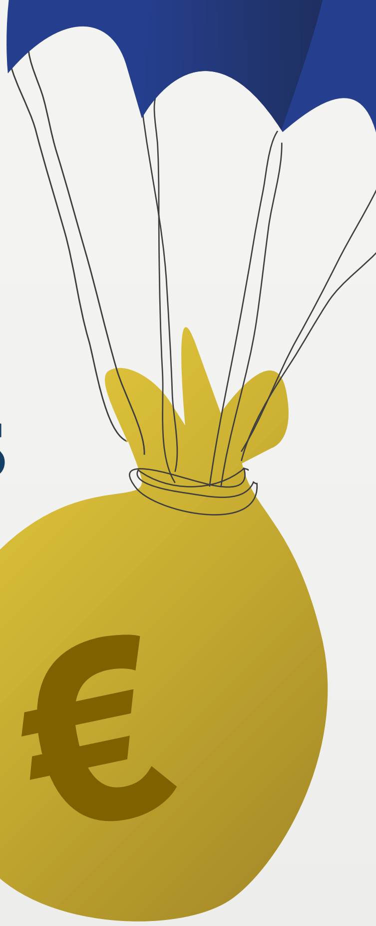
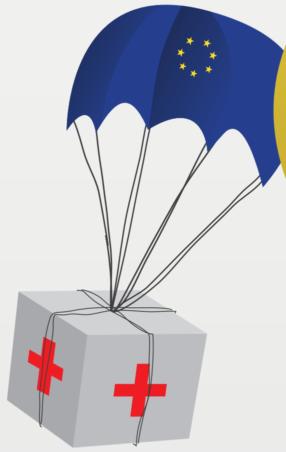
ISSUE BRIEF

The Bail Out Business

Who profits from bank rescues in the EU?

Sol Trumbo Vila and Matthijs Peters





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AUTHOR: Sol Trumbo Vila and Matthijs Peters

EDITORS: Denis Burke

DESIGN: Brigitte Vos

GRAPHS AND INFOGRAPHICS: Karen Paalman

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Executive Summary

Since the 2008 financial crisis, European citizens have grown accustomed to the idea that public money can be used to rescue financial institutions from bankruptcy. Between 2008-2015, European Union (EU) member states, with the approval and encouragement of EU institutions, have spent €747 billion on different forms of rescue packages or bail outs (like recapitalisations or other measures to provide liquidity), plus another €1,188 billion made available in guarantees on liabilities.

Up to October 2016, **€213 billion** of taxpayers' money – equivalent to the GDP of Finland and Luxembourg – has been permanently lost as a result of the various rescue packages. Despite this sizeable and growing number, bail out packages have a further hidden cost: the massive fees charged by financial experts for giving advice to governments and EU institutions about how to rescue the banks.

Following our analysis of the wave of privatisation programmes precipitated by the economic crisis in the EU in *Privatising Europe* (2013), and our investigation into the corporations pushing for and benefiting from Europe's privatisation schemes in *The Privatising Industry in Europe* (2016), this Transnational Institute (TNI) report exposes the private companies that have made huge profits from the bail out packages implemented in the EU at the expense of taxpayers.

The bail out business is made up of firstly the audit firms that audited the banks before the crisis and who have continued to service them after the crisis (dominated by the so-called Big Four: EY, KMPG, Deloitte and PWC). As well as providing auditing services, many of these firms also provided financial advice to the same banks. Secondly, it includes financial consultancy firms that assessed the banking sector's financial state and risks for both debtor governments and the European Commission and have also advised on how to structure and carry out the bail out programmes (such as Lazard, Rothschild, Oliver Wyman, BlackRock and Marsh and McLennan).

The Bail Out Business in the EU report shows that:

- **Bail outs in the EU have a hidden cost for taxpayers. Contracts worth hundreds of millions of euro have been given to financial consultants to advise member states and EU institutions on how to rescue failed banks.**

- **The Big Four audit firms (EY, Deloitte, KPMG and PWC), which operate as a *de facto* oligopoly, together with a small coterie of financial advisory firms, have designed the most important rescue packages.** Combined with their roles as consultants and auditors, the concentration of this work in just a few firms often leads to conflicts of interest. In cases where the bail out consultants gave poor or inaccurate advice on the allocation of state aid there have been few consequences, even when state losses actually increased as a result. Bail out consultants have often been rewarded with new contracts despite their repeated failures.

- **The firms responsible for assuring investors and regulators that EU banks were stable, the Big Four audit firms, maintain their market dominance despite grave failures in their assessment of the EU banking sector's lending risks.** Failed banks were systematically audited by one of the Big Four before being rescued. In every case, another Big Four firm took over the audit of the saved bank. Up to June 2016, the Big Four also provided non-auditing services to their clients, leading to repeated conflicts of interest, which have so far had little or no legal consequence. The Big Four are still receiving massive contracts from EU member states and institutions for advisory and auditing work.

- **Current EU legislation does not tackle the influence of the Bail Out Business.** New audit regulations tackle the worst practices and conflicts of interest of the Big Four: the provision of advisory and auditing services to the same clients. However, such regulations do not tackle the dependency of governments and EU institutions on the Big Four. The effectiveness of the Banking Union in reducing the burden of future bail outs on taxpayers remains to be seen. However, it institutionalises the use of taxpayers' money to save failed banks upon the decision of the European Central Bank (ECB). This centralisation is likely to deepen further the influence of the Bail Out Business as a result of the ECB's practice of outsourcing its mandated supervisory activities.

Introduction

Finance and banking are complex and constantly evolving industries. Despite, or perhaps, because of this complexity, ordinary citizens are increasingly dependent on these industries. In the EU today, it is not possible to receive a salary or a pension, set up a business, pay taxes or access housing (rent or mortgage) without a bank account. The global connectivity of the finance and banking industry is profound. Basic financial products like credit cards are now linked to a vast web of financial instruments that are bought and sold all over the world several times a day.

Since the 1990s, as a result of liberalisation, growing financialisation and the rapid expansion of EU banks into other countries, the size of the financial sector measured as bank-credit to GDP has more than doubled in the EU. The total assets of the EU banking sector amounted to 274 percent of the EU's GDP in 2013. By contrast, US banks' assets added up to 83 percent of the GDP.[1] The increase in the size of the industry coincided with the concentration of capital in a few major banks, elevating them to the status of 'too big to fail' after the 2008 financial crisis (now labelled 'systemically important financial institutions' by regulators). The size of the financial sector explains the long-lasting effects of the 2008 financial crisis on the global economy. The Great Recession has left its mark all over the EU. The need to urgently tackle a financial crisis which threatened to 'collapse' the entire economy has seen economic policy reform in the EU implemented at an unprecedented speed.

To prevent this economic collapse, national governments and EU institutions approved a series of bail out programmes or rescue packages for struggling banks and other financial institutions. According to the European Commission (EC), almost €747 billion euro was injected into different forms of rescue packages (such as recapitalisation, nationalisation or other measures to provide liquidity) up until 2015,[2] plus €1.188 billion in guarantees on liabilities. As governments try to dispose of their shares in nationalised and recapitalised banks, they often receive a mere fraction of what they initially paid. Support for financial institutions during the crisis led to an irrecoverable loss of €213 billion, the equivalent of the GDP of Finland and Luxembourg combined, suffered by the 28 EU member states up until 2015, and this figure is still increasing. The recent €8 billion bail out of the Italian bank Monte dei Paschi di Siena[3] is just the latest instance of a public institution coming to the rescue of a failed bank. The common result is a loss of taxpayers' money. The costs of the bail out programmes have mostly been financed by the issuance of public debt, which became unbearable for several EU countries – Greece, Ireland, Portugal and Spain – leading them to request aid from the other EU member states and to sign agreements with the Troika.[1] Such agreements led to vast privatisation programmes, as discussed in TNI's *Privatising Europe* (2013) report.[4] The scope of these privatisation programmes resulted in a flourishing *privatising industry in Europe*. A small coterie of financial, audit and law firms benefited enormously from the privatisation programmes, and conflicts of interest and corruption were rife, as explained in TNI´s *The Privatising Industry in Europe* (2016) report.[5]

1 In the context of the EU financial and debt crises, the Troika is composed of the European Commission, the International Monetary Fund and the European Central Bank.

Building on these findings, we decided to scrutinise those firms involved in the numerous EU bail out programmes and found a similar pattern: a hidden cost in the rescue packages remains largely unknown. Lucrative advisory contracts were awarded to a small group of firms – the global audit companies, known as the Big Four, a handful of financial consultancy firms (like Lazard, which has also been very active in privatisation programmes) and the advisory branches of the world's major hedge funds, like BlackRock. Their services alone have cost hundreds of millions of euro. Many of the same companies provided expensive consultancy services to banks that later needed costly rescue packages. These firms have been rewarded with new business, despite the fact that many gave poor advice and failed to raise the alarm about inconsistent business models and risky practices. They are now considered as leading 'experts' on bailing out failed banks. They advise governments and EU institutions, notably the new central authority responsible for bail outs, the European Central Bank (ECB). Together they are the Bail Out Business in the EU.

The Bail Out Business in the EU

The Bail Out Business in the EU operates as an oligopoly. After eight years of the financial crisis, the central role these actors hold in the finance sector (and therefore in the economy as a whole) has not been reduced but continues to expand. EU institutions and member states are highly dependent on the private banking sector for basic arrangements, including the payment of salaries, pensions, unemployment benefits or collecting taxes. When a bank runs into trouble – which continues to happen due to political and economic uncertainty – and expedited action is required, the Bail Out Business is often the only option. This leads to an immediate problem as the case studies below will show. Poor advice that leads to further losses to taxpayers is often rewarded with new contracts in other EU countries, as was the case with the consultancy firm Lazard, despite the ill-informed advice to the Dutch government costing billions of euro, as explained later in this report. Thanks to civil society groups and dedicated journalists, several scandals at the national level have been revealed, exposing some of the most flagrant malpractices and conflicts of interest; for example, Deloitte, which prepared accounts for the Spanish bank Bankia and then later provided auditing services to the bank.

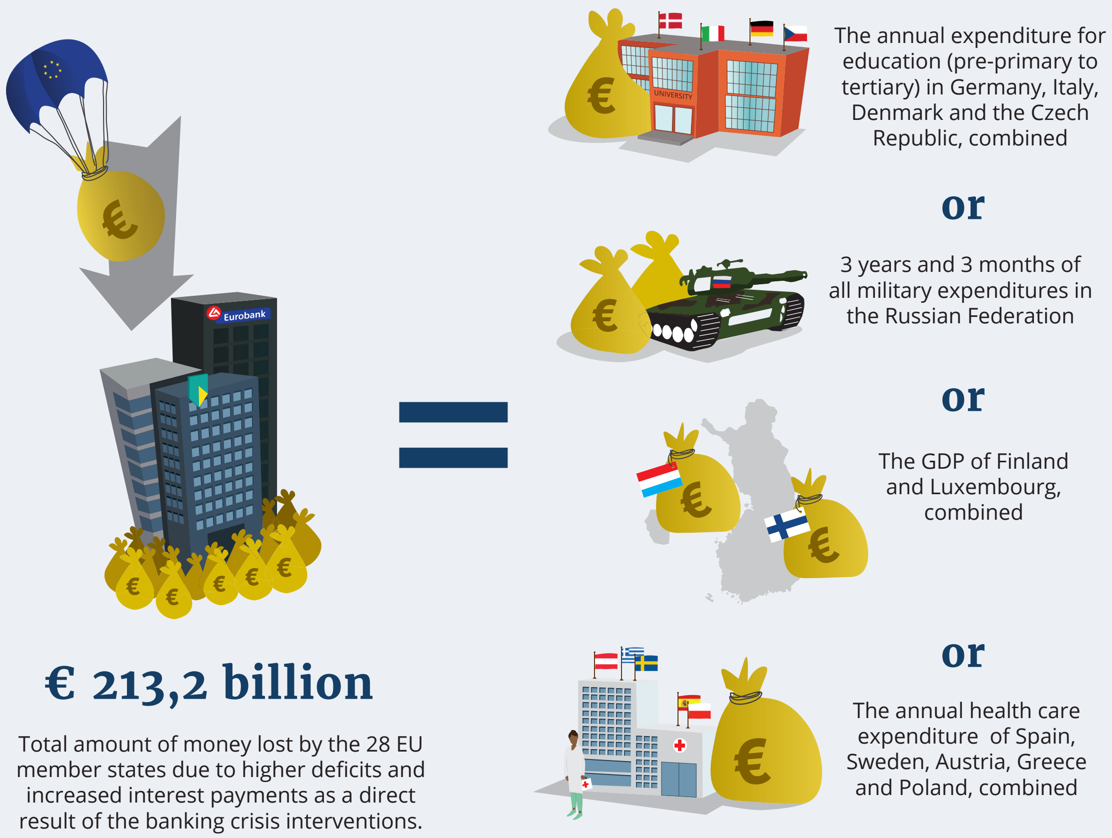
This report exposes the systemic character of these practices throughout the EU and puts the spotlight on the main actors involved. The capacity of EU institutions and national authorities to legislate new policies aimed at controlling public spending and regulating welfare and labour benefits, known as austerity policies or the EU Economic Governance agenda, contrasts with the uneven progress in the regulation of the economic sector that caused the crisis – the finance industry. Thanks to public pressure, some legislation has been approved that aims to tackle some of the worst practices discussed in this report, such as preventing audit firms from providing auditing and advisory services to the same client. However, no progress has been made on weaning the EU or members states off their dependency on an increasingly influential Bail Out Business. On the contrary, the Banking Union's concentration of decision-making powers in the ECB has deepened the dependency on external consultants.

The opportunity to increase EU states' capacities to handle financial and banking affairs is lost. The public money involved in the rescue packages was sufficient to consider the creation of public banks. In some cases, as with the nationalisation of ABN AMRO in the Netherlands, the government deliberately avoided taking full ownership and control of the bank, despite being its effective owner after its rescue. Evidence suggests that public banks are safer and more democratically accountable that private banks (see Info box 6) – two characteristics that the EU banking crisis revealed to be of paramount importance. The creation of public banks could have been the first step to strengthen the capacity of public and accountable institutions in handling financial and banking affairs, and therefore reduce dependency on bail out consultants which, as this report will show, were not accountable enough for their failures.

Despite the more than one trillion euro used to safeguard the EU's banking sector, its credibility remains damaged, as evidenced by the scrutiny of German giant Deutsche Bank. Rescue packages are a new reality, which are likely to reoccur, providing good business prospects for the Bail Out Business.

GRAPH:[6]

Permanent losses for rescue packages between 2008-2015



€ 213,2 billion

Total amount of money lost by the 28 EU member states due to higher deficits and increased interest payments as a direct result of the banking crisis interventions.

Sources: Eurostat (data from 2014 at current market prices) and the Stockholm International Peace Research Institute (data from 2015)

1 The Bail Out Business in the EU

1.1 Understanding the bail outs in the EU

Using public money to rescue failed banks is a bitter pill to swallow for taxpayers. A common argument by governments implementing rescue packages has been that bail outs are basically loans to banks that will be recovered in the future. Measuring the total cost of bail outs to taxpayers is not an easy task due to the different measures a government can take to rescue a bank. Info box 1 presents the most relevant measures.

Different methodologies are used by member states and between EU institutions – the EC and Eurostat use different figures. However, according to Eurostat figures, between 2008 and October 2016, 213 billion euro was permanently lost – equivalent to the GDP of Finland and Luxembourg, combined.

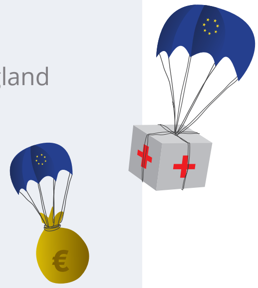
Permanent losses can be calculated when a government sells its stakes in a rescued bank at a loss. Many banks throughout the EU are currently still partially owned by governments due to recapitalisation measures taken during the crisis. However, states are increasingly looking to sell off their remaining shares in banks due, in part, to EU regulations regarding state aid. Although the EU cannot, in theory, interfere in member states' decisions to privatise or nationalise an asset (due to Article 345 of the Treaty on the Functioning of the European Union, which stipulates that the 'Treaties shall in no way prejudice the rules in Member States governing the system of property ownership'),[11] recapitalisation efforts are considered to be a form of state aid and state capital must be remunerated according to market standards, which often makes re-privatisation inevitable. While the privatisation process helps in alleviating public debt levels in the short term, governments usually receive significantly less than what they initially paid for their shares.[12] Moreover, while there is a tendency for governments to deem the re-privatisation of banks a success since selling these shares usually leads to positive effects on a state's annual budget, the fact that the initial capitalisation measures led to increased debt and high annual interest payments is often ignored. Despite their diversity, there are common features between the major interventions to save EU banks.

- First is the absolute control of the so-called 'Big Four' audit firms in the provision of audit services to banks undergoing bankruptcies, costing taxpayers billions. According to the EU, audit firms are responsible for rendering independent and reliable opinions (for which they receive their income) to assess the accuracy of companies' accounts. This information is essential for investors and shareholders, and therefore 'contributes to the orderly functioning of markets by improving the integrity and efficiency of financial statements.'[13] The Big Four audit firms did not foresee any problem in these banks in the years before the crisis, however 'deficiencies, and in some instances misstatements' found in audit reports forced the EU to take action. The new legislation approved by the EU was a recognition that the Big Four had failed to provide adequate auditing services. However, there have been little or no consequences for these failures and the Big Four continue to be awarded new contracts. This is particularly true at the EU level.

INFO BOX 1:

How to rescue a bank?

"Global banks are global in life but national in death" [7] – Mervyn King, Governor Bank of England



There are several measures a government can take to 'save' its banks; the four main types are as follows:[8]

1

Guarantee

Governments can guarantee bank deposits, bonds and liabilities. In this case, state aid is not directly implemented, but the bank has guarantees that aid is available if necessary. According to the EU, 19 member states have used this form of state aid, with a total expense of 1.2 trillion euro or 8.5 percent of the EU´s GDP for the period 2008-2014 (up to 3.25 trillion euro was allocated in 21 EU countries to provide guarantees).[9]

2

Equity support

A second measure is providing equity support to strengthen the capital base of financial institutions. In this case, governments recapitalise their banks. Nineteen EU member states have executed this form of state aid, with a cost of 453.3 billion euro or 3.2 percent of the EU's GDP for the 2008-2014 period.

3

Creating a bad bank

A third form of absorbing the losses of the financial system is the creation of a so-called 'bad bank'. In this case, a separate legal entity is created as a private entity, run by the bank itself or the banking sector as a whole, or as a public entity, managed by the government. Bad banks buy the bad loans of a bank in order to rid the failing bank of non-performing or 'toxic' assets.[10] Eleven EU member states have used this form of state aid, with a cost of 188.5 billion euro or 1.5 percent of the EU´s GDP for the 2008-2014 period.

4

Nationalisation

A fourth form of state support to failing banks is nationalisation. In this case, a large part or all of a bank's assets are directly taken over by the state. Nationalisation also often entails recapitalisation in order to make a bank healthy again.

Note: The figures included in this Box are based on the estimates of the EC Directorate General for Competition.

- A small coterie of major financial consultancy firms receives the most important contracts to design rescue packages for EU banks. A pre-eminent example is Lazard, which also dominates the global market of public company privatisation programmes. Often the packages are badly designed, resulting in additional losses for the public.

The following case studies illustrate how the Bail Out Business works in the EU.

1.2 Case Studies: The Bail Out Business

BANK	COUNTRY	CONFIRMED LOSSES (IN BILLIONS)	AUDITOR BEFORE BAIL OUT	AUDITOR AFTER BAIL OUT	FINANCIAL ADVISOR DURING BAIL OUT
Bankia	Spain	€16	Deloitte	EY	Lazard
Eurobank	Greece	€10	PWC	PWC	Lazard
ABN AMRO	Netherlands	€5	EY and Deloitte	KPMG	Lazard
Royal Bank of Scotland	UK	€£27.6 (€34)	Deloitte	Deloitte	Rothschild
Irish Bank Resolution Corporation*	Ireland	€36,1	EY and KPMG	KPMG	Merrill Lynch

** former Anglo Irish Bank and Irish Nationwide Building Society*

Spain: Bankia

Expected state loss: at least €16 billion
Auditor before bail out: Deloitte
Audit after bail out: EY
Financial advisor: Lazard

Spain received a bail out package from the European Stability Mechanism (ESM) under the supervision of the International Monetary Fund (IMF) in 2012, when the country was unable to rescue its failing banks. The most paradigmatic case of the challenges faced by Spain's financial sector is the nationalised bank Bankia, which was established in 2011 as a conglomeration of seven regional savings banks – *Cajas de Ahorro* – with severe liquidity difficulties due to their exposure to the real estate market. The rescue of Bankia illustrates how an audit by one of the Big Four sees no serious consequences for the firm despite grave wrongdoing. On the contrary, it is even rewarded with new contracts. The financial advisor hired in the process that would lead to the bail out – the global leader, Lazard – also provided an inaccurate assessment and had questionable connections with the bank's management.[14]

The formation of Bankia was the result of efforts by Rodrigo Rato, the former IMF director, who was also the director of Caja de Madrid, the biggest *Caja* of the new conglomerate. The seven *Cajas* became privately owned banks under the commercial name Bankia. Bankia had its stock market launch – Initial Public Offering (IPO) – in July 2011, with many small investors and the public persuaded to buy shares, based on the bank's assurances that their investment was as safe as a savings deposit.[15] Bankia reported profits of over €300 million in 2011 – audited by Deloitte. However, less than a year later Bankia had to be nationalised by the Spanish government. The state spent €19 billion to save it, in addition to the €4.5 billion it had lent to Bankia when it was established.[16] Shortly after the nationalisation, the records audited by Deloitte turned out to be flawed,[17] as the bank had actually lost €4.3 billion.[18] This led to hundreds of thousands of small investors losing their life savings.

Bankia's case has been beset with controversies and signs of corruption that are currently under investigation. Deloitte played a big part in covering up the bank's losses.[19] It was hired by Bankia to prepare its financial statements, and then audit them. Deloitte was paid generously for these services. In the six months prior to Bankia's IPO, Deloitte was paid €2.4 million for its advisory services, in addition to €1.6 million for auditing services. The Bank of Spain later declared Deloitte's reports for Bankia as invalid, citing grave irregularities.[20] Deloitte ignored at least 12 clear errors in Bankia's financial statements while profiting from lucrative consultancy work from the bank.[21]

The financial advisory company Lazard was also involved in some questionable deals regarding the bank's IPO in 2011. Currently, Rodrigo Rato, the former IMF director who worked at Lazard before becoming the director of Caja Madrid, was the director of Bankia for two years until 2012; he is on trial in relation to five different contracts given to Lazard during his presidency.[22] Rato provided his former employer with contracts worth a total of €16.4 million. At the same time, in 2011, Rato received €6.1 million from Lazard to an offshore bank account. Despite the enormous costs of Lazard's advisory work, Bankia had to be rescued shortly afterwards.[23] While the Spanish government and the Spanish Central Bank officially maintain that a total of €23.5 billion of public money was used to save Bankia, recent research by the Spanish Central Bank found that the actual cost was at least twice that amount,[24] with €16 billion lost permanently. Despite these losses, the only consequence so far has been that Deloitte was fined €12 million by the Spanish authorities for its wrongdoings. As a result, another Big Four firm – EY, replaced Deloitte as Bankia's auditor in 2013. However, Deloitte was still hired by Bankia to audit its pension funds in 2014.[25]

Greece: Eurobank

State loss: over €10 billion
Auditor before and after bail out: PricewaterhouseCoopers (PWC)
Financial advisor: Lazard

In January 2015, former Greek finance minister, Yanis Varoufakis , calculated that up to that point 89 percent of Greece's bail out money from the Troika was used primarily for debt repayment, interest payments and bank restructuring. The rest was used to fund the state's operating costs. While much of the loans went straight into debt repayment, another big expense was the government's bail outs of the country's failing banks. Almost €50 billion of the loans went straight into recapitalisation measures in order to stabilise the country's financial sector.[26] To do this, the Greek government nationalised a number of Greek banks through its Hellenic Financial Stability Fund (HFSF). In 2013, the Greek government acquired 95 percent of Greece's Eurobank equity at an emergency share issue, at €1.54 per share, totalling €5.8 billion.

Through a series of recapitalisation measures and acquisitions, the Greek government spent a total of €13.3 billion borrowed from the European Financial Stability Fund (EFSF) on Eurobank within a couple of months.[27] Shortly after injecting this fund, the HFSF decided to launch a new share issue to raise new capital, with agreement from the Troika and the government. With the financial advisory services of Lazard, the new share issue was meant to bring private ownership back to the bank. Despite interest from investors in the shares, their price was set 80 percent lower than the original price paid by the Greek government and lower than what was quoted in the Athens Stock Exchange at that moment.[28] The share capital increase, from which the government was excluded from participating by the Troika, eventually raised only €2.86 billion, but it did lead the HFSF stake in the bank to drop by 60 percent to a mere 35 percent. The Greek and European taxpayer lost over €10 billion on this deal, with the state's equity dropping from €13.3 billion to a mere €2 billion. The auditor of Eurobank – PWC, one of the Big Four, gave no warning of any potential risk before the bail out was required. PWC remains as the auditor of the bank at the time of writing. Despite the losses incurred by the bail out package designed by Lazard, it has retained its role as leading advisor to the Greek government.[29]

Netherlands: ABN AMRO

Expected state loss: over €5 billion
Auditor before bail out: EY
Auditor during bail out year: Deloitte
Auditor after bail out: KPMG
Financial advisor: Lazard

In October 2008, just months after the financial crisis struck Europe, the Dutch government announced the complete nationalisation of ABN AMRO, the Fortis bank and the Fortis bank's insurance activities.[30] While the government initially reported it had paid a total of €16.8 billion for the entire purchase, the Dutch National Centre for Statistics calculated in 2015 that the purchase and further capital injections for all three assets had totalled roughly €28 billion, of which €21.7 billion was for ABN AMRO alone. The Centre for Statistics calculated that besides the acquisition and capital injections, the state had paid an additional €6-7 billion in interest due to increased national debt. Currently, ABN AMRO is in the process of re-privatisation. At the bank's IPO in November 2015, it was valued at €16.7 billion.[31] While the bank's director and the current finance minister, Jeroen Dijsselbloem, considered the IPO a success, the sale at IPO price meant that taxpayers would incur a loss of roughly €5 billion excluding the state's increased interest payment in the past years.

Lazard once again played a big role in the state incurring losses. In 2008, when ABN AMRO was nationalised, the Dutch government hired Lazard to provide advice regarding the amount it should pay for the bank. For three days' work, Lazard's advisers received almost €5 million, but failed to mention that the bank had outstanding debts, which should have been deducted from the overall payment.[32] Due to this omission, the Dutch state had to inject another €6.5 billion into the bank to keep it afloat. When Lazard's consultants were confronted with their blunder, they refused to acknowledge their mistake, stating, 'We tried giving an estimate of the bank's value. The price is determined during the negotiations, which can be far from the actual value. It is up to the client to decide how much he is willing to pay.'[33] In other words, while the firm was hired and paid substantially by the government for their supposed financial expertise, the firm denied any wrongdoing by stating that their advice was non-binding. Lazard continues to receive contracts from ABN AMRO for providing advice on the sale of its Asia wealth unit.[34]

United Kingdom: Royal Bank of Scotland (RBS)

Expected state loss: approximately £27.6 billion (€34 billion)
Auditors before and after bail out: Deloitte, EY to take over from 2016[35]
Financial advisor: Rothschild

The collapse of RBS, which reported record losses in 2008, was triggered by its £49 billion (approximately €62 Billion) acquisition of Dutch bank ABN AMRO (see above) in 2007.[36] In 2008, the UK government acquired, through a series of transactions, an 83 percent stake in RBS. In total, the government spent about £46 billion (approximately €60 billion) on these transactions. At the current market value, the total loss to the state is approximately £27.6 billion (€34 billion). With the current government aiming to dispose of the state's stake in the bank before the end of the current parliamentary term, UK taxpayers are expected to incur a significant loss.[37] A 2015 report by the financial advisory group Rothschild (another famous privatisation advisor analysed in TNI's *The Privatising Industry in Europe* report) concluded that a further delay in re-privatising RBS would be damaging to the economy. For this reason, the UK Treasury decided to sell off an initial 5.4 percent stake, meaning a direct loss of £1.1 billion (€1.25 billion) for the state.[38] Leaked documents suggest that this urgency was due to fears of further decline in the value because of an ongoing investigation into RBS's maltreatment of SMEs, with a potential liability of £15-30 billion (€17.5-35 billion).[39] [40] Rothschild had hired the former head of Global Equity at RBS one year before.[41] Despite these losses, Deloitte kept its role as auditor of RBS until 2016.

Ireland: Irish Bank Resolution Corporation (former Anglo Irish Bank and Irish Nationwide Building Society)

State loss: €36.1 billion
Audit firm before the bail out: Anglo Irish, EY/Irish Nationwide, KPMG[42]
Financial advisor: Merrill Lynch
Responsible for the liquidation of the Irish Bank Resolution Corporation (IBRC): KPMG

One of the countries that suffered the most devastating impact due to the financial crisis was Ireland. Right after the collapse of Lehman Brothers, the Irish government decided to guarantee €440 billion of liabilities of the country's oversized financial sector (weak domestic regulations allowed banks to borrow cheaply in the international money market).[43] This amount was three times the country's GDP, resulting in one of the worst sovereign debt crises in Europe. Within two years, Ireland nationalised the country's four biggest banks.[44] The country spent roughly €66.8 billion recapitalising its failing banks between 2009 and 2014.[45] In 2014 it was estimated that €43.1 billion of that is irrecoverable due to the decrease in value of nationalised banks, and it remains to be seen whether the remaining €23.7 billion will be fully recovered.[46] According to Eurostat, the irrecoverable losses up to October 2016 amount up to €46.6 billion.

The nationalisation of two financial entities, which were merged upon nationalisation, has been particularly costly for the Irish state: the Anglo Irish Bank and the Irish Nationwide Building Society

(INBS), which together formed the Irish Bank Resolution Corporation (IBRC). The first bank to be fully nationalised in Ireland was the Anglo Irish Bank. Anglo had been heavily exposed to property lending and was severely affected by the global downturn in housing markets in 2007-2008, causing a value drop from €13 billion to €242 million between 2007 and 2009.[47] However, what eventually led to the bank's collapse was the ethical failing of its directors, most notably its chief executive, Sean FitzPatrick. In September 2008, while the government was planning the recapitalisation of the banks in order to safeguard stability in the financial system, a major loan scandal erupted in which the directors of Anglo had secretly taken personal loans from the bank, which were hidden from the bank's balance sheets.[48] FitzPatrick had personally hidden €87 million in loans by moving them temporarily to another bank.[49] In total, Anglo directors had €150 million in loans hidden from the bank's balance sheets.[50] These revelations eventually led to the dismissal of FitzPatrick, who nonetheless maintains that his actions were legal, and the inevitable nationalisation of the bank was due to the public's loss of confidence in the integrity of the institution.[51]

One of the central actors indirectly involved in the hidden loan scandals was EY, which was the bank's auditor in the ten years prior to the crisis, earning €10.3 million in fees for its services. In 2012, EY was sued by the IBRC, the former Anglo Irish Bank, which claimed that EY had failed to uncover improper loan transactions.[52] This was the first time an Irish bank sued an auditor over its role in the financial crisis. In July 2016, Judge Martin Nolan stated, 'It seems incomprehensible how these accounts were signed.' Nevertheless, EY will not face any consequences, arguing that under Irish law, it was the responsibility of the bank and its then directors to ensure that financial statements met legal and accounting standards.[53] Although EY had approved the bank's highly dubious financial statements for years, the Irish government considered it a good idea to retain EY as the auditor of the bank's real estate holdings. In that role, EY received fees of up to €22 million from the state in the period of 2013-2014.[54] The IBRC was liquidated in 2013, with an estimated net cost of €36.1 billion to the Irish public. The company chosen to execute the process was KPMG.[55]

INFO-BOX 2:

Saving German Banks

The German economy is the poster child of the eurozone, accounting for 20 percent of the EU´s GDP. During the EU´s financial and banking crises, all eyes were on the peripheral countries, particularly those under Troika packages. The biggest contributor to the rescue packages have been the German taxpayers. This created a narrative of the efficient Germans having to save their lazy southern neighbours. Nevertheless, banks in Germany, from the semi-public *Landenbanken* to the currently struggling giant Deutsche Bank, also made extensive use of financial products which were revealed to be a failure, and therefore such banks required extensive bail out packages. The German government created a €480 billion fund[56] – twice the GDP of Greece – to secure its banking sector, with a net loss of up to €38 billion before 2015.[57] The liquidated WestLB, the biggest *Landebank*, cost €18 billion alone.[58] Recent academic research suggests that German authorities behaved badly in disciplining German banks,[59] and that such banks adopted risky practices because they expected the state to step in if necessary,[60] as has happened in the past.[61]

1.3 The role of the audit firms in the Bail Out Business

The audit services industry is highly concentrated, especially for big corporations and certain banks. PWC, EY, Deloitte and KPMG, commonly known as ‘the Big Four’, account for 61 percent of EU auditor market share, while in countries like Spain and Italy this can be as high as 80 percent,[62] and for the major corporations the numbers are even higher. Ninety eight per cent of FTSE (London Stock Market Index) 350 audits and 95 per cent of Fortune 500 company audits are done by one of the Big Four firms.[63] While external audits are designed to provide assurance for stakeholders as an objective verification of an institution’s financial statements, this has not been the case in the years leading up to the crisis.[64] The Big Four have developed relationships with their clients that have often lasted for decades – 120 years in the case of PWC and UK bank, Barclays.[65] While auditors are supposed to provide objective statements, their fees are determined by the institution they are auditing. In the EU, before and during the crisis audit companies regularly provided other lucrative financial consultancy services to banks and companies. In fact, research shows that fee dependency impairs claims of independence and has the capacity to silence auditors, which might cause serious conflicts of interest.[66] This private sector model of auditing relies on profit-seeking institutions to control each other, which means that none of the inspectors are truly independent.[67] Such practices were banned in the United States under the Sarbanes-Oxley Act in 2002, but continue in the EU until 2016 when new legislation was introduced (as discussed in the chapter 2 of this report).

While approximately 150 EU banks were rescued during the crisis, none of their audits reported any problems.[68] It can be argued that the audit firms were merely applying inappropriate legislation or that practices like offshore structures and off-balance-sheet financial vehicles impeded proper evaluation of risks. However, such firms have been systematically hired as global experts on these matters (see Table 2). During and after the crisis, investigations have been or are being launched all over the EU (as well as in the US) into cases where banks received an audit approval by a Big Four firm the year prior to receiving bail out funds; however, these inquiries have yielded little or no legal implications. Deloitte was fined €12 million for malpractice in its auditing of Bankia, which confirmed a loss of €16 billion. In the US, EY was fined €10 million for wrongdoing in auditing Lehman Brothers, whose bankruptcy sparked the Great Recession. Several case studies illustrate how audit firms provided inaccurate assessments and services but were nevertheless rewarded. To further question whether audit companies were partially to blame for the crisis, two notable cases in which the Big Four have been or are currently under investigation for in the EU will be discussed.

United Kingdom: KPMG, PWC and Halifax Bank of Scotland (HBOS)

In 2016, the UK’s Financial Reporting Council (the UK’s financial watchdog) started an investigation regarding KPMG and PWC´s conduct prior to the financial crisis and its judgements on HBOS’ bad debt provisions.[69] HBOS’ lending spree prior to the crisis led to £45 billion (€51 billion) in bad debt and, after the bank was bought by Lloyds Banking Group, a £20 billion (€23 billion) bail out.[70] In 2015, Paul Moore, a former HBOS risk and compliance manager, published *Crash Bank Wallop: The Memoirs of the HBOS Whistleblower*, a comprehensive account of greed and malpractice leading up to the downfall of HBOS. As Moore’s job had been to report potential risks to the bank’s management, in 2004, he raised concerns about the relentless sales culture at the bank, which manifested in the misselling of millions of insurance policies and reckless lending.[71] However, he was fired by the bank's director, James Crosby, for questioning the bank's growth strategy.[72] After being dismissed, Moore took his concerns to the now-defunct UK Financial Services Authority (FSA). The FSA asked KPMG, the firm that provided both auditing and consultancy services to the bank, to conduct an 'independent inquiry' into the case. KPMG (also Moore's former employer) concluded that HBOS had appropriate risk controls in place and Moore's concerns were not warranted. The FSA, of which HBOS director Crosby was deputy chairman at the time, accepted these conclusions and did no further investigations.[73] There is a profound conflict of interest in KPMG handling the investigation of Moore's allegations. KPMG had been auditing the bank since it was established in 2001. If they had agreed with Moore's findings, they would have had to admit that their audits had been deeply flawed. According to a parliamentary investigation into the matter, simple and pervasive failures in risk management by the bank had been discovered, which would have been easily detected by a quality audit.[74] Moreover, between 2003 and 2007 KPMG received £55.8 million (€64.5 million) in auditing fees and £45.1 million (€52 million) in consultancy fees.[75] These high fees might be an indication as to why the firm signed off risky loan books and implicitly agreed with the extreme risks HBOS took in order to grow exponentially. The obvious conflicts of interests arising from such a position led to enormous costs for taxpayers, when the Lloyds Banking Group was bailed out for over £20 billion (€23 billion) after it acquired HBOS.[76]

Italy: PWC and Banca delle Marche

Banca delle Marche was a small Italian bank that was liquidated at the end of 2015 after years of increasing losses. The bank was divided into a bad bank and a new good bank and was one of the first institutions in the EU to be 'bailed in' under the new EU Banking Union rules, with bondholders and a special Italian resolution fund (with contributions from Italy's banking sector) bearing the costs rather than taxpayers.[77] The bank had to be bailed in after years of mismanagement and increasing involvement in risky lending operations. The bank's former board had been signing off credit to friends without consultation or further scrutiny for a number of years, leading to increasing losses. The Banca delle Marche's exposure to risky credit, for example, increased from €760 million in 2011 to over €2.4 billion in 2012.[78] While the bank's reports and financial statements contained great irregularities and the risky credit should have been detected from the beginning, PWC failed to report such irregularities or warn against dangerous practices. PWC was sued in 2015 for €182.5 million in damages by the bank's new commissioners for failing to do its job.[79] The compensation claim was part of a larger €282 million claim against the bank's former board of directors. If PWC had thoroughly checked the bank's books from the beginning of the tenure of the board of directors (from 2006 until 2012), the policy could have been amended or the Central Bank could have intervened.[80] As this did not happen, however, the bank eventually needed to be liquidated.

These two cases illustrate how the Big Four were contracted to investigate their own bad practices. These evident conflicts of interest led to judicial prosecution against some of the Big Four firms, which is still surprisingly rare in the EU. However, as shown later in this report, the widespread practice of the Big Four of providing auditing and non-auditing services to the same client has led to new EU legislation.

INFO BOX 3:

Tax avoidance through the Big Four

While the auditors' role in the financial crisis has remained largely hidden, their services have recently come under increasing scrutiny in light of leaked documents, such as the LuxLeaks. While their traditional services were aimed primarily at preparing audits, the Big Four firms have increasingly focused on advisory services in recent decades. The 2014 LuxLeaks indicated that the Big Four firms promoted tax avoidance to their clients, in particular the world's biggest multinationals, financial institutions and governments. At the same time, the market dominance of the Big Four also led governments to seek their advice to tackle tax avoidance in tax havens.[81] In the UK, the Big Four advised the government on drawing up tax laws and then told wealthy individuals and multinationals how to avoid these laws. The tax advisory business nets the Big Four a combined income of €25 billion per year globally.[82]

1.4 The role of financial consultants in the Bail Out Business

COMPANY	REVENUE GLOBALLY IN 2015	NUMBER OF EMPLOYEES GLOBALLY (2016)	HEADQUARTERS	BUSINESS
EY (former Ernest & Young)	USD 28.6bn	230 800	London (UK)	Audit, Tax, Management Consulting and Financial Advisory
PWC (PricewaterhouseCoopers)	USD 35.4bn	223 468	London (UK)	Audit, Tax, Management Consulting and Financial Advisory
Deloitte	USD 35.2bn	244 400	London (UK)	Audit, Tax, Management Consulting and Financial Advisory
KPMG	USD 24.4bn	173 965	Amsterdam (The Netherlands)	Audit, Tax, Management Consulting and Financial Advisory
Lazard	USD 2.35bn	2 610	New York (US) but incorporated in Bahamas	Financial Advisory, Asset Management and Invest-ment Banking
BlackRock	USD 11.4bn	12 000	New York (US)	Assest Management (incre-asingly financial advisory)
Oliver Wyman (owned by Marsh & McLennan Companies)	USD 1.8bn	4 000	New York (US)	Management Consulting
Marsh & McLennan Companies	USD 13bn	57 000*	New York (US)	Insurance Brockage, management consulting, reinsurance, investment advisory

** In 2014*

THE BIG FOUR AUDIT FIRMS IN

AUDIT AND FINANCIAL ADVICE

Audit firms revise banks' financial statements and give opinions about their accuracy. Audit firms also give financial advice to banks, including risk management schemes and the structuring of offshore tax deals.

The Big Four audit firms

EY Deloitte. KPMG pwc

Global Players

872.633 employees in 2016
$ 123.6 billion in revenue in 2015

Market dominance

61% **market share** in EU's audit market

Tied to multinationals

98% **market share** of corporations listed in the London stock exchange

More than auditors

around **60%** **of their revenue** comes from Advisory and Tax services

THE BIG FOUR RETAIN THEIR DOMINANCE

With the new regulations, banks are shifting from one Big Four firm to another. The oligopolistic situation has not changed. The Big Four firms continue to receive multi-million euro contracts from banks, EU member states and institutions.

THE EU BAIL OUT BUSINESS

THE BANKING CRISIS AND THE FLOURISHING OF THE BAIL OUT BUSINESS 2008-2015

When the banking crisis erupted in the EU (i.e. risk management schemes offered by the Big Four failed), national governments and EU institutions decided to rescue (bail out) the banking sector to avoid the 'collapse' of the economy.

BAIL OUT PROGRAMS

The Big Four were involved in the EU bail out programs, providing technical expertise on how to rescue the banks. They received millions of euro in fees for each case.

BIG FOUR SCANDALS

Conflicts of interest arise when a Big Four firm provides audit and non-audit services to the same client. For instance, Deloitte was hired by the Spanish bank, Bankia, to prepare its financial statements, and to audit them. Bankia reported profits of over €300 million in 2011. Less than a year later the bank was nationalised. So far €16 billion of tax-payers money has been lost in the nationalisation process. Re-examination of the records audited by Deloitte revealed that the bank had actually lost €4.3 billion in 2011. Cases like this illustrate the need for new regulations, as such scandals have had limited legal consequences. Deloitte paid a fine of €12 million for the Bankia case.

NEW REGULATIONS

The EU has created two new rules to prevent the conflicts of interest that took place before the crisis:

1. **Audit and advisory services are separate;** an audit firm can no longer provide audit and financial services to the same client.
2. **A relationship limit of 10 years (extendible to 20 years after an open bid).** Previously, a company could use the same audit firm for decades, which created space for conflicts of interest as a result of the close relationship.

While the general public has lost substantial amounts of money as a result of the crisis, a small group of financial consulting firms has reaped substantial profits through the various bail out schemes. Through their advisory and investigatory services, these firms have emerged as the clear winners of the EU's rescue packages. Financial consulting and the Big Four audit firms' services frequently overlap, for instance by advising banks or other clients on how to invest their resources. However, audit firms do not invest their own resources through their own investment business units; financial consulting firms, especially the biggest ones like Lazard, do. A recent development is that asset management firms – whose main business is to invest their clients' capital – are now entering the financial advisory business. The most prominent is the global leader, BlackRock, which manages $5.1 trillion (€4.8 trillion), the equivalent of the GDP of the UK and France combined.

The case studies here illustrate a pattern among the most costly bail out packages. The Big Four audit firms assure investors of the stability of their clients, but when bankruptcy arrives, there is little or no accountability. A small group of financial consultancy firms works hand-in-hand with bankers, advising them on how to run their business. However, the bankruptcies demonstrate that they did a poor job, but were nevertheless rewarded with new contracts.

The Troika used external consultants to determine how much indebted countries or banks needed to prevent a default. It is difficult to access data confirming the fees paid to consultants. However, thanks to a 2013 cross-border investigation by a range of European journalists we can confirm the concentration of market share in the Bail Out Business. Four firms in particular, which are relatively unknown to the general public, have made huge profits by providing their 'independent' expertise. These firms include Alvarez & Marsal, BlackRock, Oliver Wyman and Pimco. In addition, these firms tend to work with subcontractors, which almost always include one of the Big Four audit firms.[83] Nevertheless, while private firms were paid hundreds of millions of euro by the heavily indebted countries, their advice often turned out to be either wrong or insufficient. The audit and consultancy companies, whose assessments of banks' business models and activities were sought before the crisis, made tens of millions of euro working to help the government deal with the crises caused by these same banks.

Moreover, while these companies were hired by the Troika to assess the financial wellbeing of countries and banks, no public tender was conducted prior to their appointment.[84]

Spain

Like the other indebted countries, Spain hired a range of private sector consultants that received tens of millions for their advisory services to the Spanish government. The state hired Oliver Wyman, a US based consultancy firm, and Roland Berger, a German consultancy firm to undertake audits of the entire banking system's capital requirements and stress test them.[85] The Big Four audit firms were also hired to conduct another series of audits of Spain's major banks ahead of the state's 2012 request for the ESM bail out.[86] In total, the combined fees for the auditing services amounted to approximately €30 million.[87] Even Deloitte, the company found partly responsible for aggravating Spain's crisis due to its role in the collapse of Bankia, was awarded €1.8 million worth of audit work by the government. In total, FROB, Spain's bank resolution fund, spent an estimated €32 million on external advisors between 2009 and 2012.[88] These costs included €2 million in fees for the firm, Alvarez & Marsal, which was involved in setting up Spain's bad bank, Sareb, to manage the bad assets transferred from the nationalised banks. FROB also hired BlackRock Solutions and Oliver Wyman to manage Sareb and value its assets.[89] BlackRock is the world's largest asset manager, and could therefore benefit substantially from low evaluations of Spain's assets. This might lead to conflicts of interest but apparently this was not considered by the FROB's managers.

Cyprus

In 2013, Cyprus received a €10 billion bail out from the Troika. In order to assess the restructuring of the country's banking sector, the Central Bank of Cyprus hired Alvarez & Marsal, the go-to specialist for banks and countries seeking to restructure their banking sector during the crisis. In 2008, the firm managed the bankruptcy of Lehman Brothers and won a reputation as a world leader in bank restructuring.[90] The crisis provided the firm with the opportunity to grow substantially and make huge profits, receiving $91 million on the Lehman deal alone.[91] For their advisory services in 2012 and the beginning of 2013, the Bank of Cyprus paid more than €5 million to Alvarez & Marsal to evaluate the Cypriot recapitalisation and restructuring plans.[92] Shortly afterwards, Cypriot media reported that the firm had been awarded another contract by the Central Bank's director, which stipulated that the firm would receive 0.1 percent of the entire recapitalisation costs of Cypriot banks, amounting to nearly €16 million (the total recapitalisation cost of Cypriot banks was €15.7 billion).[93] The fact that the firm's fee was dependent on the total amount of the recapitalisation scheme called into question the objectivity of the firm's evaluation of Cyprus' banks. The deal was made behind closed doors and without the knowledge of the Central Bank's board. The case is currently under investigation by the Cypriot public prosecutor. In September 2012, Cyprus also hired Deloitte and Pimco, an American asset management firm, to look at its bank recapitalisation. It then hired BlackRock Solutions, a subsidiary of the world's largest asset manager BlackRock, to double-check Pimco's methodology, thus paying twice for the same work.[94]

Slovenia

In 2013, Slovenia seemed poised to be the next country to request bail out funds from the European institutions. However, after testing its banks, the country decided to fund its own recapitalisation efforts rather than allow foreign creditors to gain influence over the state's finances. There was great controversy concerning the role of the consultants during the banking tests. While various Slovenian institutions had previously assessed the recapitalisation needs of the Slovenian state banks to be no more than €1.5 billion, the consultants Oliver Wyman and Roland Berger, and auditors EY and Deloitte, which were all appointed by the European Commission and the ECB without public tender, claimed that twice that amount was actually needed.[95] This meant that an extra €1.5 billion of taxpayer's money needed to be pumped into the financial sector, causing increasing deficits. Slovenia also had to pay over €21 million to the consultants. Oliver Wyman had to flag its potential conflicts of interest due to its global network of clients, many of whom would benefit from the confidential information the company was given access to. Within the industry, so-called Chinese Walls between a firm's business units are claimed to protect against conflicts of interest, but this is not without controversy (see Info box 4).[96]

INFO BOX 4:

BlackRock, Lazard and Chinese Walls

One company that has benefited the most from Europe's financial sector reforms and bail out deals is BlackRock Solutions, subsidiary of the biggest asset management firm in the world, BlackRock. With government deals in Greece, Ireland, Spain, the Netherlands and other countries, as well as its lucrative assignment for the ECB, the company grew exponentially during the crisis.[97] Originally, BlackRock Solutions was the risk management division of BlackRock. However, since its establishment the company has become an important consultancy firm for banks and governments. Besides its work in Europe, BlackRock Solutions also advises the US Federal Reserve on the sale of assets it obtained during the financial crisis.[98] That a subsidiary of the world's leading asset management company advises governments on how to sell their assets can be defined as a conflict of interest. However, European politicians, such as the Dutch minister of finance and Eurogroup, President Jeroen Dijsselbloem, claim that there are no conflicts of interest due to the 'Chinese Walls' between the two companies – a finance industry term that implies that proper measures to avoid conflicts of interest are in place within a company.[99] These walls are based on ethical barriers set up between divisions of a multi-services business.[100] There are numerous cases that undermine the credibility of such systems. Bail out consultant and privatisation global leader, Lazard, profited from the privatisation of the Royal Mail in the UK with its investment branch; this and other cases are explored in TNI's *The Privatising Industry in Europe* report.

Ireland

According to a 2014 Comptroller and Auditor General (C&AG) report, €152 million was paid to external consultants either directly or indirectly by the Irish state.[101] The country's private sector expenditure commenced in 2008 and 2009, when the government paid €7.3 million to the American bank, Merrill Lynch, to evaluate how much it would cost to bail out the country's failing banks.[102] Merrill Lynch estimated the total costs to be between €6.5 billion and €16.4 billion. This estimate was wrong by about €48 billion.[103] As advised by Merrill Lynch, law firm Arthur Cox and audit firm PWC, the Irish state set up a disastrous bail out programme based on inaccurate assumptions and assessments.[104] In 2011, the Irish Central Bank hired BlackRock Solutions to carry out a stress test for the Irish banks by analysing some worst case scenarios. The firm and its subcontractors were paid €30 million, but it soon emerged that its forecasts had been entirely inaccurate. While the Central Bank expected profits to amount to €1.9 billion between 2011 and 2013 based on BlackRock's scenarios, they only made €0.4 billion in that period.[105] Also, in this case no public tender was conducted in the selection process due to a tight deadline under the EU-IMF bail out programme and pressure from the Troika.

In sum, while the Irish state's management of the crisis was extremely poor, at least in part as a result of the advice of external consultants, these private actors were still paid generously. According to the C&AG report, Arthur Cox was the highest paid advisor during the Irish crisis, receiving €33.1 million, followed by BlackRock Financial Management at €23.5 million, Ernst & Young (former Anglo Irish Bank auditors and advisor of the Irish National Bank on the €440 billion guarantee package) at €20.9 million, KPMG (former Irish Nationwide auditors) at €13.2 million, and Goldman Sachs at €9.4 million.[106] Since the report was published in 2014, the consultancy costs for the Irish government have increased further. For example, KPMG alone was paid €76 million in service fees for its work on the liquidation of the Irish Bank Resolution Corporation.[107]

Greece

The Greek state is a paradigmatic example of the dependency on private consultants to evaluate and restructure its debts and banks. In 2012 the country's government hired the American firm Lazard to advise on its original bail out, and paid €25 million for their services.[108] Greece also paid $8.5 million to Cleary Gottlieb Steen & Hamilton for their advice on the same 2012 bail out package.[109] At the same time, the country's public debt management agency paid approximately $5.3 million to Deutsche Bank and HSBC for their services as closing agents for the country's bond swaps with creditors.[110] Greece also hired BlackRock Solutions to evaluate the country's banks and help determine how much capital the country's banks needed to raise.[111] The contract was worth €12.3 million and included subcontracting to the Big Four audit firms.[112] As was the case in Spain, the involvement of the world's largest asset manager in the financial re-structuring of a country raises concerns about possible conflicts of interest.

These cases illustrate the common features of the Bail Out Business in the EU. A small coterie of firms received huge contracts to advise governments on saving failed banks. These same firms are global leaders in the provision of financial and management advice, as well as auditing services, and have reaped enormous profits advising on how to rescue banks that were often their clients before the crisis.

2 New EU regulations and the Bail Out Business in the EU

> *"The behaviour of the financial sector has not changed fundamentally in a number of dimensions since the crisis. [...] The industry still prizes short-term profit over long-term prudence, today's bonus over tomorrow's relationship."*[113]
> – Christine Lagarde, IMF Director, May 2014

Between 2008 and 2010, when the damage from the crisis was most visible, EU lawmakers promised broad and far-reaching reforms to prevent a financial meltdown from occurring again in the future. The proposals included the division or downsizing of banks considered 'too big to fail', a financial transaction tax, a public European rating agency, the limiting of bonuses for bankers, a global agreement on tax evasion, and a genuine Fiscal and Monetary Union.

Although assessing the results of the various regulatory attempts to tackle some of the root causes of the crisis goes beyond the scope of this publication, the implications of the latest EU legislation for the booming Bail Out Business bears further scrutiny.

The EU has developed significant legislation in the construction of the genuine Fiscal and Monetary Union. This far-reaching agenda was the result of the EU lawmakers' understanding that one of the main causes of the EU banking crisis was the uncoordinated response to it.[114] Uncoordinated national bail outs were insufficient and inefficient. Furthermore, some countries could not afford to rescue their banks, which was deemed a priority to prevent the collapse of the economy. The Troika packages were the first forms of coordinated efforts by the EU to tackle banking crises in specific countries. The pools of EU money created in 2010 to fund the Troika packages – the

European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) – led to the creation of the current European Stability Mechanism (ESM) with a capital of €500 billion of taxpayers' money. Spain and Cyprus have used these funds to stabilise their banking sector, with their citizens ultimately paying for the losses (see the Bankia case above). These and other measures reflect a legislative trend in the EU since the crisis: the gradual concentration of decision-making from member states to EU institutions. For the purpose of this report we will analyse two specific legislations that have consequences for the functioning and prospects of the Bail Out Business.

First, the new legislation to regulate the activities of the audit sector in the EU and second, the concentration of the eurozone banking sector oversight and troubleshooting in the ECB with the Banking Union (a key element of the Genuine Fiscal and Monetary Union). Some advances have been made to avoid the worst practices and conflicts of interest. However, there has been little or no action to tackle the dependency of EU member states and institutions on the Big Four and the leading financial advisory firms that make up the Bail Out Business.

2.1 Can the Big Four continue with 'business as usual' in the EU?

> *"Anywhere that there's regulation creates an opportunity for us."*
> – David Sproul, chief executive at Deloitte UK

As a result of the crisis, the EU has in fact taken some steps towards limiting the power of the Big Four and regulating the auditing services in a more sustainable way. In 2011, the EC presented a draft law aimed at separating auditing and consultancy services in a bid to increase competition and prevent conflicts of interest.[115] After three years of negotiation the new regulation has the potential to limit the worst practices of the audit firms including the conflicts of interest arising from providing auditing and non-auditing services to the same clients. This was a common practice, as explored earlier in this report, as in the case of Deloitte preparing Bankia's accounts in Spain and later auditing them. The regulation includes a 'black list' of non-auditing services that cannot be offered to clients receiving auditing services from the same provider.[116] This includes 'designing and implementing control or risk management procedures' and 'services linked to the financing, capital structure and allocation', which if properly set up before the financial crisis would have prevented some of the most scandalous conflicts of interest. These provisions have existed in the US since 2002 with the Sarbanes-Oxley Act.

What was the reaction of the audit industry?

This legislation was strongly opposed by the Big Four. The EC called their lobbying activities 'fierce and excessive'.[117] While the EC initially condemned these tactics, the Big Four's efforts eventually bore fruit. The initial proposal stated that public interest companies, such as banks and listed companies must change auditors every six years and auditors would be barred from providing consultancy services to clients whose books they audited. In the final regulation and directive, approved in 2014 and implemented in June 2016, the rotation period was extended significantly to 10 years, with an optional additional 10 years after an open tender for selection and 14 years in cases of joint audits. There are no restrictions preventing a Big Four firm from taking over another. Nevertheless, the legislation includes a ban on the regular practice of contractors and investors explicitly requesting that audits should be conducted by one of the Big Four.[118]

Conclusion: While the EU has taken seriously the need to avoid the most flagrant conflicts of interest of the Big Four audit firms, two issues should be highlighted:

- The almost total absence of penalties for audit firms' conflicts of interest. Deloitte paid €12 million for serious wrongdoing in their bail out advice to Bankia, which has incurred a €16 billion loss so far. The result of the prosecution of the Big Four firms in the ongoing cases involving Halifax Bank of Scotland and Banca delle Marche remains to be seen.
- An obligation to change auditors is positive, but is very limited and misses a key issue – the enormous market concentration. As the case studies have demonstrated, banks move from one Big Four firm to another. Furthermore, major investment in technology by the Big Four is unmatched by regulators, deepening their dependency on them.[119]

2.2 What are the implications of the Banking Union for the Bail Out Business?

> *"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises."*
> – Jean Monnet, one of the EU's 'founding fathers'

As a regulatory response to the financial crisis, the EU developed a system that is supposed to prevent taxpayer money from being used to save the financial sector in the future. The European Banking Union was proposed in 2013 and entered into force on 1 January 2016.

The Banking Union has provided the ECB with considerably more power than it ever had before. By putting the eurozone's biggest banks, covering 85 percent of the eurozone's financial assets,[120] under the supervision of the ECB its power has increased substantially at the expense of the national central banks.

In contrast to the bank resolution methods during the crisis, one of the key developments of the Banking Union is that for future crises, banks must be saved using bail in mechanisms rather than bail out mechanisms. This can be seen as a significant improvement, as it limits the burden on sovereign states and helps in preventing taxpayer money from being used to pay for private debts. However, by making this mechanism the obligatory primary tool for future bank resolutions, little emphasis is placed on the nature of the bank's problems and the potential consequences of such a move, which might not always be beneficial to the solution.[121]

When in November 2014 the European Central Bank became the central supervisor of Europe's biggest banks, with the introduction of the Single Supervisory Mechanism it decided to stress test (also known as 'asset quality review') all the banks under its supervision. The ECB hired consultancy firm Oliver Wyman to assist with this exercise despite the firm's controversial role in past stress tests. The ECB ignored the fact that Oliver Wyman had named Irish AIB the 'best performing bank in the world' in 2006, three years before it had to be nationalised and nearly

INFO BOX 5:

Bank bail out versus bail in

In 2013, Cyprus, struck by an enormous financial crisis, took a different approach to its banking problem from the other European member states. Rather than using taxpayer money to bail *out* the country's largest banks, the government decided to bail *in* the creditors of the Bank of Cyprus and Laiki Bank. This meant that the banks' creditors had to bear some of the burden of the crisis, by having part of the debt they were owed cut off. In the case of Cyprus, the creditors were bondholders and depositors with more than €100,000 in the bank. The measure of bail ins is an effective way to ensure that the burden of a financial crisis does not land on the shoulders of taxpayers but is instead shifted to private creditors. However, during the crisis the measure was not used by other governments because of fears that it would lead to panic among creditors of other banks.[122] By being the first government to use bail ins, the country set a precedent and the new Banking Union has determined that bail ins should be given priority over bail outs for future banking failures.

caused the bankruptcy of its host country.[123] The ECB paid €14 million for Oliver Wyman's services and welcomed the team to their headquarters. The fact that Oliver Wyman provides services to those to be tested is not seen as a conflict of interest thanks to the existence of 'Chinese Walls' (see Info box above 4).[124]

An estimated €500 million was spent on external advisers by banks and national governments throughout the eurozone for the 2014 stress tests alone.[125] The consultants that benefited most from these stress tests were Oliver Wyman, BlackRock Solutions and the Big Four accountancy firms.

Later in 2014, the ECB also hired BlackRock Solutions to advise on developing a programme to buy asset-backed securities.[126] This programme was initiated prior to the Quantitative Easing programme the ECB embarked upon in 2015. Once again, similar to the case in Spain, the potential conflict of interest arising from this relationship did not appear to be a problem for the ECB. Besides getting a front row seat to the ECB's asset purchase programme, it has been reported that BlackRock also increased its self-declared EU lobbying expenditure by 1000 percent between 2012 and 2014; from €150,000 in 2012 to €1.5m in 2014.[127]

Conclusion: Seeking ways to reduce the use of taxpayer money to save banks should be welcomed after more than €200 billion of accumulated losses. However, regarding the Banking Union, we should not overlook two facts in relation to the Bail Out Business:

- First, the Banking Union normalises and institutionalises under the ECB's authority the rescue of failed EU banks using taxpayer money. However, the ECB has been heavily criticised by civil society groups for its lack of direct accountability to EU citizens.[2]

2 This criticism has emerged from the ECB's direct or indirect opposition to measures with strong public support that have the potential to tackle some of the root causes of the crisis - such as the financial transaction tax and the European Rating Agency - and from the cutting off of liquidity to Greek banks when the Syriza government was negotiating the reduction of austerity measures with the EU.

- Second, the ECB is expected to decide on a bail out upon the identification of an emergency with potential to endanger the eurozone. The stress tests are the main tools for that assessment. Remarkably, the ECB has relied on external consultants for this, and the key actors of the Bail Out Business in particular.

INFO BOX 6:

An alternative to restore public capacity: public banks

The Bail Out Business report shows how private firms with a track record of failure are rewarded with new government and EU contracts. Why does this happen? One explanation is the lack of in-house capacity even after decades of finacialisation of the economy and the gradual outsourcing of the elaboration of financial legislation to private actors.

While some European public banks have been nationalised completely or partially by member states, national governments never intended rescued banks to remain in public hands or serve the public interest. Rather, most governments distanced themselves from banks' management by creating independent entities to oversee and manage the banks in preparation for eventual re-privatisation. Examples of such entities are the NL Financial Investments in the Netherlands and the Hellenic Financial Stability Fund (HSFS) in Greece, which are often managed by former top executives of failed banks. The rescue, with the nationalisation of failed private banks across Europe, could have been an opportunity for governments to serve the public interest and take a first step towards the strengthening of public capacity to control their financial and banking systems.

Public banks can provide financial services that are vital for citizens, which are counter-cyclical and long-term, as well as offer 'green' lending and democratisation. Furthermore, they are more resilient to crises – according to *Global Finance* magazine, nine out of the top ten safest banks are public and European.[128]

It is important to recall that public banks are not inherently superior and can be poorly run. Public banks need strong mandates and real accountability to perform better. Properly mandated and democratically accountable public banks can effectively serve the public interest. Moreover, there is often little incentive for public banks to provide shelter for illicit or illegal financial transactions, privileging instead transparency and serving the public good. The financial and banking crisis has evidenced the need to improve these areas within the banking system. The potential benefits of public banks enhance the possibility of states to strengthen their capacity to manage their financial and banking systems, and therefore reduce dependency on the Bail Out Business.

For more on public banking alternatives, see Marois, T. (2013) 'State-owned banks and development: Dispelling mainstream myths', Occasional Paper No. 21, Municipal Services Project.

3 Conclusions

The evidence discussed in this report illustrates a systematic pattern in bank rescue schemes implemented in the EU. A highly concentrated and increasingly influential group of audit and financial consultancy firms has made millions advising EU institutions and its member states on how to rescue the banking sector after the financial crisis. This constitutes a hidden cost that adds to the more than €200 billion of taxpayer money that has been permanently lost with more than a trillion euro available for new rescue packages. This coterie of firms constitutes an industry built on the Bail Out Business in the EU.

After the crisis and despite failures that cost billions to taxpayers, the Big Four firms continue to dominate the audit and financial advisory markets and have made exorbitant profits through helping to design rescue packages for their former clients. They are not the only winners. Financial advisory giants like Lazard and BlackRock have also won lucrative contracts despite errors in the design of bail out packages which cost billions of euros, as seen in the Netherlands and Greece.

In addition to their high market concentration, which functions as an oligopoly in practice, it is also of deep concern that some Bail Out actors work on both sides of the deal – providing advice to governments on how to value banks and their assets and simultaneously advising their clients and potential investors on the same assets. The bail out consultants could potentially invest in and profit from those same assets. Global leader BlackRock is a good example of how this might happen. Possible conflicts of interest are deemed nonexistent because of ethical barriers known as Chinese Walls. Evidence, like Lazard profiting from the privatisation of the UK's Royal Mail, suggests however that self-regulation is not enough.

Why are firms with a track record of failure rewarded? One possible explanation is the well-known problem of revolving door appointments in the EU, where former top finance executives hold leading positions in EU institutions and vice versa. Another is that governments and EU institutions lack alternatives.

The increasing complexity of finance in recent decades, the widespread belief that self-regulation was the best model, and the gradual outsourcing of the formulation of financial legislation left governments unarmed when trouble arrived. Since 2008 the context in the EU has been one of instability, haunted regularly by the apparition of a banking crisis, from the peak moments of the Greek crisis to the recent €8 billion bail out of Italian bank Monte dei Paschi di Siena and the public scrutiny regarding a possible €150 billion bail out for Deutsche Bank. The constant need to take expedited action to avoid 'contagion' has forced public institutions to seek the support of the Bail Out Industry. Despite their repeated failures they remain almost uniquely positioned to deliver authoritative opinions on these matters.

Recent legislation has addressed the worst conflicts of interest within the Bail Out Business, such as prohibiting audit firms from providing auditing and non-auditing services to the same clients. However, the increasing dependency on financial consultants remains unresolved. The Banking Union's efforts to reduce the burden of managing failed banks on taxpayers are positive. However, the centralisation of supervision and decision-making in the ECB has institutionalised the idea that failed banks should be rescued with taxpayer money. Furthermore, the ECB has relied on the Bail Out Industry to execute its supervisory mandate, leading to further market concentration, which could increase cases of conflicts of interest.

Dependency on a finance sector dominated by private companies and interests must be addressed, and public, democratic alternatives should be created to replace, or at least function alongside the private oligopolies of audit companies. Public banking can be a first step towards the strengthening of public institutions to manage finance and banking affairs and their capacity to respond to new crisis.

It is only possible to change the mindset of European policy-makers and politicians when the very root of their thinking is contested with evidence. In order to create a transformation in which the financial sector works in service of the citizens instead of the other way around, the EU and its member states must keep their commitment to tackle the worst practices. There are alternative mechanisms to make policy-makers and supervisory institutions accountable for their decisions. A key question is how citizen political power can be harnessed to implement these alternative in the EU. These proposals and related questions will be the subject of future TNI publications.

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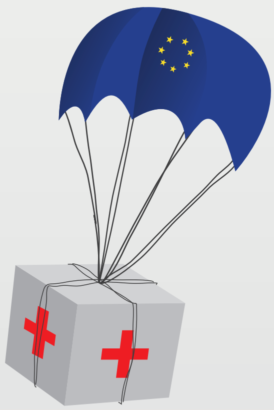
Since the 2008 financial crisis, European citizens have become familiar with the idea that public money can be used to rescue financial institutions from bankruptcy. Until 2017, more than €200 billion of EU taxpayers' money has been permanently lost as a result of the various rescue packages or bail outs, which is equivalent to the GDP of Finland and Luxembourg combined.

«The Bail Out Business» is the most comprehensive and thorough report outlining what steps have been undertaken since the 2008 crisis to understand who benefits from rescue packages in the EU. Above all, it highlights in a fresh and documented way the role of the Big Four (audit firms) and a small coterie of financial consultancy firms in the business of designing and implementing bail out programs in EU Member States.

The report explains the consequences of the Banking Union for the rescue business, and finally, it explores alternatives proposed by TNI, such as the promotion and creation of public banks.



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