BRIEFING

The relationship between banking supervisors and banks' external auditors

Different roles

The stability of the banking system is a matter of public interest. Both banking supervisors and external auditors contribute to the trust that the public puts in the banking system, yet they have separate, to some extent complementary roles:

The role of the banking supervisor

The key objective of the banking supervisor is to establish confidence in the financial system, minimizing the risk of losses for depositors and other creditors. To that end, supervisors license the provision of banking activities, verify that a bank complies with laws and regulations, review a bank's organisational structures and the qualifications of its management, and last but not least assess that a bank is adequately equipped with capital to withstand the risks that lie in the nature of its business.

The role of a bank's external auditor

The external auditor's role, on the other hand, is to support the credibility of a bank's financial statements which provide an account of the bank's past performance and which were set up in the ultimate responsibility of the bank's management. The auditor's opinion does neither provide assurance on the future viability of a bank nor an opinion as to the efficiency or effectiveness with which the management has conducted the business affairs.

Exchange of information

Given that banking supervisors, concerned with the soundness of individual banks, and external auditors, concerned with the correctness of their financial statements, often look at the very same issues, it is evident that both parties can benefit from an exchange of information, even if they look at the same issues from a different point of view. Until now, however, such flow of information is typically unidirectional, as auditors are obliged to report certain issues to the supervisor but not the other way round; in future, supervisors and auditors shall establish a more effective dialogue.

Obligation to report serious issues

Given that external auditors may become aware of serious issues that banking supervisor should know about in the public interest, it is a long-established principle in the EU that external auditors of banks are obliged to report to the supervisor those facts or decisions which

- constitute a material breach of laws,
- affect the ability of a bank to continue as a going concern,
- or lead to a qualified audit report.

1 For a more detailed description of the different roles, see for example "The relationship between banking supervisors and banks' external auditors", published by the Bank for International Settlements in January 2002.

2 See, for example, Article 53 of Directive 2006/48/EC of 14 June 2006 on the taking up and pursuit of the business of credit institutions.
Establishment of an Effective Dialogue

The financial crisis was initially sparked by a severe misjudgement of risks in the banking sector; those risks might have been better anticipated and dealt with had there been a more effective dialogue between supervisors and external auditors.

One of the conclusions that the European Commission has drawn from the financial crisis was that those two parties should reinforce their dialogue to the benefit of both; a regular exchange of information, designed in a two-way process, is thought to improve things in that respect.

Consequently, the legal framework for statutory audits has recently been reformed; it now includes the provision that banking supervisors and auditors shall establish an Effective Dialogue, as set out in Article 12 of the Regulation (EU) No 537/2014.

The new Regulation makes clear in Article 12 (2) that the responsibility for establishing an effective dialogue rests with both parties. It furthermore stipulates in Article 12 (3) that an auditor's disclosure of information in the context of such a dialogue does not constitute a breach of any contractual or legal restriction on disclosure of information.

The practical modalities of such a dialogue are worked out by the European Banking Authority (EBA) which has recently launched a public consultation on related guidelines.

What are the prerequisites for such Effective Dialogue?

In a briefing paper provided for the European Parliament, Huizinga makes clear that a prerequisite for an Effective Dialogue is that the supervisor is able to recommend the resolution of failed banks without a need to resort to regulatory forbearance, including the acceptance of inflated financial reports. The introduction of bail-in as the main avenue to resolve failed banks hence offers the prospect of ending the need for regulatory forbearance, and of improving the quality of accounting data.

Other relationships

Supervisors regularly make use of information that is provided or that was reviewed by auditors. A recent study, commissioned by the ECON Committee of the European Parliament and drafted by Donato Masciandaro, summarises some more elements of their relationship, finding some notable differences in EU Member States:

First of all, in the majority of Member States (15 out of 26; for two Member States there was no information available) the banks' external auditors have to be approved by the national supervisor; the approval shall ensure that the banks' financial statements, an important source of information not only to investors and other market participants but also to the banking supervisors themselves, are reviewed by sufficiently skilled and experienced auditors.

The insight that external auditors gain through their work can obviously be useful source of information; however, as the study documents, the extent to which auditors may share information with supervisors differs in the EU (see Chart 1): While all of the banks' national supervisors in the EU receive a copy of the auditor's report on the financial statements, just more than half also receive a copy of the auditor's letter to the management of a bank, and even less than half receive copies of other information that the auditor sends to the bank's audit committee.

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4 Regulation (EU) No 537/2014 entered into force on 17 June 2014 yet is only applicable as of 17 June 2016.
5 See Harry Huizinga "An effective dialogue between supervisors and auditors – how can its implementation be monitored?", briefing paper provided in advance of a hearing of the Chair of the Single Supervisory Mechanism in ECON on 22 March 2016.
6 See Donato Masciandaro "Banking Supervision and External Auditors in the European Union" (September 2015).
The supervisor-auditor dialogue, which in future shall take place in all EU Member States, is currently practised on a regular basis in only 12 countries, while in 13 other countries it takes place on an exceptional basis; in 3 countries supervisors stated that until now no such dialogue exists.

Furthermore, the study shows that a regular (partial) delegation of supervisory tasks - as the most advanced form of cooperation - is a very rare case indeed (see Chart 2): 18 national supervisors stated that they would never delegate any supervisory tasks to external auditors, 6 supervisors delegate tasks on an exceptional basis, and a regular delegation of supervisory tasks is apparently practised in only 2 Member States (for 2 Member States there was no information available).

Source: Own calculation based on information provided in the Annex II of the study by Donato Masciandaro "Banking Supervision and External Auditors in the European Union"
Enforcement of accounting rules

Banks' financial statements are an important source of information; who is thus in charge to ensure the correct application of accounting rules and to clarify alleged accounting misstatements?

In line with the basic division of responsibilities set out above, the enforcement of accounting rules typically falls outside the remit of the prudential banking supervisor. Those banks whose shares and bonds are traded at a stock exchange in the EU have to mandatorily apply International Financial Reporting Standards (IFRS) accounting rules for their consolidated financial statements, like all other companies whose securities are traded in a regulated market. The correct application of IFRS then falls under the authority of the competent securities market regulator; in practical terms, the enforcement process takes different forms in the EU, as the competency is in some EU Member States assigned to the central bank, in others to specialised public authorities, and in a few countries all or part of the enforcement process is handled by government-appointed privately organised institutions. The European Securities and Markets Authority (ESMA) is mandated to foster supervisory convergence in that respect, and regularly reports on the progress made with the enforcement of accounting rules.

While the general assignment of responsibilities is straight forward, different views can of course lead to a bit of a turf war. Prior to assuming new banking supervisory responsibilities in 2014, for example, the ECB carried out the Comprehensive Assessment of 130 banks in the Euro area and reviewed the carrying values of their assets; the ECB published their results in an aggregate report, underlining that the results reflect the supervisory view and are only of prudential nature. However, in a number of banks the Comprehensive Assessment has also resulted in write-downs and other accounting adjustments, which shows that in practice the supervisor's view about the "correct" carrying values has de facto an impact on how assets are accounted for, blurring respective responsibilities.

Redrafting accounting rules

If set accounting rules turn out to produce misleading results or to have unintended consequences, they should be revised. In the context of the financial crisis, for example, the "incurred loss model" underlying current financial accounting rules was criticised for its delayed recognition of loan losses and blamed to produce procyclical effects; banking supervisors therefore called standard setters to change the respective financial accounting rules. Under new rules, set out in IFRS 9 that is applicable as of 1 January 2018, banks will move to the "expected loss model" which is thought to better reflect the credit quality of financial assets, addressing supervisors' concerns.

Those new rules for the accounting of loan losses will more closely align the accounting and the supervisory approach. However, supervisors and auditors have different roles and for that very reason their own approaches to accounting; a perfect alignment of how to account for certain issues may therefore be neither productive nor desirable.

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