are a helpful complement to them but they have their own analytical teams, their own staffs, including experts in duration analysis and interest rate risks. So many institutional investors, at least as they used the ratings in the past - today they also might be reflecting on whether they had capabilities - would say that they used the ratings only to a limited degree. Other investors may have relied on ratings to be all-encompassing, not reflecting as carefully on the risks that they did not cover.

Q539 Mr Todd: Do you think regulators were included in this perhaps over-reliance, just looking at your labels and saying that tells me all I need to know?

Mr Joynt: I think not. Most regulators - bank regulators certainly - we meet with often are sophisticated users of ratings and understand their limitations. In the United States insurance regulation is split up by State and so possibly they are not quite as sophisticated but the SEC and other regulators that have used ratings in regulation I think understand how the ratings are defined and how they should be used.

Mr Hancock: We would certainly endorse that. Certainly the UK FSA will spend a lot of time with us to get behind what the ratings are actually saying and, probably, as important as that to understand our thinking and our research on the various sectors that we are rating. I would think they are certainly expert users.

Q540 Mr Todd: Others will probably explore this but this comfort of the business model which indicates a reliance on someone who is seeking a rating for the funds to pay for your services, do you think that is properly understood by customers as being an area at least of indicated caution when they look at your products and what they tell you? Do you think people realise that?

Mr Madelain: Yes, I do. I think the model is well understood, well publicised and well known.

Q541 Mr Todd: It certainly is now, I agree, it is an area of criticism.

Mr Madelain: I did not say criticise, I said publicised.

Q542 Ms Keeble: Last time you came you described how you set about doing the ratings, and you, Ian, gave a particular example. I wonder if you would say what it is that triggers a downgrading and how you go about doing that.

Mr Bell: There is not a one size fits all, it depends whether you are looking at a structured product, whether you looking at a corporate, a government, a sovereign. There will be periodic reviews, the frequency of which will depend on the type of product that you are looking at. If the periodic reviews show that something has occurred, that there has been a deterioration - I am speaking for my business, other people around the table can speak for other assets - then we will investigate that deterioration, try to understand it and re-run our models to see how things pan out with the new re-run. At the same time there may be downgrades because the world has changed so even though the data in the pools show no deterioration we know that something has happened in the world. A classic situation is a downgrade on sovereign, for example, and then we may downgrade that too.

Q543 Ms Keeble: There was a discussion just now about one of the risk factors being price; presumably if you see the prices go down you will look and have a downgrade. There has been a suggestion that the process can become quite circular, both that you chase the prices down.

Mr Bell: No.

Q544 Ms Keeble: Or that you can help to drive prices down along with short selling. What do you say to that?

Mr Bell: We never downgrade as a result of a price decline. What we do is we look at the price decline because we realised that a lot of people in the market were looking at things, so if we see prices decline it is more of a note to the analysts saying "You know what, maybe this is something we should look into because clearly the market believes that something is happening here." It therefore draws our attention to a particular rating but we never downgrade because the price has gone down; it would only, as I said, be a flag.

Q545 Ms Keeble: With some of the figures around what happened with some of the Atlantic banks it looks very much as if your ratings changed to chase down what was happening with the banks, which makes you wonder what is the point of having a credit ratings agency that would, one would hope, be able to see in advance what the risks are.

Mr Hancock: It is an area that is discussed an awful lot. We need to be aware of what is happening to the prices and we have elaborate systems that our analysts have to analyse all the prices of the different products available in the market, but certainly as Ian points out it is not a trigger to change a rating and if you use the example of this week or the last couple of weeks of Barclays' share price, which has been up and down all over the place, we have not initiated a change in that rating driven

by that because we are looking at the intermediate and long term fundamentals of that business as opposed to the short term trading movements.

Q546 Ms Keeble: One of you, and I should have checked which one - one of the companies - suggested that there was going to be a downgrade of UK Government bonds.

Mr Hancock: Not us, we affirmed it two weeks ago.

Q547 Ms Keeble: Which one was it?

Mr Madelain: It was not us.

Q548 Ms Keeble: Who was it then because it was well-reported. It was reported in the Telegraph and it was quite widely discussed on the back of that. It was one unnamed person in one credit ratings agency and on the back of that there was all kinds of speculation, so somebody must have known. I mean, there are only three basic companies.

Mr Hancock: It is certainly not S&P, I am certain of that.

Mr Joynt: It is not Fitch.

Q549 Chairman: Can we look under the table?

Ms Keeble: That episode must have brought very firmly to your attention the impact that even this one unnamed person floating a rumour in the Telegraph and the consternation that that can cause. How carefully do you look or what do you do before you put out a downgrade in terms of looking at what the likely impact is going to be, basically on the real economy because there is really not much of a divide between financial services and the economy.

Chairman: Is that Jim Rogers you are talking about? If you remember Jim Rogers, the financier, he made a comment a couple of weeks ago.

Q550 Ms Keeble: No, there was one that was reported and I think Mr Fallon actually repeated it at Prime Minister's Questions, or somebody did anyway. If it was not you, somebody else did. Somebody did. There was also a question about regulation. Obviously because you work globally the arguments are that regulation has to be global. I wonder if somebody other than Barry or Ian would like to comment on that, as to where we are with that and how you would see that moving forward.

Mr Joynt: I would be happy to comment. I think the European environment is moving quite quickly through Mr McCreevy and his sponsorship of the European Parliament to try to reach a conclusion about a proposal about oversight for rating agencies. All the rating agencies have been involved in giving commentary about that and generally I believe that the issues that are being presented there in a way are almost like a constructor for the industry, nothing to do with being regulated. We ourselves, at least at Fitch, are implementing many of the procedures that are there or we have the procedures in place so I think we feel relatively constructive about what is happening with the proposals in Europe. We do not agree with every facet of it and some of the implementation will be costly and difficult, but we feel pretty good about that.

Q551 Ms Keeble: Can I just ask about timescales because things that work in Europe or globally can be very slow.

Mr Joynt: My understanding is that that is moving very quickly forward, that people are trying to reach a consensus in the European Community and have a proposal as soon as April.

Q552 Ms Keeble: April.

Mr Joynt: I believe that is the case. In the US it is a little bit different with the change in administration and the review of our regulator, the SEC, together with the review of rating agencies. Either relatively soon there will be a proposal put forward to think about regulation and how that can be more effective, or they need to study it further. On that I am not quite certain about the timing but we would hope that both those approaches can find a common way to oversee rating agencies so that we can operate as a global firm constructively.

Q553 John Mann: These are questions to Moody's and Fitch. Perhaps you could explain what went wrong January to September in your ratings for the Icelandic banks.

Mr Madelain: In January of 2008 we did place the ratings of the three Icelandic banks that we rate under review. We moved down the rating later in February, we published a research note on the Iceland banks at the beginning of March, flagging the weaknesses we saw in the system.

Q554 John Mann: A research note for whom?

Mr Madelain: To all the users of Moody's ratings. We actually positioned the Icelandic banking system at the time at a level that is comparable to the one of Panama or other systems that are effectively in terms of ranking at the fifth level in our ranking structure for banking systems, so we flagged the risks that were embedded into the Icelandic banking system. The ratings assigned to the bank were of a singular category and the reasons for assigning a singular rating to those banks, despite the fact that our assessment of the financial fundamentals were lower than that was that we incorporated in the rating an assumption of support by the Icelandic Government which actually we see coming for many countries throughout this crisis, which did not materialise and which led to the situation.

Q555 John Mann: But you could work that out, that was not too difficult to work out, was it?

Mr Madelain: That the Icelandic banks would not be supported?

Q556 John Mann: Yes, that they could not be by the government at the time to the level required.

Mr Madelain: That was not the view we had or the assumption we made.

Q557 John Mann: But that was the view of other commentators, was it not, in April and May? For example, the Scandinavian commentators and central banks.

Mr Madelain: That may be the case.

Q558 John Mann: May be?

Mr Madelain: It was not our view at the time.

Q559 John Mann: In March you got this report done. The rational local authority, what should they have done, based on your report in March?

Mr Madelain: I do not know what investment guidelines are applicable or know the decision process for investment by local authorities.

Q560 John Mann: You do not know.

Mr Madelain: I do not know.

Q561 John Mann: That is not going to be much comfort to local authorities or local authority taxpayers, is it? Is it worth having your service for a local authority?

Mr Madelain: The people using our service had in front of them our assessment of the banking system. There was a very clear explanation of the assumptions that were within our ratings including the level of support we had incorporated, State support, so investors who disagreed with our assessment, as the one you mentioned, could make the decision that effectively our ratings were incorporating a form of credit enhancement that was not justified.

Q562 John Mann: I have read your ratings over the period of time and I do not see what would signal, at that stage, anything happening. You are different though, are you not, you did a special report in May, if I recall

Mr Prescott: We had been warning about the Icelandic banks for some time.

Q563 John Mann: Sorry, for some time before you did your special report?

Mr Prescott: Since 2006. In April we put those banks on watch and in May we downgraded them and maintained two of them on watch and one of them on negative outlook.

Q564 John Mann: Why did you pick it up before April?

Mr Prescott: Our ratings were A-minus which is the lowest rating in the A range; we had been looking at these banks for some time and the issue with these banks was to do with wholesale banking and liquidity. There had been an improving situation over time so that had been taken into account, but clearly as the issues with banking got worse we felt that the negative sentiment that existed in the market had to be pointed out and so we brought out our report, we warned clearly that there was an issue with this and we felt that rating was appropriate at the time. It was only the collapse of Lehman that ---

Q565 John Mann: I have read your special report and, having read that, your special report would indicate that there were problems, it was very clear. To the layman it was very clear therefore; do people actually get to see these special reports or are they something that just is there in the ether in reality?

Mr Prescott: We place those special reports on our website and we do have subscribers to our service.

Q566 John Mann: But it is a special report. It seems to me that there is an issue here in terms of your report was pretty convincing to the lay reader but people did not pick it up - they either ignored it or they did not pick it up. You must put lots of reports out, lots of advice, lots of changes month in and month out; how do people pick up that it is a special report that needs particular attention? How do you highlight that?

Mr Prescott: I see what you mean.

Q567 John Mann: Looking back are there better ways in which you and others should be highlighting reports of that nature?

Mr Prescott: We certainly put it out as a special report but I see where you are coming from, whether people interpret that special report as something that they should read or not - it is up to them really. It is not a normal report, it is a special report.

John Mann: I get thousands of emails. If someone puts something in bold with a red exclamation mark alongside it then I am either going to immediately delete it because it is a nutcase or I am going to read it because it is important. There are ways in which you can highlight.

Q568 Chairman: Could you give us a quick answer, we are moving on?

Mr Prescott: There are ways we can think about how we could highlight that.

Q569 John Mann: Final question: is it the fault of those local authorities that they missed what was there or is it your fault that you were too slow in your credit ratings for them to pick up on what was happening?

Mr Prescott: My comment on that would be that we gave warning and that it was the consequences of Lehman and the market closing that caused the issue, so anyone who had read the report I think would have had ample warning.

Q570 Mr Fallon: It was the case, Mr Prescott, was it not, that you did not downgrade Kaupthing below A-minus until September?

Mr Prescott: That is correct.

Q571 Mr Fallon: Why was that?

Mr Prescott: Because we thought that A-minus was the appropriate rating. It was only when the collapse of Lehman changed the market and the market closed completely that these banks found themselves in difficulty obtaining liquidity.

Q572 Mr Fallon: At no point before September did it occur to you that the government of a population of 300,000 people would not be able to stand behind these three enormous banks in the lending they had done.

Mr Prescott: Our rating was based on the stand-alone rating of the entity, it had nothing to do with the government.

Q573 Mr Fallon: So you never considered the state of public finances in Iceland.

Mr Prescott: The way in which we were looking at the bank was on a stand-alone basis.

Q574 Mr Fallon: Mr Hancock, it is true, is it not, that back in November you did warn about the UK's credit rating, your Mr Frank Gill; is that the man?

Mr Hancock: He is indeed one of our staff members.

Q575 Mr Fallon: He warned that the UK might lose its top-notch credit rating, is that correct?

Mr Hancock: He said that, he said that to a journalist I believe. Subsequent to that, two weeks ago, we had a review of all the large triple-A economies and we affirmed the rating had a stable outlook.

Q576 Mr Fallon: What is it that would trigger a change in your credit rating of a sovereign country like the UK? Would it be if there was a series of uncovered gilt auctions or a new budget plan? What would trigger it?

Mr Hancock: In itself it is unlikely to be a single event. Our group of economists are looking at the long term debt burden, they would be looking at the growth prospects, they would be looking at a variety of other scenarios and indeed the structure of the economy in coming to that decision. Clearly, as I mentioned, when we affirmed the rating two weeks ago we had a very good look at all of the factors we look at and, given that this is an inquiry into the banking crisis, we also factor in a degree of support that the Government will provide on account of the banking system so we are actually adding in some contingent liabilities that might arise through the banking system stress. We add those into the rating and, based on all of that, we affirmed it two weeks ago with a stable outlook.

Q577 Mr Fallon: But your Mr Gill said "Nothing is forever, we are in the process of assessing whether the Government can reverse the damage that is about to be done to its balance sheet over the next three years."

Mr Hancock: Indeed and we did have our formal credit committee. Frank Gill is one of our members of the sovereign team but no decisions by rating agencies and certainly S&P are made by individuals alone. The committee met formally and affirmed the rating and left it on a stable outlook. The point I think he was making is that ratings are constantly reviewed and updated depending on the circumstances that are prevailing at the time.

Q578 Mr Fallon: How often do you look at it for a sovereign country?

Mr Hancock: We had a very thorough review of all of the major triple-As ---

Q579 Mr Fallon: You downgraded Spain, did you not?

Mr Hancock: We did indeed, and Greece, and we changed some outlooks on some other countries.

Q580 Mr Fallon: How often do you look at the UK figure?

Mr Hancock: We are looking at the ratings on an ongoing basis. If there were major shocks or changes we would look at the rating again, but at this point our best judgment is that the outlook for it is triple-A because we have actually said it is a stable outlook.

Chairman: You could maybe have helped us before because Sally feels a bit misled. She was asking you who made the comment and you saw her ---

Q581 Ms Keeble: I asked quite specifically because it was in the Daily Telegraph and on the Today programme which is what I was thinking of, but not in this report.

Mr Hancock: Frank's comments were many, many days ago.

Q582 Ms Keeble: When I asked you all denied flatly that it had happened, but you must have seen it had happened.

Mr Hancock: It was many weeks before the Daily Telegraph speculation of a week or two ago.

Chairman: It would be helpful to us if you were alert on that; it would have saved a bit of a problem there. Jim.

Q583 Jim Cousins: I just want to be clear about this because two things that are slightly contradictory have been said here. You have just said that when you are rating the bonds issued by a government you look at the underlying contingent liabilities.

Mr Hancock: Correct.

Q584 Jim Cousins: Which would include their exposure to the protection of their banking system. You do that as a matter of routine presumably.

Mr Hancock: Certainly. The issue of nationalisation is one that comes up often.

Q585 Jim Cousins: Sorry, how does the issue of nationalisation come up specifically?

Mr Hancock: Certainly there is speculation in the press and indeed the Chairman's comments in the FT have raised a lot of issues about the impact that nationalisation would have on the sovereign rating. Certainly at S&P our view is that nationalisation in itself does not increase the government debt burden; it may be a signal of some other issues but in itself we are looking at the banking system as a contingent liability as a part of our analysis. We certainly look at the amount of capital that may need to be injected into the banking systems, and that is a very important element of our analysis.

Q586 Jim Cousins: I just want to be clear about what you have just told us. Are you suggesting that an article our Chairman writes in the newspaper might affect the credit rating of the UK Government?

Mr Hancock: Absolutely not, I am just saying that obviously it created a lot of discussion which I am trying to respond to here to clarify our position.

Q587 Jim Cousins: I am sorry, I do want to explore this point because it is quite troubling in a way. You said that discussion of nationalisation of banking entities in a country would affect your rating of that country's bonds.

Mr Hancock: What I actually said was nationalisation in itself does not increase the government debt burden and in itself would not affect the sovereign rating. What might lead to a nationalisation may lead us to rethink our assessment of other factors, but in itself the government debt burden and the sovereign rating are not automatically impacted.

Q588 Jim Cousins: But our friends down the end of the line said you only looked at the entity, you did not look beyond it at these other factors that have just now been mentioned.

Mr Joynt: Yes, it depends how you are looking at the bank. Obviously as time has gone on and there have been lots of government schemes coming in, we now do bring support into our ratings for banks. This is nothing to do with the sovereign issue.

Mr Bell: You can think about it as looking at the credit of somebody who has got a guarantee. I am not saying banks were guaranteed but if you are looking at the credit of somebody who has a very powerful guarantor standing behind him you might give credit to that guarantor. If you have a very weak guarantor who is not really worth the money of the guarantee you would discount it, and I think in some cases you have got banking systems with very strong economies and very strong governments standing behind them; you would give more credit to the support of that strong economy and that strong government. In a situation where you have got very big banks with very weak governments standing behind them you do not incorporate much government support because you know it is not up to it. You would have to look at it in each case; it is not a one rule fits all.

John Mann: It is total nonsense.

Q589 Jim Cousins: Let us take the example of Iceland because it might be slightly more comfortable for us. Using that line of thinking surely you should have spotted that the Icelandic banks were at risk well before you did, using exactly that logic that has been set out to us.

Mr Hancock: In terms of Iceland we only rated one of the banks in Iceland and indeed we started warning about sovereign itself back in February 2005 due to the rising imbalances and currency risks from the leveraging of the banking system. We certainly took a somewhat different view; ratings are opinions and other agencies have different opinions.

Q590 Jim Cousins: That is not what you did. The other two outfits, you are quite clear that you did not do that exercise, looking at the background factors, you just looked at the entity itself, and if you had looked at those background factors - I have absolutely no idea what the Icelandic Parliament was doing in terms of looking at its banks, and the chairmen of its committees making statements - surely you would have come to a more pessimistic view of the Icelandic situation than at the time when you did.

Mr Prescott: That is why we had the warnings out, because we were aware of this. The sovereign rating of Iceland was A-plus so it was a reasonable rating at the time and we were not expecting the impact of the magnitude on the markets that the collapse of Lehman led to.

Q591 Jim Cousins: Are you anticipating any more banking collapses? Having missed out on Lehman's what is your rating of the possibility of another Lehman-style collapse somewhere in the world?

Mr Madelain: I would like to go back to what I said before at the outset.

Q592 Jim Cousins: I am sorry, I do not want you to go back to where you were at the outset, I want you to start from where we are now. You missed out on Lehman, what are the chances of another banking collapse?

Mr Madelain: Our ratings incorporate a number of assumptions including in a number of countries the availability of government support. We believe those assumptions are assumptions that are reasonable in the current environment and based on the facts we know; therefore we will have to see at the time to what extent these assumptions prove to be correct. I cannot today give you any assurance but we are developing opinion on the basis of central scenarios that we develop on the

situation of the banks, on the transient term of pricing in terms of availability of liquidity, in terms of availability of support, so there are a number of assumptions in the development of our ratings.

Q593 Sir Peter Viggers: In carrying out your assessment of the UK sovereign position what assumptions did you make about the obligations of Royal Bank of Scotland and are you certain that you had a robust assessment of the total commitment?

Mr Hancock: Standard & Poor's point of view on this - and I am very happy to supply you with all the material we have published on it - assumes that up to approximately 20% of GDP in the form of bank assets could be problematic in the future, and that is included in our analysis and the numbers for the sovereign, so approximately 20% of GDP by way of non-performing assets as a contingent liability.

Q594 Sir Peter Viggers: A completely different subject, moving forward now, a change in regulation. The European Commission put forward some quite sweeping proposals in November 2008. How are you responding to the probability of different regulation worldwide and how are you adjusting for this internally and externally? Can you very briefly just summarise your position on this?

Mr Joynt: As I mentioned earlier we follow carefully the proposals that they put forward as they have been moving around. Some of them are things that we do already, some of them are procedures that we want to strengthen in terms of identifying, and the management of, conflicts of interest in how we go about assigning ratings and deciding not our criteria or approach but the way they have asked us to look at the collection of information, and the transparency with which we present not just our rating but our analysis and our conclusion. I feel that we are moving forward, we are not waiting for someone to establish a new set of regulations for us to follow, we are responsive today to adjusting our process and our thinking to what we would anticipate in the main are reasonable proposals.

Q595 Sir Peter Viggers: Thank you, I have to ask you to be brief.

Mr Drevon: First of all I should say that as part of bringing back confidence in the system we think that the regulatory proposals which have been put forward are very important. It is one of the things which will bring back confidence in investors that there has been a change in the regulatory framework for rating agencies, so we have been in fact engaging with regulators in many different countries in a very organised and supportive way to have these changes made in an appropriate way. Clearly there are different regulatory initiatives around the world; they are not necessarily going to be done in a very consistent and co-ordinated way and I certainly think there is a risk that different proposals end up somewhat creating conflicts between different parts of the world and somewhat affecting the global nature of the markets. So as much as we can when we are speaking with regulators we are trying to put forward the idea that greater co-ordination is going to be needed as we move forward.

Q596 Sir Peter Viggers: Thank you. Standard & Poor's?

Mr Bell: Very similarly we welcome the regulatory proposals that are being put forward, we think they are an important part of re-establishing the credibility of our industry. We have worked very closely with the European Commission and Members of the European Parliament. The three things that we would emphasise in the regulation and the three things which we think are essential are that any regulation protects the independence and integrity of our opinions - and certainly some of the text of the European Commission in that respect is very positive - the second thing we think is very

important is that there should be global consistency. That does not mean one global regulator, and we have no particular view on how you achieve global consistency, but certainly one of the benefits of ratings is that they create a global benchmark and therefore if we had a European rating style, a Japanese rating style and a US rating style all operating in different ways with different rules and different procedures I think that would be very damaging for the industry. Some kind of global consistency, however it is achieved, is therefore very important we think. Finally, the regulatory scheme should be workable.

Q597 Mr Love: Let me just press you on that. One of the things that was said to us when we went to Europe was that the standard that was coming out of Europe was a good deal higher than that in America. How can we ensure that we do not disadvantage ourselves but achieve a reasonable standard of regulation for the industry?

Mr Bell: The most important thing is going to be consultation and dialogue between the major industrial powers and major financial centres in Japan, in Australia, Europe and the United States to come to standards. I do not think the various regulators are actually very far apart in the things that they would want to see from the agencies; it is more a question of making sure that there is dialogue.

Q598 Mr Love: Is the industry on board on this?

Mr Bell: The industry is absolutely on board on this.

Q599 Mr Love: You are not going to race for the lowest standard?

Mr Bell: The other agencies can speak for themselves but we are in Europe, we have no desire to leave Europe, it is a very important market for us and we are here for the duration.

Q600 Mr Love: One of the things that the European Commission has addressed, to the disappointment of some in recent comments, is the whole business model based on issuer- pays. There has been a lot of comment about this and that we should have an investor-pays type of model; from your perspective as the industry is talk about an investor-pays model realistic?

Mr Madelain: The key point here in my mind is that if the issue is about conflict there is conflict with every model. I am sure you are fully aware of the conflict inherent to an investor-pay model: people who short bonds or short stock have a keen interest in seeing a very aggressive downgrade; people who hold bonds have a very key stake in keeping the ratings stable, so nobody is out of conflict. If you go to a government organisation you will also have a similar conflict which will be linked to national interests, protecting their industries, competition against others, regulatory arbitrage - there may be different types of situations. The key to us is that we believe that the current model is the best model but it needs to be managed effectively and as we mentioned before we can do our share to give credibility to that model, but we believe that regulation as contemplated will effectively provide further assurance to the investors and to the other stakeholders that we are managing properly the conflict. That is the value we see in the introduction of this regulation.

Q601 Mr Love: Does anybody want to add to that?

Mr Bell: Just one thing about the investor-pays model, I think the circle that will not square with the investor-pays model is the transparency. What the issuer-pays model gives you is the capacity for us to put the ratings and the explanations and the analysis out for free for everybody to see - potential investors, putative investors, regulators, policy-makers. If you have an investor-pays model it is

difficult to see how that model works when anybody can get for free what another investor has to pay for. That is the big problem we see with the investor-pays models.

Mr Love: Finally, by sticking to the same model you are effectively saying to us that we have to depend on your assessment of your own reputation as the safeguard for getting it right. Can we do that? What additional regulation do we need so that in effect we do not end up just depending on you being worried about your reputation?

Q602 Chairman: Give us a quick answer, we are moving on.

Mr Madelain: Very quickly what I was trying to say is that effectively we would rely on regulation to give you that extra level of comfort independent of the regulator and compliance system that will come up and check that. The rules and the dependence that you are seeking are effectively in place in the organisation.

Q603 Mr Love: You are all happy with the European Commission's proposals.

Mr Bell: We have a lot of comments.

Q604 Nick Ainger: I want to direct these questions at the two representatives from Moody's. Your former managing director of credit policy who finished with you in August 2007 gave written evidence to the Committee on Oversight and Government Reform at the House of Representatives in October 2008 and part of his submission was: "My view is that a large part of the blame [about the failures of the credit rating agencies] can be placed on the inherent conflicts of interest found in the issuer-pays business model and rating shopping by issuers of structured securities. A drive to maintain or expand market share made the rating agencies willing participants in this shopping spree. It was also relatively easy for the major banks to play the agencies off one another because of the opacity of the structured transactions and the high potential fees earned by the winning agency." Do you agree that unless there is greater competition and more credit agencies Mr Fons's very critical analysis will actually continue?

Mr Madelain: First out I would state that I would disagree with the assessment of Mr Fons but the issue he raised is one we recognise and actually we have been very vocal on, which is that we view it as essential that the level of transparency that we have today on the corporate ratings side is available on the structured finance side, which means that we need to have a level of information available to all market participants which is equivalent to what we see when we rate corporate or when we rate local authority or government or financial institutions. Today that information is not publicly available, it is only available to the rating agency that rates the transaction or to a select group of market participants and we think that is something that needs to be changed. We have been very vocal on this issue, our CEO has made remarks on that and we have made a proposal and we think that that is an area where the regulators and the policy-makers need to step in and actually make that happen.

Q605 Nick Ainger: What about the issuer-pays business model, particularly in relation to derivatives, CDOs and so on?

Mr Madelain: That issue disappears as soon as the information becomes publicly available because when the information is publicly available, even if we are not retained as the rating agency and we want to express an opinion, we would be in a position to do that.

Q606 Nick Ainger: You believe that there is sufficient competition between the credit rating agencies to prevent a bank or an issuer of CDOs playing you off against another one and getting a better deal, in other words getting you to do the business but actually doing it at a lower rate.

Mr Madelain: If you make that information available to the public and either one of us or a new participant is in a position to express an opinion, even without a fee, that issue will be resolved.

Q607 Nick Ainger: Finally, can I move on to another contribution that was put to the Homeland Security and Government Affairs Committee of the Senate by Senator Carl Levin who I am well aware had done an awful lot of work in this area. Part of his submission was "Internal emails [these were within credit rating agencies] contained the following: 'Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both.' '[Our rating] model def[initely] does not capture half of the ... risk ... We should not be rating it.' '[Credit rating agency professionals are continually "pitched" by bankers, issuers, investors ... whose views can colour credit judgment.' 'Let's hope we are all wealthy and retired by the time this house of cards falters'." In the past year you have rated triple-A bonds which have now been re-categorised as junk bonds. We have heard the problems that local authorities have experienced because of their belief in the credit rating that you have given to certain institutions including the Icelandic banks. Bearing in mind the damage that has been done to your industry's reputation, do you worry about the future for the whole industry?

Mr Madelain: First of all these comments would not reflect at all the ethics and the work that are taking place within our organisation. Second, we are doing a number of things as we described to your Committee when we last came and we have done a lot of work to improve our processes and make them more robust. As I said before there are a number of things we believe we can achieve through the efforts we are deploying; we also believe that there is some improvement that has been delivered to third parties, including regulators, and we do believe that assuming those efforts take place we will be able to continue to provide value and help the market to recover.

Q608 Nick Ainger: You believe investors should trust you now.

Mr Madelain: That is correct.

Q609 Chairman: Thank you for your appearance. Could I just sum up what you have said? You accept that some assumptions made by CRAs, particularly regarding sub-prime markets and CDOs, turned out to be incorrect.

Mr Madelain: I would not. Personally I think this is a contraction of a very complex issue.

Q610 Chairman: Some of you would accept that proposition.

Mr Hancock: Yes.

Mr Joynt: Yes.

Q611 Chairman: Okay, some of you do, just one does not. You broadly welcome the moves from Europe and the US to revisit regulation of CRAs but hope to see global co-ordination in regulatory approaches, is that fair enough?

Mr Hancock: Yes.

Mr Joynt: That is correct.

Q612 Chairman: You believe that institutional investors and regulators are what you call "sophisticated users" of ratings who understand the limitations but accept that some investors continue to place undue reliance on ratings.

Mr Joynt: Yes.

Mr Madelain: I would dispute the second part.

Q613 Chairman: Some investors continue to ...

Mr Bell: We do not know whether some investors do. Certainly it would appear that some have in the past.

Q614 Chairman: Would that be a good investigative opportunity for you to find out about some investors?

Mr Bell: We try to speak to a lot of investors.

Q615 Chairman: If you are speaking to a lot of investors you must have some feedback on it.

Mr Bell: What we have found in the past is that the investors we speak to tend to be the sophisticated ones because they are the big ones, they are the people we know. It is harder to reach out ---

Q616 Chairman: Will you make it your job to speak to the unsophisticated ones?

Mr Bell: We try.

Q617 Chairman: So that we get a view on that. CRAs really should have recognised that even sophisticated users did not have time to look beyond the ratings; is that fair enough?

Mr Madelain: I think the level of resources that are deployed or were deployed in the institutions that were mentioned earlier today in this debate is very significant.

Q618 Chairman: You have no concerns about sophisticated investors at all in terms of their understanding.

Mr Madelain: Yes, they have the resources and the skills and the technology to understand.

Q619 Chairman: That is good for the public record. On Iceland, the points that were made earlier, the CRAs made assumptions that the government would and could stand behind the banks but this assumption proved incorrect and should have been known to be incorrect even without hindsight.

Mr Madelain: I dispute that.

Q620 Chairman: Did you make assumptions that the government could and would stand behind the banks?

Mr Madelain: We rated the banks incorporating an element of support, so there was an element in the credit side.

Q621 Chairman: Did some of you make assumptions that the government would and could stand behind the banks?

Mr Madelain: But that was only one element of the rating.

Q622 Chairman: But was that an assumption; that is what I am trying to get?

Mr Madelain: There was one element of assumption.

Q623 Chairman: So there was an assumption.

Mr Madelain: Yes.

Chairman: That is fine. Thanks very much for your time and maybe - maybe - we will see you again. Thank you.