TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

An tAcht um Thithe an Oireachtais
(Fiosrúcháin, Pribhléidí agus Nósanna Imeachta), 2013

REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
(Inquiries, Privileges and Procedures) Act, 2013

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Ernst & Young
EY: Core Book 38

January 2016

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THEME: B1

Effectiveness of banks' board governance, client relationships and business models

LINE OF INQUIRY: B1a

Composition, skills and experience of the board and board subcommittees

File Note

Author: Kieran Kelly

Date: 7th February 2007

Present: Kieran Kelly
Ted McGovern

I met Ted McGovern, Chief Executive on 7th February 2007.

KK gave TMcG a brief update on the progress of the audit and indicated that no significant issues were arising.

TMcG commented on both the short term and longer term goals of the society. He said that his key short term goal is to deliver on the annual plan and commented that in recent years they have been quite focused on regulatory and auditing type matters and that in the coming year that as a focus between these issues and business type issues needs to be changed. In the medium to long term he said that there are a number of strategic objective;

- Brand -The society needs to refocus on what its brand stands for and to be clear to the market place on the benefits of EBS. He commented that it is not EBS's mission to be the cheapest but to be competitive whilst offering an attractive suite of extras.

- The re-positioning of the society's capital model, business model and cost base is a long term goal. He particularly referred to the capital issue where the society has not been generating internal capital to the advance of its business. He said that this is understandable in periods of super normal growth but is an area of keen focus. TMcG also spoke about re-positioning in terms of the services that the society offers between own manufactured and re-packaged. The instance for example, the Project Westport plan as being an area where the society is attempting to leverage better on its credit and market insights. Also the sale of Epsam and Bank Assurance projects are cases where the society has decided that it would be more cost effective to purchase in some services manufactured by others. TMcG said that the cost base is of concern and that it needs to be brought more into line with a competitive financial services organisation.

TMcG said that there were a number of non-negotiable in terms of their long term planning and these include compliance, meeting regulators requirements and so forth.

In terms of the key risks facing the society, he instanced the following:

- Lack of focus among the management team
- The bandwidth of senior management to manage what has to be done
- Relationships with the Regulator and he commented on this that these are fundamental for the society to be allowed do what it needs to do.

- An external market shock such as a credit shock
- Competitor activity and instanced the threat of a smaller player in the market taking some actions and larger players responding to protect there position.

TMcG said that he manages these risks by continually monitoring the society's achievements against its plans.

[redacted] Oireachtas-P He also commented that whilst his confidence in the financial reporting function is improving he is still finding that there is imprecision in figures and that people are being forced into taking actions which are in turn imprecise and slightly unfocused.

In respect of control breakdowns in the year, TMcG commented that there will appear to be fewer that in previous years, which he took as being a positive outcome from some changes and actions which had been taken. He said that there were a couple of fraud instances and behavioural instances which caused him concern as to whether the ethos of the society was hopefully understood. In overall term he did not seem overly concerned about this although he did comment that he needs to be continually on guard.

I asked TMcG how there focus on commercial lending fits in to the ethos of the society as a retail financial services provider. Essentially, TMcG said that this is a business line that they feel they can make return commensurate with their risk and for which they have skills and opportunities to capitalize on. He sees the business as having the potential to generate returns which can be fed back into the rest of the business and the possibility that they may be creating a franchise that is attractive for the future.

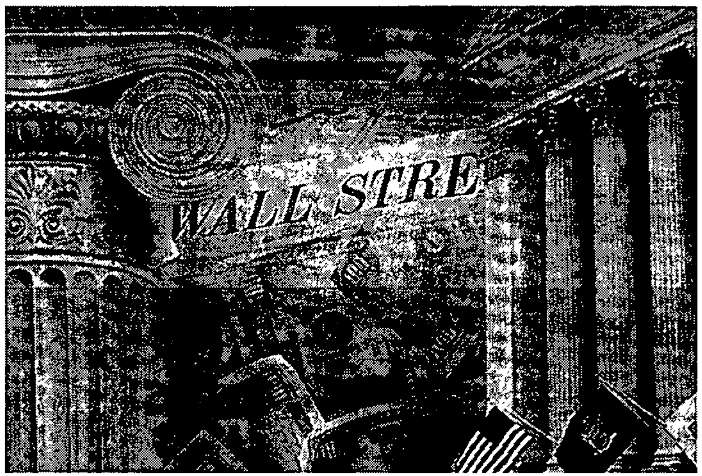
That concludes the File Note.

Signed

Kieran Kelly

EBS Building Society

Management Letter



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In planning and performing our audit of the financial statements of EBS Building Society for the year ended 31 December 2005, we considered its internal control to determine our auditing procedures for the purpose of expressing our opinion on the statutory financial statements and not to provide assurance on internal control. During our audit, the following matters came to our attention that we believe merit your consideration. We present these observations for your consideration and welcome further discussion regarding implementation of effective change.

Topic	Observation	Risk	Recommendation	EBS Response
Format of non-Euro Bank Account Reconciliations	During the course of our audit, it was noted that the format of these reconciliations did not present a complete and correct representation of certain foreign currency bank accounts and their reconciling transactions. We noted that the foreign currency translation was not presented on the face of the reconciliation. This omission resulted in incorrect postings in atleast one account in the past which was difficult for a reviewer to identify and subsequently correct.	There is a risk that the Society may fail to identify errors, mispostings or foreign exchange gains/losses on a timely basis. As a consequence monthly management finance reports may be inaccurate.	We recommend that the foreign currency reconciliation format identify all foreign currency translations at month end as a reconciling item.	This recommendation was implemented in November 2005 by management.

Topic	Observation	Risk	Recommendation	EBS Response
Use of Spreadsheets	During the course of our audit, it was noted that the Finance Department make extensive use of Microsoft Excel spreadsheets for the preparation of reconciliations and other reports. The formulae in certain key spreadsheets had been deleted and replaced with actual detail that in turn was not updated correctly in the monthly cycle.	There is a risk that the Society may fail to identify errors or mispostings arising from uncontrolled changes to formulae or data in key spreadsheets. As a consequence, the financial statements of the Society may be misstated. Key accounts may be reconciled using incorrect data resulting in financial reports that may be inaccurate.	We recognize that Excel spreadsheets are very useful to an organization in financial reporting. However, the use of spreadsheets for summarizing or sorting information is subject to inherent error. Best practice would dictate that certain controls are put in place to reduce the risk of such error. These include: 1. Maintenance of the spreadsheet file on a secure server, to which only authorized finance personnel involved with the data have access. 2. Password protection of key spreadsheets, to which only the preparer and reviewer have read/write access. 3. Protection of cells containing formulae. Access to these cells is held only by Head of Finance or his nominee.	Management recognize the inherent risks in spreadsheets and are actively working on initiatives to eliminate the use of large complex spreadsheet models where possible. Examples of these initiatives include Phase II off the IMP project and the implementation of the new Regulatory Reporting System. In addition finance currently use password protection on key reconciliation models such as the RE and ST control reconciliation models. Notwithstanding these initiatives finance will consider what further control improvements are appropriate in this important area.

Significant accounting and auditing issues (cont'd)

	Description	Conclusion
Maintenance of credit quality and the appropriateness of loan provisioning	Given current market conditions, there is an increased likelihood that borrowers will be unable to repay loans. Should there be a default on a loan, there is an additional risk that the collateral securing the loan is insufficient. Provisioning is an area of judgement and estimation and depends on many factors such as general economic conditions, collateral values, the timing of cash flows and other external factors. Factors which we considered included: loans arrears, the source of repayment and timing of cash flows, the performance of the financed project, collateral valuation and loan to value ('LTV') ratios, restructuring activity, the credit grading of the facilities and any credit committee and management comment. Our valuation considerations are based on the Society's formal asset valuations, our understanding of current market yields and declines in asset values, together with specific case by case circumstances.	The Society's provisioning process comprises two elements, namely the specific provisioning process and the collective provisioning process for losses incurred but not reported (IBNR). We reviewed the Society's Credit Impairment Policy to understand and consider the Society's methodology for determining specific and collective provisions. We are satisfied that the methodology complies with the requirements of IAS 39. We performed both controls testing and substantive procedures around the specific provisioning process. Our controls testing focused on the credit review process and the role of the Credit Risk Committee in assessing asset quality and approving impairment provisions. We concluded that the credit review process is robust and that there are suitable controls around the process. We noted that there is a strong risk consciousness in general throughout the Society, with a dedicated commercial risk team in place to manage the higher risk loans. Our substantive audit procedures were designed and executed to ensure there were no material unidentified impaired loans at the year end. Our procedures focused on larger loans, connected party exposures, obligors which have been materially provided for and the sectors which have been most depressed in the current economic climate. Specifically, these procedures included:

Acquired Loan Assets

NAMA was established in December 2009 following the enactment of the National Asset Management Agency Act, 2009 in November of that year. Five institutions (and their subsidiaries) were designated as participating institutions by the Minister for Finance in February 2010: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Nationwide Building Society and EBS Building Society[4].

LOAN ACQUISITION

The first loan transfers occurred in late March 2010. **Table 2** below summarises the major phases of the loan acquisition process:

TABLE 2: Phases of loan acquisition

	€bn	Date of transfer
Tranche 1	15.3	March – May 2010
Tranche 2	11.9	June – August 2010
Bulk transfer*	44.0	October – December 2010
Transfers in 2011	2.8	March and October 2011
TOTAL	**74.0**	

**At the request of the Minister for Finance, the transfer of the third and later loan tranches was accelerated as part of a bulk transfer in the last quarter of 2010.*

96% of the portfolio (€71.2 billion) was acquired within a nine-month period between March and December 2010.

Transfers in 2011 took place in two phases: a transfer of €1.1 billion in March (loans which were deemed eligible by AIB in late 2010) and a transfer of €1.7 billion in October. After the Supreme Court judgements in the **Dellway** case, NAMA instituted a process of consultation in June 2011 with debtors whose loans had not, at that stage, yet been acquired. Debtors were invited to make written representations to NAMA in respect of the possible acquisition of their loans and, in particular, as to any adverse effect such acquisition was likely to have on their interests. Debtors were also provided with an opportunity to make representations as to the eligibility of the loans by reference to the criteria for eligibility set out in the Act and in the Regulations.

Following a review of submissions received from debtors, the NAMA Board exercised its discretion, under Section 84 of the Act, to acquire loans totalling €1.7 billion and this acquisition was completed in October 2011. In the case of another €400m, the Board exercised its discretion not to acquire the loans concerned. Loans totalling €260m were deemed to be ineligible following a review of additional information received in debtor representations.

ACQUISITIONS BY INSTITUTION

Table 3 below summarises the transfers by institution:

TABLE 3: Loan acquisitions by institution (€ billion)

	AIB	ANGLO	BOI	EBS	INBS	TOTAL
Loan balances transferred	20.4	34.1	9.9	0.9	8.7	**74.0**
Consideration paid	9.0	13.4	5.6	0.4	3.4	**31.8**
Discount	56%	61%	43%	57%	61%	**57%**

Table 4 below provides a breakdown of debtor connections[5] by size of nominal debt acquired by NAMA (many of the debtors are also indebted to non-NAMA financial institutions).

TABLE 4: Distribution of NAMA debtor connections by size of nominal debt

Nominal Debt	Number of debtor connections	Average nominal debt per connection €m	Total nominal debt in this category €m
In excess of €2,000m	3	2,758	8,275
Between €1,000m and €2,000m	9	1,549	13,945
Between €500m and €999.9m	17	674	11,454
Between €250m and €499.9m	34	347	11,796
Between €100m and €249.9m	82	152	12,496
Between €50m and €99.9m	99	68	6,752
Between €20m and €49.9m	226	32	7,180
Less than €20m	302	7	2,117
TOTAL	**772**	**96**	**74,015**

4 The business of Irish Nationwide Building Society transferred to Anglo Irish Bank on 1 July 2011 and the merged entity now trades as Irish Bank Resolution Corporation Ltd. (IBRC). EBS Building Society was acquired by Allied Irish Banks plc. on 1 July 2011 and now operates as a subsidiary of AIB.

5 Debtor connections may consist of one debtor or a number of closely-connected debtors whose aggregate debt is considered by NAMA to be best managed as one cohesive connection rather than managed through separate debtor entities.

THEME: B3

Effectiveness of banks' funding, liquidity strategies and risk management

LINE OF INQUIRY: B3e

Capital structure and loss absorption capacity

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Internal Memorandum

To: File — 14 February 2009

From: Eilish O'Sullivan

Ref: PGAP 12.1

Going concern/liquidity/funding – issues to be considered in respect of the audit for the period to 31st December 2008.

i. Executive Summary

Under auditing standards we are:

(1) required to consider whether we believe management's use of the going concern assumption is appropriate and whether the period used for this assessment is adequate;

(2) required to perform additional audit procedures where events or conditions have been identified which cast significant doubt on an entity's ability to continue as a going concern; and

(3) if a material uncertainty exists we are required to consider whether adequate disclosure has been made and whether (notwithstanding any disclosures made or not made) there are any implications for our audit report.

This memo describes our findings to date on this matter, our proposed responses to those findings and the further procedures we expect to execute.

ii. Background

We have identified from our market knowledge that there is a potential going concern problem for EBS (and for all Irish credit institutions), in that severe market pressures comprising an outflow of funds combined with dramatic falls in share prices had culminated in a blanket guarantee of the liabilities of the six domestically organised Irish banks being announced by the Irish government on 30th September. These self-same circumstances had since the collapse of Lehman Brothers into administration in mid-September led to (variously) government takeovers, capital injections, or enforced mergers in several European banks such as HBOS, Fortis, ABN AmRo, AIG, and many others.

Going concern for EBS must be reviewed under several headings. These are:

- liquidity (i.e. actual availability of cash) and funding (duration of the liquidity); where the risk is that insufficient funds are available to repay debts as they fall due or that the bank has insufficient cash or cash equivalents available to meet the FR's liquidity tests;
- capital adequacy and availability of capital; for which the risk is that markets may view the bank as insufficiently strong to lend to; and
- future developments and assessment of management's assumptions which support going concern basis.

iii. Discussion of the Issues and our Approach

Liquidity and funding

The primary reason for the provision of the guarantee by the Irish government was due to a crisis of confidence in the US and European banking systems. Whilst it is difficult to perceive the exact reasons why any individual credit institution was subject to what essentially amounted to a 'run', in general credit institutions which were assessed as being weaker in terms of capital adequacy, ratio of customer deposits to loans, or asset quality, suffered from a lack of confidence by other credit institutions, thus shutting off the interbank market to them. In general all Irish credit institutions suffer to a greater or lesser degree from each of these problems. Irish bank capital ratios were typically seen as being lower than the majority of their continental European peer group, and more in line with the majority of UK banks, a number of which had either been rescued or forced into merger.

The closing of the interbank market was followed by the reduction of the repo market to trades in government paper only, and even then only with those banks seen as being stronger. These facts, combined with a year running up to this in which accessing wholesale term funding had been difficult, if not impossible, left the Irish banks with increasingly shorter duration liability profiles, and by the last half of September suffering from net outflows at accelerating rates.

During the audit we met with management of EBS to discuss the above and the impact on the Society of the government guarantee in the period since and looking forward. EBS management who we discussed the above with were Alan Merriman, Finance Director Audrey Collins, Head of Finance, Gerry Murray, Head of Treasury and Damien Lee, Treasury Risk & MIS Manager. Refer to 08 C03.2 EBS Liquidity Memo.doc and 08 C03.1 Meeting with Damien Lee Memo.doc.

One liquidity mechanism available to Management is via the ECB (and to a lesser extent other credit institutions) through repo agreements. To do this the Society must have eligible collateral, and creating this out of otherwise ineligible mortgage assets has been one of the Society's main areas of work over the last year. The methodology to date has been different for different jurisdictions, but is essentially the following:

1. in the UK, to sell mortgages to a limited partnership, have the Bank buy the covered bond issued by the LP, and repo this as necessary with the Bank of England; or
2. in Ireland, to sell mortgages from the Irish book to a securitisation vehicle, buy the bond issued, and then repo this with the ECB as necessary.

Emerald 5 incorporated in early 2008 for this purpose has been used as collateral for repo deals carried out by EBS.

Another development is the approval by the Central Bank of EBS Mortgage Finance, a covered bond bank (sighted email from Financial Regulator). This bank will allow EBS to issue bonds backed by commercial mortgages, either to third parties or to the main bank. The bonds will be ECB eligible collateral.

Note 14 to the financial statements discloses pledged ECB collateral and within audit file at Q14 we have a list of all assets that are available to pledge as collateral from Bank of New York.

The current regulatory liquidity limits for the 0 to 8 days category (requirement is 100%) and the 9 to 30 day bracket are being met (requirement is 90%). On certain dates in March, November and December 2008 the ratio in timeband 2 was not being met. Occurrence in March was due to gap between redemption of Emeralds 1,2 and 3 and in November/December was due to tightening in the liquidity markets prior to issuance of Covered Bond Bank EBS Mortgage Finance bond. We are required to report these breaches to the Financial Regulator. [redacted]

Oireachtas-P

Capital adequacy and availability of capital

The Society is comfortably ahead of its regulatory minimum capital requirements at around 7.9% core Tier One and Total Capital Ratio at 10.5%. Any injection of capital by the government will increase tier one ratio to a range of 10% to 11

Once sufficient liquidity is available, capital only becomes critical in the run up to the end of the government guarantee period in September 2010, I do not believe that the issue is germane to the going concern consideration at the end of December 2008.

Future developments and assessment of management's assumptions which support going concern basis

It is clear that significant loan losses will arise over the next two to three years. As part of the Society's application for support under the Credit Institutions Support Act EBS presented a three year business plan in December 2008, This plan was amended in January 2009 to take account of more up to date information. We have reviewed both plans and our findings are documented in **PGAP 12.2.** Key findings from our review is that EBS require €300m in Q1 2009 to support ongoing lending, expectation is to breakeven in 2009 and become profitable in 2010 and the preference is to remain as a mutual building society but are agreeable to merger with IL&P under certain terms and conditions.

We have discussed the entity's ability to continue as a going concern with management and they supporting rationale proposed by management include:

- Management and the public have been advised that the government will support all Irish banks and building societies
- EBS is a participant of the government guarantee scheme which extends to September 2010
- There is no intention on the part of the Board to cease trading

- Group is expected to become profitable again in 2010 at the latest
- EBS have sufficient collateral and replacement sources of funding are available through the European Central Bank

We have reviewed each of these assumptions for reasonableness with no issues noted. We are aware of the government guarantee scheme and the credit institutions support act both of which EBS are covered by. We have reviewed private minutes book of the meetings of the board of directors and there was nothing to indicate desire to cease trading. We have reviewed three year business plans which disclose EBS returning to profitability in 2010 and emphasises desire to continue trading as a sole institution. We have reviewed the assets EBS have available to pledge as collateral and those that have been pledged with no issues noted.

iv. Conclusion

Our conclusion is that management's use of the going concern assumption is appropriate, and that the period over which this has been assessed is adequate. We conclude that there is no material uncertainty over going concern.

THEME: C2

Role and effectiveness of the Policy appraisal regime before and during the crisis
Pre Crisis phase

LINE OF INQUIRY: C2c

The liquidity versus solvency debate

Liquidity Breach letter to the Financial Regulator

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Financial Regulator
P.O. Box 9138
College Green
Dublin 2

6 March 2009

Your ref:
Our ref: DF/MK

Direct Line: 01 221 2425
Direct Fax: 01 475 0595
Email:dargan.fitzgerald@ie.ey.com

Head of Banking Supervision

Re: EBS Building Society

Dear Sir/Madam,

This letter constitutes a report as required by our statutory duty under Regulation 7 (a) of the Supervision of Credit Institutions, Stock Exchange Member Firms and Investment Business Firms Regulations 1996 ("the Regulations") in relation to our Statutory Duty to report certain matters to the Financial Regulator.

[redacted]

[redacted]

[redacted]

[redacted]

This report is prepared solely for the confidential use of the Financial Regulator as required by the Regulations. It may not be relied upon by EBS Building Society or the Financial Regulator for any other purpose whatsoever. Ernst & Young neither owes nor accepts any duty to any other party and shall not bė liable for any loss, damage, or expense of whatsoever nature which is caused by reliance on our report.

Yours faithfully

Ernst & Young

Ernst & Young

20/2/08.
26/2/08

EBS Building Society

Audit Results Report for the Year Ending 31 December 2007

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The Board Audit and Compliance Committee
EBS Building Society
2 Burlington Road
Ballsbridge
Dublin 4

22 February 2008

Dear Members of the Board Audit and Compliance Committee,

Audit Results Report

We are pleased to attach our Audit Results Report for EBS Building Society for the forthcoming meeting of the Board Audit and Compliance Committee ('BACC'). This report summarises our preliminary audit conclusion in relation to EBS Building Society's financial position and results of operations for 2007. We will issue our final conclusion at the BACC meeting scheduled for 22 February 2008.

The report contains findings and observations related to our areas of audit emphasis and our views on accounting policies, judgement and estimates.

The audit is designed to express an opinion on the 2007 financial statements and address current statutory and regulatory requirements. We considered EBS Building Society's current and emerging business needs, along with an assessment of risks that could materially affect the financial statements, and aligned our audit procedures accordingly.

EBS and Ernst & Young share a commitment to quality. Our commitment to quality is and will continue to be reflected in every aspect of our work.

This report is intended solely for the information and use of the Board Audit and Compliance Committee, Board of Directors and management of EBS. It is not intended to be and should not be used by anyone other than these specified parties.

We welcome the opportunity to discuss this report with you on 22 February 2008. If you have any questions or comments, please call Dargan FitzGerald on the number above.

Yours faithfully

Ernst & Young

Contents

The contents of this report are subject to the terms and conditions of our appointment as set out in our engagement letters dated 26 November 2007. This report is made solely to the Board Audit and Compliance Committee, Board of Directors and management of EBS Building Society ('the Society' or 'EBS') in accordance with our engagement letters. Our work has been undertaken so that we might state to the Board Audit and Compliance Committee, Board of Directors and management of EBS Building Society those matters we are required to state to them in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Board Audit and Compliance Committee, Board of Directors and management of EBS for this report or for the opinions we have formed. It should not be provided to any third party without our prior written consent.

1. Overview

We have substantially completed our audit of the financial statements of EBS Building Society ('EBS' or 'the Society') for the year ended 31 December 2007. It is our intention, subject to the Board of Directors approving the annual Financial Statements, to issue an unqualified audit opinion on the annual financial statements. This report includes all the main matters and issues arising from our audit, which we consider appropriate for consideration by the Board Audit and Compliance Committee.

2. Scope update

We conducted our audit for the year ended 31 December 2007 in accordance with International Standards on Auditing (UK and Ireland), Ernst & Young Global Audit Methodology ('GAM') and Practice Note 19 (I) Banks in the Republic of Ireland in order to provide reasonable assurance that the financial statements are free of material misstatement, as set out in our engagement letters provided to the Board Audit and Compliance Committee ('BACC') dated 26 November 2007.

This audit comprises a number of sign-offs and reporting. In our Audit Planning Report, we provided you with an overview of our audit scope and approach for the audit of the financial statements. We carried out our audit in accordance with this plan. In addition, we have audited and reviewed the new disclosure requirements arising from the adoption of IFRS 7 Financial Instruments: Disclosures and IAS 1 Presentation of Financial Statements (Amended) Capital Statement for this year end.