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TREASURY AND CIVIL SERVICE COMMITTEE

BANKING SUPERVISION AND BCCI : INTERNATIONAL AND NATIONAL SUPERVISION

MEMORANDUM

By Price Waterhouse

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TREASURY AND CIVIL SERVICE COMMITTEE

Banking Supervision and BCCI: International and National Regulation

Memorandum submitted by Price Waterhouse in response to questions from the Committee.

5 February 1992

1 **The Governor of the Bank of England told the Committee that BCCI had been engaged in "massive and widespread fraud going back over a number of years." (Q2) If this was the case, why did it take so long for fraud to be discovered?**

The Governor of the Bank of England spoke of a "massive and widespread fraud going back over a number of years." In the draft s.41 report to the Bank of England, Price Waterhouse referred to "... a wholesale deception to misrepresent and falsify the financial position of BCCI over the last decade through a series of complicated manipulations."

These words reflected that the primary purpose of the deception was not to systematically steal BCCI's funds but, in fact, to disguise its poor operating performance and conceal its true financial position so as to create the illusion of a substantial bank with substantial assets and, until the mid 1980s, significant profits.

The motives of the perpetrators appear to have been far more complex than mere dishonest self-enrichment. BCCI grew from the initiative of its founder, Agha Hasan Abedi, whose vision was not to create just a profitable major international bank but an institution which encompassed the philosophies, aspirations and ambitions of the developing world. These ambitions appear to have been closely shared by BCCI's Middle Eastern shareholders whose enormous oil wealth was harnessed with a view to creating a banking institution of status, power and influence. Abedi's vision was also immensely attractive to many of BCCI's employees and clientele who shared his aspirations.

To these ends, it appears that in order to support BCCI's rapid growth, to conceal losses and to finance the increase in the group's overheads, a scheme of deception was developed in the early 1970s whereby BCCI brought in fictitious profits and inflated its own capital.

To achieve this, it utilised very substantial outside funds taken from a prominent shareholder, it failed to record as liabilities deposits which it had taken from a small number of wealthy customers and it created fictitious or non-recourse lending. Fictitious profits were produced by injecting these funds into BCCI disguised as profits arising from banking transactions. Losses were concealed by applying these outside funds to create the impression that payments were being made on loans which were in reality either bad or false. BCCI also

inflated its capital by financing the purchase of its own shares through nominees. In fact, by 1987 when Price Waterhouse assumed responsibility for co-ordinating the worldwide audit, the major part of the fraud had substantially occurred, although further fictitious transactions continued to be recorded to disguise and perpetuate the complex scheme of deception.

BCCI disguised this scheme of deception by many sophisticated means:

- the extensive use of external vehicles in the form of apparently independent corporate entities or bank accounts to route fund transfers and to "park" transactions;

- the misuse of the international banking system to enable funds to be transferred between BCCI and other entities in a way which made it impossible for the true nature of transactions to be identified. A substantial volume of such circuitous transactions was employed to create a wholly false impression of account activity;

- the collusion of major customers and other prominent individuals with BCCI management under which they produced false confirmations to the auditors confirming fictitious and non-recourse loans and acted as nominees for BCCI to enable it to acquire assets without disclosing its interests;

- the apparent collusion of certain other banks who granted loans to BCCI customers to assist the avoidance of disclosure of such lending on BCCI's balance sheet;

- the falsification of book entries and the creation of false supporting documentation;

- the creation by the perpetrators of a culture of confidentiality and unquestioning loyalty in order to command the support of many officers within the bank. It is now known that disaffected staff who threatened to reveal their knowledge were often silenced through the payment of substantial sums.

1 **(continued)**

The following factors also contributed to the length of time the scheme of manipulation continued:

- All significant executive power was concentrated in the hands of Abedi and his Chief Executive Officer, Swaleh Naqvi; their influence dominated both senior management and the Board. Until Price Waterhouse exposed him, Naqvi enjoyed the respect and engendered the confidence of all those who met him. He gave an appearance of sincerity and integrity and was a man of acknowledged competence with a remarkably detailed grasp of, and an unselfish dedication to, BCCI's affairs.

- The Board of directors, which included several experienced European bankers, gave credibility to BCCI's loan portfolio by approving the major problem loans, apparently placing reliance on their views of the customers' wealth and standing rather than requiring detailed analysis of the customers' financial positions.

- The rapid global expansion of the group and the enormous scale of daily banking transactions for its customers throughout the world enabled it to hide and spread improper transactions and added to the audit complexity. When Price Waterhouse assumed responsibility for the worldwide audit in 1987, BCCI's management information system did not adequately aggregate worldwide loan exposures. (Price Waterhouse started to gather this information so that the concentration of lending to major customers became apparent and was reported to the audit committee and Regulators.)

- The resources available to the Regulators in BCCI's main territories of incorporation - Luxembourg and Cayman - were not commensurate with the fast expanding worldwide operations of the group.

Discovery of the extent of the scheme was also delayed by the failure of representatives of the controlling shareholders to disclose to Price Waterhouse the contents of Naqvi's confessions to them in Abu Dhabi in or around April 1990.

The scheme of deception in BCCI was both sophisticated and complex; it was sustained by the availability and extensive use of substantial outside funds. Despite eight months of investigation by accountants and lawyers between November 1990 and June 1991, involving the review of many thousands of documents and files and the logging of tens of thousands of individual transactions in and around the BCCI group, and in excess of eighty interviews held with Naqvi and other BCCI personnel, the whole extent of the fraud could still not be determined; as Price Waterhouse stated in their draft s.41 report: "the true financial position of [BCCI] is unlikely to be able to be recreated."

The auditor's responsibility is to design and execute an audit so as to have reasonable expectation of detecting material misstatement in the financial statements whether due to fraud, irregularity or error. However, common sense dictates, and it is accepted internationally, that even the best planned and executed audit will not necessarily discover a sophisticated fraud, especially one where there is collusion at the highest level of management and with third parties. Under such circumstances, it is reasonable to expect that it may take a number of annual audits before accumulating concerns change to suspicions and ultimately lead to the identification of fraud; in fact, this is what happened in our audit of BCCI.

2 The Governor of the Bank of England told the Committee that "there was evidence of poor banking which emerged during the preparation by Price Waterhouse of the 1989 accounts." (Q1) When was widespread fraud first detected at BCCI by Price Waterhouse?

This question refers to "the preparation by Price Waterhouse of the 1989 accounts." It is, of course, the company which prepares annual accounts and not the auditor; the auditor's function is to audit these accounts and to report to shareholders.

As to the Governor's reference to "poor banking", our 1987 and 1988 audits revealed imprudent lending; during the 1989 audit we identified that, contrary to management's previous assurances, further lending had been permitted on the major customer accounts where the credit risk was already heavily concentrated. Additionally, around this time, Price Waterhouse identified certain loan transactions in a number of locations for which senior management were unable to provide adequate explanation. Price Waterhouse communicated concerns about these matters and their implications on the credibility of management to the Bank of England early in 1990.

Some evidence that false representations may have been made to Price Waterhouse was subsequently obtained when requests which we had sent to certain customers who in previous years had agreed their balances, were returned by the customers indicating disagreements but not making known their precise nature. It was also discovered that two small amounts drawn down on loan accounts in one country had been used to service an unrelated delinquent loan elsewhere, apparently to deceive Price Waterhouse into believing that the customer concerned was servicing the loan. As a consequence of further enquiries made in the light of these discoveries we also became concerned about transactions with a shareholder. We reported our concerns to the audit committee and, at our suggestion, an internal task force was set up to make further detailed enquiries. Price Waterhouse ensured that the Bank of England was kept informed of the development of these concerns by briefings during March and April 1990.

Price Waterhouse's report of 18 April 1990, provided to the Bank of England, described the extent of the problems as follows: "Our inquiries as confirmed by the task force have indicated that certain accounting transactions principally booked in Cayman and other offshore centres have been either false or deceitful. Whilst we and the task force have sought to identify all problem transactions, it is impossible, without an exhaustive inquiry, to know whether this has been achieved."

To remove this uncertainty and enable BCCI to finalise its accounts in accordance with the Institut Monetaire Luxembourgeois deadline of 30 April 1990, the Abu Dhabi Government, as the effective controlling shareholder, pledged that it would cover all the losses arising from these problem transactions which, until fully investigated, were not capable of quantification.

In September 1990, during a review of the developments on the major loan accounts, we learned that BCCI had concealed further lending of over US$500 million to its major customers by "parking" that lending with a Middle Eastern bank. It was said that this "parking" had continued with the knowledge and approval of the Board representative of the controlling shareholders. We were not provided with access to any documentation confirming this. We also learned that further significant loans might not be collectable.

Price Waterhouse's report dated 3 October 1990 provided to the Bank of England and College of Regulators stated that work on the major problem loans indicated that there had been: "significant transactions which we understand have been authorised by the representative of the controlling shareholders, although we have yet to see any documentation to this effect" and that: "On the basis of our discussions, we now believe that the previous management may have colluded with some of its major customers to misstate or disguise the underlying purpose of significant transactions. Whilst initial inquiries have been made about these accounts by the current management and the controlling shareholders, major uncertainties remain about their ultimate recoverability."

As to the extent of the fraud, the 3 October report stated that these transactions were unlikely to be capable of quantification until a detailed investigation had been conducted, but on the basis of some very broad assumptions, the financial support pledged by the Abu Dhabi Government to cover potential losses on these problem accounts was now estimated at US$1.5 billion not including a further $600million of loans for which the Abu Dhabi Government had already agreed to assume responsibility.

In a section dealing with developments on the major loans since the earlier report of 18 April 1990, Price Waterhouse stated: "These accounts are still operated on a day to day basis by former management whose conduct we have found to be unsatisfactory."

2 **(continued)**

At the meeting of the Board on 5 October 1990, following pressure from Price Waterhouse, the resignations of Abedi and Naqvi were secured. Nevertheless, Naqvi continued to be retained by BCCI as an "advisor" and worked in a suite of rooms in Abu Dhabi apparently with bank files. In November a detailed investigation was commenced and Price Waterhouse sought access to the rooms and the securing of the files. On obtaining access, we found a large quantity of files, some of which contained significant information previously withheld from us.

During December 1990 a preliminary review of these files was carried out. Initial interviews were then conducted with senior management and Naqvi to explain the emerging picture of fraud. This provided evidence of the creation of substantial fictitious loans and BCCI's collusion with customers to create borrowing which the customer was relieved of any responsibility to repay. Additionally, it was suggested that some of BCCI's customers had agreed to act as nominees for it in the control of outside companies. It also emerged that BCCI had failed to record deposits of nearly US$600 million from a small number of wealthy customers and may have made use of outside funds belonging to a shareholder to disguise losses and inflate its profits. We were advised that these matters had been known to the controlling shareholders since April 1990.

Price Waterhouse reported orally to the Bank of England during January and February 1991. There was a concern that the unrecorded customer deposits might not be genuine and that any report about investigations into them might become more widely known and prompt fictitious claims. In order to maintain secrecy it was agreed that Price Waterhouse should be instructed by the Bank of England under s.41 to investigate and report on this and any related matters.

Over the following months as part of extensive further investigations, Price Waterhouse sought access to certain related companies and bank accounts which we suspected may have been under the control of Abedi and Naqvi. When this access was finally obtained, further evidence of the way in which funds were circuitously routed around the banking system came to light. The results of the ongoing investigations were summarised in the draft s.41 report.

During this period we sought to corroborate details of the fraudulent flows of funds. This was an extremely onerous and painstaking task involving the review of many thousands of documents and files and in excess of eighty interviews with Naqvi and other BCCI personnel. It also involved the logging of tens of thousands of individual transactions in and around the BCCI group.

Even at the time that the draft s.41 report was delivered to the Bank of England on 22 June 1991 Price Waterhouse had significant unanswered questions and had been able to corroborate only certain of the fraudulent transactions and funds flows. We had seen enough to be sure that fraud on a significant scale had been committed and that it had involved a significant number of people both inside and outside the bank.

3 **What was the first date when the Bank of England asked Price Waterhouse whether they were satisfied that BCCI met the criteria for authorisation stipulated by the Banking Act? Would Price Waterhouse have given the same answer a year earlier?**

We have never been asked by the Bank of England whether we were satisfied that BCCI met the criteria for authorisation stipulated under the Banking Act.

In 1988 and 1989 we submitted to the College of Regulators and to the Bank of England various confidential reports (see question 10) on the results and operations of BCCI which included matters (eg as to concentrations of risk) which may have been relevant to the criteria for authorisation.

Separate reports were also submitted to the Bank of England on controls and prudential returns for the UK region.

As audit concerns increased there were frequent contacts between Price Waterhouse and Bank of England officials during which discussions about the directors and management took place.

4 According to an article in the Financial Times, Ernst & Whinney threatened to resign in 1986 if BCCI did not do "something about its management style and systems". (FT 15.11.91) Did Price Waterhouse share Ernst & Whinney's concerns at that time?

5 Until 1987, BCCI had two sets of auditors, Price Waterhouse and Ernst & Whinney. What were the circumstances surrounding Price Waterhouse's assumption of sole responsibility for the full audit?

The Financial Times article of 15 November 1991 included the statement that Ernst & Whinney ("E&W") "told Abedi that it would decline to be reappointed unless it was given the whole group to audit and BCCI did something about its management style and systems."

In fact, in April 1987, E&W subsequently modified this position and indicated by letter to BCCI that they were entirely willing to continue to act as BCCI group auditors provided that they were appointed as sole auditors to the group. Their letter stated that their continued involvement was no longer conditional on changes in management and reporting.

The concern over audit coverage arose because until 1987, E&W were the BCCI group auditors responsible for the consolidated accounts of BCCI Holdings, and were also auditors to BCCI SA and most BCCI group companies but they were not auditors to BCCI Overseas (registered in Cayman) and BCC (Emirates) (registered in Abu Dhabi) which were audited by Price Waterhouse firms. Those Price Waterhouse firms reported to E&W on their work, made available their working papers for review and discussed the results of their work with them. This is normal procedure in the audit of large groups. Approved auditing standards require primary auditors (E&W in this case) to accept full responsibility for the opinion on the group accounts. Price Waterhouse understood E&W's concerns at this time and similarly felt that the group audit could be more effectively and efficiently conducted by firms within the same international grouping.

In June 1986, Price Waterhouse were approached by one of BCCI's non executive directors who requested us to consider whether we would be prepared to take on the BCCI group audit. This was followed by a more formal request in 1987.

Price Waterhouse considered how it should respond to this invitation. At this stage Price Waterhouse were not aware of any matters that raised doubts about the integrity of management but were aware that BCCI's management and systems of control had not developed in line with the international growth of the group. However, the Board which included senior bankers of experience and expertise appeared to be committed to change.

We discussed privately our potential appointment as group auditors with the Bank of England who indicated that they were supportive of Price Waterhouse offering themselves as the sole auditor to the group.

Accordingly, Price Waterhouse wrote to the Board of BCCI in March 1987 confirming that it would be prepared to serve as BCCI's group auditors. The letter made clear Price Waterhouse's views on the way forward for the group, in particular its need to strengthen management, the necessity for a formal strategic plan, the need for more effective formal controls and for effective financial reporting with further disclosure and a greater degree of prudence in accounting matters.

The letter also identified Price Waterhouse's belief that BCCI needed to develop a close working relationship with the Regulators if it was to achieve its goal of becoming a leading international bank, and concluded that if the Board shared these views Price Waterhouse would be prepared to become group auditors.

As both Price Waterhouse and E&W had agreed to serve as group auditor, the Board of BCCI were faced with a choice between two leading firms of accountants. The Board chose Price Waterhouse.

6 Do you believe fraud would have been easier to detect if BCCI had always had a sole auditor?

For the reasons set out in the answer to question 1 above, in particular the ability of Abedi and Naqvi to misappropriate funds from outside sources and inject them into BCCI, we believe it would always have been difficult to detect the fraud. The absence of a "sole auditor" prior to 1987 may have contributed to the difficulties by hampering the auditors in gaining comprehensive knowledge of operations conducted in nearly seventy countries.

The appointment of a "sole auditor" (in fact audit firms which are part of a co-ordinated international network), with a common sense of purpose and integrated worldwide approach, does in our opinion lead to a more efficient and effective audit for most international groups of companies. In the case of an international bank this is particularly so because of the ease with which it can transfer funds around the world from one subsidiary or branch to another.

We believe that the appointment of Price Waterhouse in 1987 as auditors to BCCI Holdings (Luxembourg) SA and the majority of BCCI operations resulted in a more effective audit because of the following:

- The central audit team developed a good understanding of the worldwide operations of the group through a comprehensive programme of visits to principal operating units.

- Communication between auditors in about 70 countries in which BCCI operated improved because of their familiarity with each other and ability to make informal, telephone or fax contact at any time.

- Comprehensive group audit instructions were prepared in London and sent to all auditors. These instructions provided for uniform procedures including the submission of detailed memoranda in standard form.

- The central audit team developed systems to collate large credit exposure information which BCCI was unable to provide.

6 (continued)

- Issues arising from around the world requiring follow up with senior management were channelled through the central audit team in London. This facilitated the more concentrated pursuit of explanations and highlighted areas where complete answers or explanations were not forthcoming, and eventually led to the discovery of false or deceitful accounting and the obtaining of confessions from management.

7 **The Governor of the Bank of England spoke to the Committee of "around 6000 files and records which had been held personally by Mr Naqvi and previously absolutely concealed from Price Waterhouse." (Q2) When did Price Waterhouse first become aware of the existence of these files?**

Price Waterhouse first became aware of the existence of the records now known as the "Naqvi files" in November 1990.

Price Waterhouse's report to the directors of 3 October 1990 revealed that management may have colluded with some of BCCI's major customers to misstate or disguise the underlying purpose of significant transactions. Following this, the controlling shareholders of BCCI, under pressure from Price Waterhouse, agreed to a full investigation of the problem accounts and to enforce the resignations of Abedi and Naqvi as directors.

An Investigating Committee comprising representatives from Price Waterhouse, E&W Middle East Firm (who were auditors of the Abu Dhabi Government interests), two firms of lawyers and the Abu Dhabi Government was established in November 1990 to supervise the investigation into the problem accounts. Price Waterhouse were advised by senior BCCI management that Naqvi had been retained as an "advisor" to provide explanations to the Abu Dhabi Government and that they could not have access to files being used by him. Price Waterhouse made clear to the controlling shareholders that without access to Naqvi and the files he was using there could be no investigation.

Ultimately access was granted and we were shocked to find that Naqvi was holding around 6,000 files. After initial steps to secure the files, a preliminary review revealed that amongst them were details of transactions and agreements not previously disclosed to us despite management's prior assurances that they had provided all relevant information to Price Waterhouse.

The immense task of sorting, cataloguing and analysing the information contained in the files then began. The files formed the basis of a detailed investigation and together with the results of over eighty interviews with Naqvi and other BCCI personnel and the logging of tens of thousands of individual transactions, they enabled Price Waterhouse to draw together some of the pieces of the complex picture summarised in the draft s.41 report. Price Waterhouse have not had access to the files since the closure of the bank.

8 Is it now apparent that BCCI was regularly withholding information from Price Waterhouse? Was BCCI's management generally cooperative with Price Waterhouse?

It is now apparent that BCCI was regularly withholding information from Price Waterhouse and was also providing misleading information.

A section of Price Waterhouse's draft s.41 report was headed "Responsibility for and knowledge of the irregularities." That section made clear that it was apparent from our investigation work that the senior management of BCCI had abused their responsibilities to depositors, shareholders, investors and Regulators.

As we stated in that report, there is evidence that Naqvi was instrumental in account manipulations as far back as the late 1970's. Naqvi surrounded himself with a core team who were largely responsible for the falsification of documentation and account entries, and the routing of funds to disguise the true nature of transactions. Given the scale and complexity of the deception it was clear that most of the senior management of the bank were extremely loyal to Abedi and Naqvi and were or should have been aware of certain elements of the fraud.

BCCI's operating staff were generally courteous and co-operative but often they appeared to lack the necessary authority or initiative to provide readily and efficiently the information requested from them and frequently referred questions to more senior management. Price Waterhouse regarded this involvement of a number of people to discuss relatively minor issues as an inefficient use of management and audit time but understood it to be part of the cultural environment at BCCI and in part attributable to a perceived inadequacy of middle management.

With hindsight it now appears that Abedi and Naqvi developed a management culture based on unquestioning loyalty to BCCI even if this required staff to withhold, or provide misleading, information to outsiders. It is now known that disaffected staff who threatened to reveal their knowledge were often silenced through the payment of substantial sums.

9 Did banking secrecy laws abroad ever cause problems for Price Waterhouse while acting either as auditor or as reporting accountant for BCCI?

Generally, we do not believe that bank secrecy laws caused significant problems for Price Waterhouse while acting either as auditor or as reporting accountant for BCCI. One exception to this is in respect of BCCI's Swiss affiliate, whose auditors were precluded by Swiss secrecy laws from providing us with customer specific information.

In written reports submitted to the College of Regulators the names of certain customers who banked in offshore centres were coded. However, at meetings with Price Waterhouse, College members indicated that they were able to identify these customers and consequently we do not believe that this procedure created significant problems.

Although it does not stem directly from banking secrecy laws, there is an aspect of banking practice which does make it more difficult for auditors to detect improper transactions. This is the ability of banks to transfer funds through the international banking system in such a way that the identity of the original paying or receiving bank's customer is concealed. This facility was used in BCCI to conceal the circular routing of funds when fictitious loans were drawn down and reintroduced into BCCI disguised as the servicing of loans to unrelated customers. We attach a discussion paper on possible improvements in banking practices which might address this problem and help members of the Committee to understand the point at issue.

Since the closure of BCCI, banking secrecy laws have created significant difficulties for Price Waterhouse in providing information to investigators including the Serious Fraud Office and the Bingham Inquiry. In order to resolve some of these difficulties we took the initiative of commencing proceedings in the High Court seeking declarations as to our rights and obligations in relation to the confidential information in our possession. A copy of Mr Justice Millett's judgment in these proceedings has been given to the Clerk of the Committee.

Whilst the judgment of Mr Justice Millett has enabled Price Waterhouse to provide information to the Serious Fraud Office, the Bank of England and the Bingham Inquiry we continue to be inhibited by bank secrecy and confidentiality laws in the UK and other countries from responding to requests for information by other bodies, including the press. This has resulted in Price Waterhouse being unable to respond adequately to ill informed or unjustified criticism in the press.

10 **The Economic Secretary told the House that "there have been a number of reports in recent years relating to the financial condition of BCCI." (Official Report, 15/7/91,c81). How many of these reports were commissioned from Price Waterhouse?**

There have been nine separate reports by Price Waterhouse on BCCI's financial condition either commissioned by or provided to the Bank of England and/or College of Regulators to which we assume the question refers. They were as follows:

27 May 1988	:	Report on results and operations for the year ended 31 December 1987
18 November 1988	:	Interim report on results and operations
20 June 1989	:	Report on results and operations for the year ended 31 December 1988
17 November 1989	:	Interim report on results and operations
18 April 1990	:	Report to the directors
3 October 1990	:	Report to the audit committee
27 March 1991	:	Preliminary restructuring proposals
28 March 1991	:	Report to the directors
22 June 1991	:	Draft report under s.41 Banking Act 1987

These reports varied in length from 10 to over 100 pages and covered a wide range of topics including:

- Significant accounting and audit issues;
- Credit, including a commentary on major loans, and concentration of risk;
- Capital adequacy and regulatory matters.

From 1990 onwards they also dealt with problem loans and the levels of financial support required from the controlling shareholders.

In addition to the above, six reports were issued in relation to controls and banking returns of the UK branch network.

11 **Do you believe fraud might have been detected earlier if the Bank of England had had its own in-house investigations unit?**

We are not aware of any reason to believe that a Bank of England investigations unit would have detected the fraud earlier. Such a unit would not have had the cumulative background knowledge of the group or familiarity with the systems and controls that the external auditors had and which was vital in this case where numerous overseas locations were involved and a strongly co-ordinated approach to the work was required.

A Bank of England investigations unit might possibly have had access to confidential information obtained through their supervisory role or from information provided by other banking supervisors or from access to records maintained by other banks enabling them to corroborate transactions recorded in BCCI records. Paragraph 126 of Auditing Guideline 307 records the Bank of England's confirmation that it will take the initiative in reporting to auditors any matter it believes is of such importance that it could affect the way in which the auditors carry out their work or form their opinion. On the assumption that such communication takes place, the existing arrangements should mean that there is no advantage in the Bank of England conducting its own investigations.

12 **So far as banks are concerned, in addition to the audit of an institution carried out for shareholders, do you think there is a case for having a separate audit on behalf of the regulator?**

An audit of annual financial statements is designed to enable the auditor to report to shareholders whether the financial statements prepared by management show a true and fair view. It does not provide Regulators with detailed information about the specific financial position of each individual operating unit, the way the institution is run, the quality of its assets, the nature of its business, its customer profile, the adequacy of controls or compliance with banking and other regulations. In other words the requirements of Regulators go well beyond the scope of the audit report to shareholders.

The separate needs of the Regulators in the UK are already addressed by the Banking Act 1987 which under s.39 provides for regular reports by "reporting accountants". Such reports usually cover either accounting and internal control systems or the returns to the Bank of England used for prudential purposes, but the Bank of England can ask for any matter to be covered in respect of UK authorised institutions. Although the reporting mechanism requires the accountant to report to the authorised institution which, in turn, forwards the report to the Bank of England, it is the Bank of England that sets the scope of the report.

In practice, the reporting accountant is usually the authorised institution's auditor and there are significant advantages in this. Combining the role of reporting accountant and auditor allows the Regulator direct access to the auditor's cumulative knowledge of its client and allows the statutory and regulatory audit work to be combined, thus avoiding excessive expense.

It is the usual practice for the scope of the work under s.39 to be performed in accordance with a rotational plan so that each principal area of an institution's operations is covered in a 3-5 year cycle. Nonetheless, the existing legislation empowers the Bank of England to vary the scope of the work as it deems necessary. In the case of the BCCI group, the reports submitted to the College of Regulators for each of the years from 1987 covered most aspects of the group's activities.

In summary therefore we believe the existing UK legislation provides adequate mechanisms for the needs of the Bank of England in respect of UK authorised institutions.

13 **Price Waterhouse acted for BCCI as auditor, as reporting accountant under the terms of the 1987 Banking Act and as advisor on the various capital and management reconstructions of the group. Did this ever cause a conflict of interest for Price Waterhouse? Do you believe in future the roles of auditor and advisor should be separated?**

Following the appointment of Price Waterhouse by BCCI as group auditors in 1987, we were also appointed reporting accountants for the UK branch network by the Bank of England under the provisions of the Banking Act 1987. In late 1990 and early 1991, in addition to our audit role, we carried out an investigation into problem loans and advised on BCCI's restructuring plans. In March 1991 Price Waterhouse were also appointed by the Bank of England to report under s.41 of The Banking Act 1987. (BCCI was notified of this appointment by the Bank of England but it did not see a copy of our draft s.41 report.)

Whilst we acknowledge that a conflict of interest may appear to arise under the regulatory framework for auditing banks and financial institutions in the United Kingdom, auditors are accustomed to assuming the responsibility for reporting both to their client and the Regulators. We do not believe that the performance of separate roles for BCCI and as reporting accountant for the Bank of England affected our ability to report objectively to either.

In the normal course of reporting to the Bank of England, draft reports are discussed with management who require any criticism to be balanced with their own views. This was the case with Price Waterhouse's reports on BCCI in 1988 and 1989. Our 18 April 1990 and subsequent reports in contrast focused on the problem issues and were submitted directly to the Bank of England at the same time as they were provided to BCCI. This approach drew strong criticism from the directors who accused us of acting for the Regulators. Nevertheless, we continued to report in the manner we considered appropriate.

Our background knowledge of the group was important in carrying out the investigation role. For another firm to have attempted to do so without such knowledge would have led to inefficiencies and considerable delay, if indeed it would have been possible. Further we do not believe that it would have been possible to perform our audit role without being involved in the investigation and making an assessment on the implications of its findings on the financial position of the group; this would have been important for the Regulators, new management, shareholders and ourselves as auditors.

To give advice on restructuring it was necessary to have current knowledge of the financial position, the implications for the group of findings from the investigation and the requirements of the Regulators.

BCCI recognised and accepted the need for us to report to banking supervisors about our investigation work and this was specifically provided for in our letter of instruction. Once we were able to satisfy ourselves about the reliability, completeness and relevance of information obtained through our investigation role, we reported such information to the Bank of England.

In this case by performing these various roles we were ultimately able to establish the truth of the manipulations which had been perpetrated, communicate them to the shareholders and the banking supervisors and explore alternatives for restructuring. We believe that had we not been able to combine the various roles it may not have been possible for us to make so much progress in discovering the full extent of the fraud.

The reputation of Price Waterhouse is founded on the integrity, independence and objectivity of the partners and staff. We would not risk compromising our reputation in relation to the affairs of any one client.

14 **BCCI's report and accounts were never qualified. In Price Waterhouse's "Sandstorm" report of June 1991 for the Bank of England, it was stated that "disclosure of the full extent of the losses at this time would have jeopardised the very existence of the bank." Does this mean a bank's accounts can never be qualified for fear of prompting a run on the bank?**

The statement at the beginning of this question is incorrect. The audit report on the accounts of BCCI Holdings (Luxembourg) SA for the year ended 31 December 1988 contained a qualified opinion due to the uncertainty regarding the liabilities that might arise following legal proceedings in Tampa.

The words quoted from Price Waterhouse's draft s.41 report are used here entirely out of their proper context. They derive from Section 1.4 of that report which refers to Abedi and Naqvi's decision in the 1970s to commence their scheme of manipulation to cover losses arising on bad lending. The report states "They [ie Abedi and Naqvi] apparently believed that the disclosure of the full extent of losses at this time would have jeopardised the existence of the bank". It is not a reference to any audit opinion but to management not admitting to the true financial position.

Our audit reports on BCCI Holdings (Luxembourg) SA were prepared under International Auditing Guidelines. Under such guidelines, up to October 1989 there were two major categories of audit report qualification; qualifications arising from disagreement about some aspect of the accounts and qualifications arising from uncertainty about one or more of the amounts included in the accounts. Each of these categories can result in two forms of qualification according to the significance of the matter giving rise to the qualification. A disagreement that is fundamental to the financial statements will result in a statement that "the financial statements do not give a true and fair view ..." If the matter is not fundamental the opinion will contain the words "except for the failure to (eg provide for depreciation) the financial statements show a true and fair view ..." Similarly, in the case of uncertainties, if the uncertainty is very material, so as to affect the accounts fundamentally, the auditor may have to disclaim any opinion but if it is less material the opinion may be expressed as subject to any adjustment that may be required when the uncertainty is resolved.

Our audit report on the 1988 BCCI accounts contained a qualification about an uncertainty that was not regarded as fundamental and used the words "In our opinion, subject to the effects of such adjustments, if any, as might have been required, had the outcome of the uncertainty referred to in the previous paragraph been known, the consolidated accounts give a true and fair view of ....."

Qualified audit reports expressing disagreement can lead in the United Kingdom to legal proceedings against the directors for failure to comply with the requirements of the Companies Acts to prepare accounts which show a "true and fair view". Qualifications expressing disagreement are therefore relatively unusual because directors, if faced with a draft audit report expressing disagreement, will normally endeavour if possible to correct the accounts so as to remove the need for qualification. Depending upon the reason for the disagreement the view of a company by shareholders and others may or may not be significantly affected.

Audit reports qualified for uncertainty were more common. In the UK they would not normally justify legal action against directors if the uncertainties are not within their power to resolve, but, depending upon the perceived significance of the uncertainty, they may well influence the views of shareholders and others regarding the financial position of the company.

In October 1989 following a revision of International Auditing Guidelines, uncertainty was no longer a ground for a qualification. Instead, International Auditing Guidelines recommended the inclusion of a separate paragraph drawing attention to the appropriate note in the financial statements where the uncertainty is more extensively discussed.

The effect of a qualified audit report is likely to be greater in the case of a bank than, for example, in the case of manufacturing company. Customers of banks will often be able to call for the repayment of their deposits and transfer them to other banks at short notice if their confidence in a bank is undermined. The ease with which customers can withdraw funds makes banks very vulnerable to a "run" following publication, or even rumours, of bad news. If it cannot be controlled, a run may cause a bank to have to realise assets under conditions of urgency in order to pay the depositors. Such a situation may lead to the collapse of the bank itself.

When considering the wording of an audit report on the accounts of a bank, auditors therefore owe a duty to shareholders to consider very carefully the possible impact of their report. A carelessly worded report which precipitated rumours which led to a "run" on a bank and led to its closure with substantial losses would, with good cause, be criticised if it subsequently became apparent that steps had been taken to protect the bank's capital base such that closure would not have been justified if the "run" had not occurred. The need to exercise exceptional care before issuing a qualified audit report in the special case of a bank is recognised in many jurisdictions and by the Banking Act 1987 which, by Section 46(2), requires auditors to notify the Bank of England in advance if they intend to qualify their audit report on the accounts of a bank.

If circumstances arise that cause auditors to consider the need for a qualification in their audit report there will almost certainly be tri-partite discussions involving the Board of directors, the Bank of England and the auditors. If the Bank of England concludes that withdrawal of the banking licence is not justified because adequate steps are being taken to deal with the problem, it becomes necessary for the Board to develop an appropriate form of disclosure in the financial statements which adequately describes the circumstances and arrangements being made. If adequate disclosures are made, the grounds for qualification of the auditors' opinion may no longer exist.

The circumstances existing in the last week of April 1990, when Price Waterhouse had to decide on the form of report on the accounts of BCCI for the year ended 31 December 1989, were extremely complex as there was material uncertainty about the recoverability of significant loans and advances shown in the balance sheet. Significant matters taken into account included the following:-

- the Abu Dhabi Government had given a commitment to indemnify BCCI against loss either by taking over balances at no loss to BCCI or by contributing equivalent funds to make good any losses incurred on the loans and advances in question;

- the Government of Abu Dhabi and related institutions had taken a controlling (over 77%) interest in BCCI and stated their intention to make further share acquisitions and to reorganise and restructure BCCI.

- the Bank of England and the Institut Monetaire Luxembourgeois had been informed of all the uncertainties known to Price Waterhouse and of the financial support commitment by the Government of Abu Dhabi and had decided to allow BCCI to continue to operate;

- whilst evidence of certain false and deceitful transactions had been discovered we believed the extent of these transactions to be limited to a small number of specific situations;

- the individuals in management who were thought to have been responsible were to be removed;

After very careful consideration of all the circumstances and discussion with the Bank of England, we decided to report as follows:-

"Report of the Auditors to the Shareholders of BCCI Holdings (Luxembourg) SA

We have audited the consolidated accounts of BCCI Holdings (Luxembourg) SA on pages 28 to 40 in accordance with International Auditing Guidelines. These accounts have been drawn up on the basis described in note 1.

In our opinion, the consolidated accounts give a true and fair view of the financial position of the group at December 31, 1989 and the results of its operations and changes in financial position for the year then ended in accordance with International Accounting Standards."

Note 1, referred to in our audit report, included the following:

"Basis of Preparation: Since December 31, 1989 the Government of Abu Dhabi has subscribed US$400 million for new shares and acquired a major holding from an existing shareholder such that together with related institutions they now hold over 77% of the share capital of the holding company.

They have advised the directors of their intention to maintain the group's capital base whilst the reorganisation and restructuring necessary for its continued development is undertaken."

... "The loan loss provision is based on management's review of the loan portfolio having regard to the proposed restructuring referred to above."

In addition the accounts themselves showed:

(i) a loan loss provision charge of US$600 million

(ii) a loss for year of US$498 million

(iii) a reduction in shareholders equity from US$886 million at 31 December 1988 to US$424 million at 31 December 1989

We believed at the time, and still firmly believe, that in the light of the above disclosures our audit report on the 1989 accounts of BCCI was appropriately worded to recognise all of the circumstances.

15 **The 1987 Banking Act grants an auditor or reporting accountant the right to share concerns with the Bank of England, without breaching their duty of confidentiality, to a client. Should the 1987 Banking Act be revised to make it a legal duty to confer with the Bank? Would this have changed anything in the case of BCCI?**

S.47(5) Banking Act 1987 empowers the Treasury to issue statutory regulations governing the circumstances when an accountant has a professional duty to communicate with the Bank of England if it is not satisfied that the guidance issued to accountants by their relevant professional bodies is sufficient. To date, the Treasury has not felt it necessary to issue such regulations.

The guidance of the Institute of Chartered Accountants in England and Wales governing the relationship between auditors and the Bank of England is set out in the Auditing Guideline No.307 "Banks in the United Kingdom". This Guideline takes account of the provisions of the Banking Act 1987 and the Bank of England's own guidance notes setting out its interpretation of certain parts of the Act.

Paragraphs 171-191 of the Guideline address the question of "Ad hoc" reporting and, in the Guideline's own words, "have been prepared to assist auditors and reporting accountants in understanding the circumstances in which they should take the initiative in bringing important matters to the attention of the Bank of England."

The Guideline goes on to describe the procedures an auditor should follow when he believes a matter should be reported to the Bank of England. In most circumstances, this reporting will be done through his client, either by the client reporting the matter himself or through an ad hoc tripartite meeting. In exceptional circumstances, as outlined in paragraphs 184 and 185, the Guideline requires an auditor to report directly to the Bank of England. To enable him to make such a direct report, the auditor is given an exemption from his duty of client confidentiality by s.47 of the Banking Act 1987. In our experience, the Auditing Guideline is clear and the guidance has worked well in practice.

We do not believe, therefore, that it is necessary to impose a legal duty on auditors to confer with the Bank of England as the existing self-regulatory standards of the accounting profession provide a satisfactory framework for such discussions.

15 (continued)

In the specific case of BCCI we fully exercised our rights under s.47 and first approached the Bank of England with our concerns about senior management in early 1990. From that time we had a regular dialogue with the Bank.

We do not believe that the existence of a legal rather than a professional duty to communicate matters of concern to the Bank of England would have changed any of the events or circumstances in the case of BCCI.

16 **In the light of the BCCI case, would Price Waterhouse have any recommendations for the reform of the 1987 Banking Act? What lessons do the circumstances of BCCI teach that the Committee should consider in its inquiry?**

We have not at this stage answered this question as to do so would require extended consideration of the many complex issues arising. In the limited time available to us since the questions were submitted, we have concentrated on responding to your other questions relating principally to the specific facts in the case of BCCI. The circumstances of the collapse of BCCI do raise a number of questions about banking regulation, particularly as it was a major multi-national group which lacked a home base and a strong lead regulator.

We have agreed with the secretary of your committee that we shall respond to this question in further detail as soon as possible.

FUNDS TRANSFER

DISCUSSION PAPER ON POSSIBLE CONTROLS TO PREVENT THE MISUSE OF THE BANKING SYSTEM

From a number of recent well publicised examples, it is apparent that the banking system is open to abuse by customers for the movement of funds for illegal or improper purposes. This can take the form of the improper operation of an account within a bank or on a larger scale by the improper transfer of funds through the international banking system involving passing of funds through nostro accounts at one or more correspondent banks.

In most cases the banks concerned will only be reacting to counterparty instructions and consequently may not expect to identify or prevent such abuse. Nevertheless, their unwitting involvement can lead to adverse publicity or, in more extreme cases, to regulatory recriminations or the seizure of assets.

There are some basic procedures which we should press our client banks to adopt to help prevent such transactions passing through their books. These procedures, whose performance should be closely monitored by the internal audit division, can be summarised as follows:

Correspondent banking (operation of nostro/vostro accounts)

- All counterparty banks for whom nostro/vostro accounts are operated should be thoroughly vetted and a clear understanding of the anticipated volumes and values of transaction throughput obtained. This should be regularly updated and liaison officers should be appointed to develop a good understanding of the activities of the counterparty. The account terms should specify due diligence procedures to be adopted by the counterparty to ensure that the account is not abused.

- All instructions for transactions to be cleared through the account should identify:

  The paying bank

  The paying bank's customer (preferably by name, or in a limited number of cases where there may be numbered accounts - by customer account number)

  The receiving bank

  The receiving bank's customer (preferably by name, or in a limited number of cases where there may be numbered accounts - by customer account number)

  The suppression of any one of these pieces of information, or the use of unusual endorsements on the payment instructions such as "pay without mentioning our name" or "pay without mentioning customer's name" should lead to enquiry and should place the payment department on notice so that the liaison officer can be advised to follow up this point with the counterparty bank concerned.

- Account throughput, both in terms of volume and value of transactions should be monitored and explanations sought for unusual fluctuations or large and unusual items.

- Unusual patterns in fund transfers should be identified, particularly where significant transfers take place between sensitive countries or customers. Explanations for these should be sought from the counterparty as appropriate.

- Authority limits for funds transfer should be established commensurate with the anticipated throughput of each counterparty so that higher authority is sought for unusual fund transfer instructions (both receipts and payments).

Paying Bank

- Payment instructions to correspondent banks should clearly identify:

  The account from which the funds have been drawn

  The name of the receiving bank and the customer name or account number to be credited

- In addition to normal authorisation routines, payment instructions from customers should be reviewed so that transactions which are abnormal to the customer's usual business pattern can be identified for special approval and for follow up. (For example, internal procedures should be in place to raise a query if a customer who has a chequing account with a small monthly turnover receives and pays a one-off amount substantially in excess of this.)

Receiving bank

- Funds received into a bank should be supported by a statement showing the the bank and customer name/account number from which the funds originated and the customer/account number for whom the funds are intended.

- Customer accounts should be monitored so that large or unusual items received into an account can be reviewed with the customer to ensure that all such transactions are understood by the bank's staff.

General

- All transactions should be recorded in the bank's ledgers - even if they represent same-day inflows and outflows of funds. Failure to do so could enable improper transactions to otherwise be ignored.

- Effective procedures should be in place for identifying and notifying possible money laundering (eg drug trafficking offences).

- Proper compliance procedures should exist for the receipt of substantial cash deposits.

Whilst the above procedures will not prevent the abuse of the banking system, they represent good housekeeping techniques which could help prevent criticism if a customer has contrived to use the bank for the illegal or fraudulent movement of funds.

SJC
2 January 1992