Opening statement to the Committee of Inquiry into the Banking Crisis.

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Chairman, Members of the Committee. Thank you for affording me the opportunity to outline my views on the Banking Crisis.

1. At the outset I would like to express my deep personal regret for my role in what occurred. I am keenly aware of the damage caused and this fact occupies my thoughts on a daily basis. In my statement I will address the themes that the Inquiry has highlighted. However, I would first like to briefly outline the context for the crisis from my perspective as someone who spent 38 years in banking.

2. I had seen the Industry experience serious problems during economic cycles. I expected that on this occasion the industry would once again ride out the cycle and pull through. The onset of the global financial crisis was a shock. Regulatory and sovereign responses without precedent and systemic fractures never seen before confounded bankers worldwide. After a decade of above average GDP and property growth Ireland was poorly placed to emerge from the crisis unscathed. Ireland’s banking system expanded in the post Glass-Steagall\(^1\) world of light regulation and blurred boundaries between retail and investment banking. With high growth prospects and free of any public service obligation, specialist banks, domestic and foreign, were drawn to the Irish market. The emergence of these institutions had profound and negative implications for Irish banking.

3. There are many factors that contributed to the crisis. In my view an important factor was the degree to which decision makers became increasingly reliant on data driven, predictive risk models to guide our plans. This approach led to overconfidence and diluted the influence of less rational factors such as intuition, experience and fear. The ability to resist the statistical model approach was constrained by legal, regulatory and market orthodoxy which, did not allow for latitude.

4. I agree with a description offered by a colleague who reflecting on the crisis described our approach as a massive intellectual failure. This failure

\(^1\) Glass-Steagall Act. A U.S. law that limited the activities of investment banks precluding them from retail commercial businesses. Not allowing money market risk taking to contaminate the high street banks. Repealed in 1999, an action that led directly to the U.S. sub-prime crisis and initiated the global crisis.
led to the triumph of models, consensus and market pressure over experience and common sense.

5. Quality of business model setting process

6. The AIB comprised 4 business divisions, RoI, Capital Markets, Poland, GB and a 22.5% stake in M&T Bank in the U.SA. Each of these businesses operated in separate market segments or geographies. These were long established legacy businesses. Unless the business fundamentals had changed over the previous year the process included an element of continuity in addition to consideration of the strategic and environmental challenges to the model.

7. The business models were challenged on an annual basis through the planning and budget process. Debate focused on the financial forecasts and the actions required to meet these forecasts. In addition, there was a rolling 5 year strategic plan. The strategic plan together with inputs from the Bank’s economists and external data informed the basic assumptions supporting the annual plan. The annual plan was constructed through a combination of top down group objectives and bottom up business line analysis by divisional management teams. These plans were discussed at group executive, aggregated into a Group plan and then submitted to the Board for approval.

8. In September 2005 I issued guidelines to the Divisions for the upcoming planning process. I reduced CAGR\(^2\) to 10% from 12% for the period 2006-2010, reducing growth over 5 years to 61% from 76%. I justified this reduction, due to funding issues, slowdown in GB, unrealistic cost saving expectations and increased capital expenditure and revenue costs to complete strategic projects. In addition, the long-term linear decline in net interest margin (NIM\(^3\)) and non-interest income was an ongoing concern.

9. The risk process was embedded in the organization structure. Each division had a senior risk person on the management team who reported to the Chief Risk Officer. While the objective was to grow the business there was no appetite for balance sheet growth for its own sake. In hindsight, credit risk was not adequately weighed in the planning process.

\(^2\) CAGR. Compound annual Growth Rate, is a geometric progression ratio that produces a constant rate of return over the time period.

\(^3\) NIM. Net Interest Margin, is the difference between the interest income banks earn on their assets (loans) and what they pay to their depositors relative to the amount of earning assets they hold. It is similar to the gross margin in non financial companies.
10. Other sources of income such as fees and charges were declining as costs continued to increase. Property related risks totally dominated the market and other business lines had slow growth. Limited alternative risk classes, declining returns, loss of ability to collect fees and competitive intensity influenced the model setting process. From 2003 the Irish business was caught in a pincer of declining margins and fee revenue. Between 2003 and 2007, NIM declined by 103bps to 2.67%. This decline in NIM was driven by competition. At industry level this loss of billions of Euro in income was catastrophic and led to real systemic risks.


12. Our property related risk strategy reflected our relative strength in the market and legacy business performance over time. In RoI Division our strategy was to meet the demands of our existing customers. This was influenced by intense competition from domestic and foreign competitors. We did not have a strategy to take business from other Banks.

13. Between 1995 and 2007 commercial property values increased by about 200% and residential by 180%. Increases in valuation, customer demand, the absence of other income growth opportunities, and pressures to perform in the market resulted in the Bank developing an increased dependence on property lending. Competition in the lending market also led to the weakening of loan structures and covenants over time. We were underweight in the mortgage market due to our decision to curtail intermediary business and not offer a 100% LTV mortgage product. In the SME sector we were market leaders. Other than modest growth in working capital credit lines most of this SME loan growth was property related. Our SME property lending strategy was to support customers and defend key relationships.

14. In response to the rapid growth of property lending in Ireland we established a specialist Builder and Developer sector team. As the size and complexity of the transactions increased we needed to centralize and create a concentration of expertise. I reviewed the appropriateness of the sector team approach to our property lending in September 2005. The options were to continue with the relationship based sector team approach in RoI Division or transfer the business to capital markets, where a transaction model applied. Having consulted widely with colleagues, I decided to retain the status quo. I was unconvinced that the transaction driven model was inherently superior. Remuneration models are generally more aggressive in investment bank type cultures. I was concerned that a change would result in disruption to the relationships business model in the Bank’s biggest division.
15. Our lending and risk strategy was influenced by past success. Many of our developer sector team customers had projects spanning all parts of the property spectrum. Typically a developer was involved in commercial and residential investment and also commercial and residential development. There was also a geographic spread with large developers having exposure to the GB market. The developers that we had dealt with to that date had diversified assets and projects, were willing to provide personal guarantees and represented reasonable risk in the economic conditions prevailing.

16. Despite our best efforts weaknesses became apparent when conditions changed. The models that we were required to use did not adequately weight the risks as between the sectors within the developer exposures. Development land represented a higher risk than investment property. Our reliance on third party professional valuations and risk mitigation afforded by project diversity in developer portfolios was misplaced. When the crash occurred this diversity was of little value as all asset classes became highly correlated due to absence of liquidity.

17. Appropriateness of credit policies, delegated authorities and exception management.

18. Our credit policies were founded on principles. In theory these principles were sound but in practice they did not protect against large losses in an extreme shock scenario. The credit process though complex can be viewed from three perspectives, that of the customer, the internal process and the external validations.

19. Our policy was to issue loans that were on a secured basis and in most cases the customer provided personal guarantees and cross collateralized their facilities. This approach was the opposite of non-recourse transaction based lending. At that time it was universally regarded as less risky as the customer’s entire wealth was committed to the project.

20. Internal processes involved the establishment of specialist teams to deal with the property and developer sector. We centralized the process of loan sanction, security perfection, drawdown and ongoing monitoring of these relationships. We had an internal RAROC\(^4\) system which was applied to large accounts and if certain capital returns were not being made the loan could not be written. The sanction levels were delegated at predetermined levels with more senior oversight and committee sign off in line with loan size. In addition, there was a cross reference between loan size and loan grade with poorer grade loans having lower discretion limits.

\(^4\)RAROC. Return on risk adjusted capital, measures the return on economic capital having taken into account credit risk, market risk and operational risk.
21. The third input into credit policy was external validation. For every large loan it was policy to obtain professional valuation of the asset being funded. It was normal that the LTV would be 75/80%. In time these valuations would not hold up but they were critical at time of loan sanction. The analysis of the macro environment was central to our risk appetite. The context phase of the Inquiry has covered this area, suffice to say we relied on these models and they were wrong.

22. There were weaknesses in the approach which we were required to follow. Reliance on the risk framework designated at the time, stress test results, portfolio diversity and professional valuations led to overconfidence and lack of skepticism. Equity release became a funding mechanism to allow customers to start new projects, before cash flow from the equity release project was flowing. Arising from the lack of syndicated lending we had a poor sight of how leveraged the sector had become. For instance, 88 local planning authorities, collected €3.214 billion for development contributions between 1999 and 2008. These gaps in our knowledge were material to our overexposure in residential development land. This asset class suffered the highest markdowns in the crisis. We focused too much on lending cases rather than the sector as a whole.

23. The exception management process followed rules which were rigorous but did not identify the flawed assumptions already mentioned. The Chairman's Committee most often dealt with cases where the facility being considered were incremental to existing facilities that had raised the exposure to the committee limit. There were no initial exposures to a customer sanctioned at the Chairman's committee.

24. **Analysis of risk concentration in the base, the adverse economic scenarios and the impact on capital structures.**

25. Risk concentrations are measured when loans are subdivided into sectors having features that will cause them to behave differently in growth or stress scenarios. In the property book we had five sub-sectors, commercial investment, residential investment, commercial development, residential development and contractors. These sub-sectors did not include residential mortgages which could be added to the property sector overall. When the crisis arrived far from behaving differently these sectors displayed very high correlations with acute stress across the board.

26. Risk mitigation in the mortgage market also failed to reduce the extent of loss. Mortgage lending was based on ability to repay. If this hurdle was not crossed the LTV was irrelevant and the process went no further.
previous cycles house values declined when interest rates increased. To reduce the risk associated with rising house prices, repayment capacity stress tests were regulated. All Mortgage repayment capacity was stress tested at ECB + margin+2%, on average 5/6% during the boom. Subsequent ECB interest rate policy reduced the cost of a 25 year €250k tracker @ 4.5% from €1,498 monthly to €971 @1.25%, a reduction of 35%. Previously there were virtually no defaults when repayments increased. However, on this occasion it appears defaults increased as repayments decreased. What appeared at the time to be a severe stress test, was not severe enough. The tests were not fit for purpose. They did not assume for a one in a hundred year event and the global liquidity crisis.

27. The Bank was required to allocate capital for credit risk, operational risk, trading risks and pension risks. Credit risk capital allocation was dynamic. The quantity, type, duration and grade of credit determined the amount of capital required to support the assets involved. In AIB’s traditional approach almost all its assets were held on the balance sheet. In a downturn, managing capital is not as simple as stopping credit growth. In fact this has no impact, the big variable is credit grade.

28. When the global financial crisis began AIB’s capital structure was sensitive to the Basle capital rules. Basle arose in response to financial innovation. It encouraged Banks to ‘originate and distribute’ loans. This allowed them to avoid holding capital thereby increasing the return on existing capital. Released from the obligation to hold assets there was less focus on credit standards. This had a contagion effect on the industry as traditional banks who originated and held loans competed with these institutions. Having reduced capital requirements in a benign environment this framework was pro-cyclical in a recession. Capital requirements increased when loans were downgraded. For example, between January and June 2008 the property portfolio exposure increased by €135m (0.4%) but risk weighted assets (RWA5) increased by €2,172m (7%). Combined with the impact of IFRS396 this resulted in AIB ultimately having insufficient capital to absorb credit shocks. Bankers were in general skeptical of both of these mandatory provisions. Basle I failed to recognise contingent credit risks and Basle II amplified the pro-cyclical nature of economic cycles.

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5 RWA. Risk weighted assets reflect the weighting of the asset depending on its inherent potential to default. For example, Government debt is rated zero whereas unsecured personal loans are rated at 100%.

29. **Adequacy of incentive and remuneration arrangements to promote sound risk governance.**

30. AIB remuneration policy was cautious by market standards, while accepting that they were high by the standards of the economy generally. We employed external remuneration consultants to monitor the governance and design of our policy. The policy placed us at the median of our peer group. In the Irish context the Chairman and I agreed a practice that our rewards would never be the highest for Irish financial institutions, irrespective of scale or profitability. (see Nyberg 2.6.4 p30)

31. Banks only exist to take risks and facilitate the mismatch between depositors and borrowers. All banking activities involve risk. Risk assessment and compliance to regulatory standards are implicit and explicit in all roles in the bank. This process was part of the day-to-day management of the business through the various risk and oversight committees. Taking risks and their consequences do not occur at the same time and in the economic cycle, the gap can be many years.

32. Remuneration levels are determined by many factors internal and external. Over time remuneration design became more complex. Typically at senior levels remuneration had three components, salary, cash bonus and deferred equity awards. The weighting of these factors was designed to reward and encourage the desired behavior. There was also a defensive role for remuneration. From the mid 1990’s we were net losers of trained staff to other institutions. Change to basic salary was costly, it created a charge which repeated annually. Cash bonuses rewarded short-term performance, and were less expensive than salary. Bonus caps are a twin edged sword they confer the benefit of an absolute limit but can lead to individuals trying to manage their earnings having reached their cap. Long-term equity compensation was linked to relative performance versus peer banks. This method may have reinforced mimetic and normative behavior across the industry. In short, all forms of compensation had strengths and weaknesses.

33. Variable compensation was linked to achievement of planned profit objectives. There were no volume related targets in the lending function. Our preference was to grow income by margin management rather than volume growth. However, our growth came from increased volumes at declining margins. Even during the boom years the mechanisms needed to trigger equity compensation fell short. Two factors caused this outcome. Firstly, the trigger criteria for AIB’s equity compensation rewards were very high. Secondly, our peers were growing faster. Staff were skeptical of equity based remuneration as it failed to deliver benefits during a long period of growth.
34. In December 2007, due to the uncertain outlook, I implemented a pay freeze for General Managers and higher ranks and suspended both the profit sharing scheme and promotions.

35. AIB was never the market leader in remuneration as evidenced by published data. There was virtually no movement of staff between AIB and Bank of Ireland. Staff attrition was driven by competitors where compensation packages offered were generally 25% higher.


37. The relationship with the State institutions can be divided into the periods before and after the Central Bank and Financial Services Authority of Ireland Act 2004. While the Act was significant for the State institutions, it had marginal impact on the day-to-day relationship between AIB and the State Institutions. Factors arising prior to the Act had in effect framed our relationship.

38. From the late 1990’s there was an intense and frequent level of interaction with the Director of Consumer Affairs who, prior to the act, shared with the Central Bank, a significant element of the responsibility for setting and controlling retail banking fees and charges. This interaction was in the main focused on pricing of consumer products. In parallel, an historic wave of large mandatory change programs required us to have frequent contact with the Central Bank, as prudential regulator. For example, 1999 was an exceptional year with the euro conversion in January and the Y2K program in December. In February 2002 the Allfirst fraud involved intense interaction with the Central Bank in assuring them of AIB’s ongoing soundness in the wake of the significant financial loss.

39. These events were proceeded by three mandatory programs, SOX, IAS39 and Basle II. Between 1998 and 2007 there was an atypical bunching of major programs with a strong regulatory emphasis which served to intensify our relationship with the regulatory authorities. These programs were highly process focused and required significant change and investment in systems and processes. Our interactions were mainly focused on measuring progress with change implementation rather than on the impact of those changes.

40. There was a wider public context which I believe influenced the priorities of Banks and the Regulator. In the 1990’s, arising from the National Irish Bank revelations, the accuracy, transparency and fairness of bank fees...
and charges became a matter of public interest and disquiet. The negative perception of the Industry was amplified by the memory of the DIRT issue. The industry was criticised by lobby groups asserting that Irish bank fees were the highest in Europe, a claim with no basis in fact, but accepted as the truth. In this environment the regulator was frequently criticised for being too easy on the banks. An increased regulatory focus on consumer issues ensued.

41. The relationship was robust and characterised by the Regulator's insistence that the Bank conduct historical reviews of all fees and charges. The second phase was the correction of past errors, providing restitution for customers and future proofing the Banks systems. These activities required large scale reallocation of management time and resources. The confluence of major external mandatory change programs, historical reviews of Bank practices and the public mood served to detract attention from prudential matters for both the Bank and Regulator, in a time of significant economic expansion.

42. The relationship with the Prudential side of IFSRA was, in the main, one of regulatory reporting by way of mandatory returns, supplemented by periodic reviews, interaction on new regulatory processes, capital raising and governance issues.

43. It is important to remember that the IFSRA model was principles, rather than rules based. This had been adopted as an appropriate basis for Ireland at a time when there was an anxiety to promote Ireland as a regulatory friendly environment for international financial services. There is misconception that resulted in easier or 'light touch' regulation. This certainly was not the case for consumer regulation. For prudential regulation, however, once banks were operating within the requisite prudential policies and ratios, which AIB comfortably was, the level of active involvement required by the Central Bank was low.

44. **The liquidity versus solvency debate**

45. The Bank Liquidity policy was determined by the Financial Regulator as laid out in their policy "Requirements for the Management of Liquidity risk" (June 06). This policy is focused on maturity cash flow analysis and increased the qualitative requirements for each institution. This policy was consistent with the Basle Committee principles outlined in their paper on “Sound Practices for Managing Liquidity”. In this respect liquidity was in effect prescribed by the International Banking supervisory System whose local agent was the Financial Regulator. Opting out of Basle rules was not an option for the Regulator or the banks. To do so would have placed the country outside the consensus and norms that were perceived to represent best practice. The Financial Regulator’s liquidity regulations were stricter than those of the Financial Services
Authority (UK), this provided some breathing space when the crisis was at its peak.

46. As regards capital requirements these rules were not reflective of local conditions. The net effect of this policy was to increase the capacity for banks to leverage their balance sheet. The capital ratio supporting this expansion was a complex mathematical construct, distinct from the simple ratios where almost all assets carried 100% weighting. The new liquidity rules allowed for new forms of deposits and financial instruments to be included in the liquidity calculations. Shorter duration deposits were diluted as reliable liquidity. This rules allowed banks to increase reliance on corporate deposits. These could be sources with longer duration but were inherently less predictable and had greater single name exposure. These rules benefited Investment Banks and institutions that did not provide money transmission, branch networks or serve the public.

47. The loss of deposits to Anglo and INBS was a regular feature at management meetings. The economic consequences of irrational deposit pricing are underestimated and contributed to the industry's problems. The cost of losing an individual account is trivial compared to the cost of re-pricing the entire deposit base. In practice marginal pricing quickly sets the norm for standard pricing. In RoI Division with €35 billion in resources a 10pbs margin contraction cost €35m. The bank would have to lend €3.5 billion in mortgages to earn this amount. The dysfunctional deposit market included the State who offered tax-free interest, which no bank could match. These activities weakened the entire financial system. The Regulation the deposits as performed by the FDIC8 in the US may have eliminated the worst excesses of irrational pricing. Regulation and competition are intrinsically linked.

48. Additional capacity to expand balance sheet growth is linked to solvency. Historically, as balance sheets expanded banks were required to hold more capital. Basle II was designed to reflect the needs of banks with off-balance sheet assets, largely money center banks. The risk weighting of assets while intellectually elegant still meant that banks held less capital and could grow with less capital. The overwhelming debate in the financial press at the time revolved around how much capital each bank would be able to release. The risk weighting of assets (RWA'S) increased the ability of a given quantity of equity to carry risk. Once the system became stressed pro-cyclicality amplified rather than reduced the risks. Grades declined, RWA’S increased, requiring more equity. In response

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8 Federal Deposit Insurance Corporation, insures bank deposits, (up to $250k), uses a system rating, Capital Adequacy, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk (CAMALS). Banks are required to pay an annual premium, weak institutions are levied high premiums, are forced to close or merge unless they are recapitalized.
large institutional depositors and rating agencies shortened the duration of deposits and reduced credit ratings.

49. From mid 2009 onwards the capital base was depleted as assets were downgraded with values declining due to lack of liquidity. Our confidence that Liquidity could be structured so as to protect banks against rapid withdrawal of funding was misplaced. In reality, both factors were interdependent. The model assumptions proved worthless in the face of the Global Financial Crisis. The manner in which bank balance sheets evolved under the rules increased risk. Under stress the system behaved in a pro-cyclical manner. Liquidity shortages extinguished all market activity driving down valuations and driving up LTV’s. This dynamic consumed capital and solvency became the main concern.

50. I believe that the apparent delay in the shift from liquidity to solvency concern occurred because, the liquidity position stabilized briefly after September 2008 before rapidly deteriorating thereafter.

51. We now know for certain that liquidity risks and solvency are very highly correlated. In fact, in the absence of liquidity, solvency is somewhat of a theoretical concept. Solvency could be defined as (a) an ability to meet all obligations as they fall due (b) having assets greater than liabilities. In effect ability to meet obligations is having adequate liquidity. In practice the fundamental concept of banking involves borrowing short and lending long and cannot withstand a prolonged run on the bank.

52. Appropriateness of the bank guarantee decision

53. I have been asked to make a statement on the appropriateness of the guarantee. Though we did not make the decision I will describe our role on the night which I have described in my contemporaneous note in greater detail.

54. Together with our counterparts from Bank of Ireland we asked for a meeting with government. At that meeting, we requested a guarantee but not the blanket guarantee ultimately provided. The meeting lasted for six hours. Our presence was not continuous and we were asked to leave the room on four occasions.

55. During the first session we attended we described what was happening in our business and how our liquidity was positioned. Given what had happened on that day in Europe and the U.S. we asked for a deposit guarantee to help stabilize the situation. We were asked to leave the meeting while our request was considered.

56. During the second session we attended we were told that Anglo was about to default. The government wanted us to give Anglo a loan to get
them through the week so that an orderly liquidation/nationalization could be arranged over the following weekend. We refused and were asked to leave to reconsider our position. Working with colleagues we developed a response that might meet the governments request.

57. During the third session we said we could give Anglo €5bn for a week. By now, on notice that Anglo was about to default we refused to go on risk to Anglo. Our offer was conditional on a government guarantee for this Anglo loan. This solution appeared to be accepted by the government and we said we would start moving assets to have the funds ready by Wednesday morning. The meeting then reverted to the deposit guarantee and its form. We made suggestions regarding duration, recommending two years rather than one and on the merits of including bonds. We were asked to leave while a drafting process was undertaken. During this period there were some individual contacts with us regarding treatment of subsidiaries and what basis would be used to determine the cost of the guarantee.

58. When we were called back for the fourth session there was a short discussion about a solvency statement being issued with the guarantee. After discussion the government decided not to include that reference. We returned to our room and at 3.30am were told we were no longer needed.

59. When we saw the guarantee document for the first time later that morning we could not understand why Anglo and INBS were included. All our discussion that night were based upon the premise that Anglo was to be taken down and as such we did not think they would be part of the guarantee. In fact, we were at that time, in response to a government request risking our own liquidity to expedite Anglo’s liquidation that weekend.

60. From our perspective a four institution guarantee was appropriate for a number of reasons. Firstly, an Anglo default was certain to result in immediate rating agency downgrades and worldwide risk aversion for all Irish Banks. Secondly, in GB with £10bn in retail deposits we could expect to experience a run on deposits immediately. Thirdly, given the public’s reaction to Northern Rock it was likely that domestic customers would panic and Irish branches would not be able to cope.

61. In the absence of a statutory mechanism to deal with a failing bank the options were to nationalise, liquidate or guarantee. There was no contingency plan nationally or at EU level to deal with the crisis on hand. In the absence of alternatives, the default option was a Deposit Guarantee for the remaining four institutions, not the blanket guarantee that was ultimately given. It offered the best chance to cope with the fallout from an imminent, default triggered by the liquidation or nationalization of Anglo and INBS.
62. Inaction was not an option and there was very limited time available for debate or evaluation of alternatives. Two weeks previously the US authorities had allowed Lehman’s to fail. This decision failed to restore market discipline and within days the Government had to rescue institutions and introduce TARP\(^9\). This experience from the US was a salient reminder that solutions that did not convince the markets would invite misfortune.

63. I wrote up my notes of the meeting within a couple of days. Absent the hindsight observations in this statement, they are a contemporaneous record of the events that night as I saw them.

64. Closing remarks

65. The Banking Crisis is a complex and sorry tale. It had negative impacts on all those involved and on the public in general. In my statement I have expressed my sincere regret and tried to avoid attributing blame to others. I draw little comfort from the extraneous factors that contributed to the crisis.

66. I hope that bankers and regulators can benefit from this process of Inquiry. Banking is founded on risk and bankers and regulators have to balance risk appetite and pressure from their constituencies. Managing this conflict is inherent in their roles. The Committee’s work can serve to widen the understanding of the complexities involved. My contribution, highlights the problems that arose, the mistakes that were made and how these may be avoided in the future.

\(^9\) TARP. The Troubled Asset Relief Program where the US government would purchase assets from financial institutions to strengthen the sector during the global financial crisis amounted to $700bn.