FINANCIAL TIMES   Opinion Inside Business   Jonathan Ford   14 October 2019

Only prudence can keep bank accounts honest Relying on accounting standards to police provisioning is a vain hope

It is simple human nature. Bank bosses hate admitting to loan losses until they have to. They would rather hang on in the hope that an asset might magically make itself whole again than accept what is reasonably foreseeable, and take a painful accounting hit. This is why the rules governing the disclosure of these losses are so important.

Until the financial crisis, most of the weight was borne by an accounting standard that was by any measure lamentably vague. Indeed, so hazy was it that many banks took advantage of the laxity to apply a system known as "incurred loss" accounting. That meant only recognising loan losses when defaults actually rolled in. It led to the sort of nonsense that saw Bank of Ireland declare a clean set of profitable accounts just months before going cap in hand to the state for a bailout that ultimately ran to €5bn.

Asked years later in a parliamentary inquiry why they had signed off on the figures, allowing the bank to conceal billions of losses and sucker the public into depositing cash in a troubled institution, the auditors argued that the standard fulfilled the legal requirement for accounts to give a "true and fair" view. Indeed they went further, claiming that the accounting standards (or how they interpreted them) could not be deviated from. "If you don't apply them, you cannot say the accounts give a true and fair view," the auditors averred.

Of course lessons have since been learnt — sort of. We now have a reformed accounting standard (known in Europe as IFRS 9) that is being introduced this year, replacing the old duff approach. But is it really that much better? The new standard is clearly more complex. Banks must now make a provision when they make a loan, and each year review it, estimating what level of additional loss they expect to incur in the next 12 months. But this graduated scale still leads ineluctably towards a cliff edge when bankers perceive a loan has experienced a "significant increase in credit risk". Then they must provide against the lifetime losses of the loan. There is plenty of scope for mischief in this new arrangement.

For one thing, it leaves the banks with considerable influence over the size of the 12 month provisions that they take, as well as when to pull the trigger and establish provisions against foreseeable lifetime loss. To put the impact of 12 month and lifetime provisioning in context, it is like the difference between trimming your toenails and chopping off a foot.

Avoiding the same problem as last time, when banks delayed recognising lifetime losses until they were deluged in red ink, will not be easy. A recent letter from the UK's Prudential Regulation Authority to bank chief financial officers laments the lack of an agreed approach among lenders towards providing for future losses. Which means that while some bank executives may take a conservative approach, those that have less capital to start with — or riskier assets — might be tempted to look on the bright side to avoid cancelling bonuses and dividends, let alone having to raise capital afresh.

Recent reviews by the European Central Bank of certain banks' figures have seen the supervisor running a red pen through provisions arrived at by bosses and their bean-counters. For instance, First Investment Bank of Bulgaria had its equity capital ratio docked by no fewer than 11 percentage points, some (if not all) attributable to moving to the IFRS 9 standard. An extreme case perhaps, but a similar review of the Finnish bank Nordea also recorded a 1 percentage point deduction. So what is the way forward, if this new standard is unlikely to solve all the problems with the last one?

Well, one answer is simply to stop obsessing about tighter rules and ever more complex models. Instead, auditors should reconnect with the original purpose of their role, which is not simply to grind mechanically through rule-based accounting standards, but to provide assurance that companies' capital is not being abused by over-optimistic or fraudulent managers. Given their elevated leverage, banks are particularly prone to abuses of limited liability, where managers and equity holders in effect make off with depositors' funds.

The law says clearly that auditors (and directors) have an overriding duty to ensure the accounts present a "true and fair" view of a company's results. This means looking through complex rules and applying prudent judgment. As the Bank of Ireland case shows, the audit profession has sometimes sought to give accounting standards precedence over the law.

That attitude needs to be reversed if bank provisioning is to work better.

Prudence, not accounting standards, is the only way to keep bank accounts straight.