# JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

## STATEMENT OF MICHAEL BUCKLEY

## SUMMARY: My time as AIB CEO April 2001- June 2005.

Before commenting on the issues which the Joint Committee has asked me to address, I would like to touch on some aspects of the business environment while I was CEO of AIB and on my focus on risk management during that period. To help my recall and to avoid the distortions of hindsight – the events took place 10-15 years ago - I have reviewed limited AIB Board documentation for the period.

I was appointed Group CEO Designate of AIB in October 2000 and formally took over as CEO in June, 2001. My successor was designated in March 2005. After a short hand-over period, I retired on 30 June 2005. A month before I retired, Standard and Poors upgraded the bank's long term credit rating to A+ from A, a grading awarded to few banks internationally. Following a detailed review, the agency said "The rating on AIB reflects its leading position in its main market, the Republic of Ireland (ROI), strong credit risk management, good underlying financial performance, and sound liquidity. They also reflect AIB's ongoing initiatives to improve its risk management procedures and control frameworks. The ratings also incorporate the challenges to manage rapid growth in a well-controlled manner, such as the strains placed on internal capital generation".

AIB in my time was an international business employing over 30,000 people. As CEO of any business, you are constantly trying to find, and then maintain, the right balance between complex risk and opportunity factors in the business to create growth in a competitive environment. Two bouts of crisis management - the Allfirst fraud uncovered in early 2002, and the fx/overcharging issues that arose in 2004 in ROI - punctuated my time as CEO and, as far as I was concerned, made me very risk management focussed. Thinking back over all of the challenges I had to deal with, I can say that, as I retired in mid-2005, I had no premonition, let alone any evidence, that a liquidity or credit crisis was building internationally or in Ireland, or that a credit crisis was building in AIB.

From the date of my retirement onward, I had no involvement in the management or Board of AIB (apart from serving as a non-executive director of M and T Bank at the request of AIB), and have no information relevant to the matters being investigated, beyond mid-2005.

### *Economic Background and Business Environment*

The business environment when I became CEO initially held considerable uncertainty. It was the immediate aftermath of the dot-com crash and of the outbreak of foot and mouth disease in Ireland. The events of 9/11 followed closely. There was great concern about growth and liquidity in the global economy. The knock on effects on the Irish economy, in tourism traffic and spending, after a period of strong growth since the 1990s, had hit confidence in the retail sector and in the prospects for inward investment. In the other main parts of AIB's business, in the UK, the USA, Poland and elsewhere, the outlook was by no means benign.

From the second half of 2003, the previous uncertainties about the business environment began to dissipate. The very positive demographic factors in Ireland came back into focus as growth drivers, and the "catching up" economic growth spurt that began in the mid-1990s resumed, fuelled by the low interest rate environment which accompanied, and was given further momentum by, the introduction of the Euro.

## ***Risk Management Focus as CEO.***

*Major regulatory projects and what they required*

When I became CEO, there were three massive, mandatory regulatory projects facing all banks - Basel II, Sarbanes Oxley and the new IFRS/IAS financial reporting standards. They were to take up a massive amount of the senior expert cadre of my colleagues in finance, credit and risk in AIB throughout my time as CEO. The Basel II project, in particular, was unprecedented in its ambition. It required banks to build from scratch a quantitative, model-based approach to assess all risks in the business, including to build risk appetite models for each different loan type. The regulators' belief was that those models would generate a sounder calculation of the total amount of capital needed to support the business, and how it should be allocated as between different types of activity.

Collectively, the regulatory projects required a single enterprise-wide support organisation to be built covering all key control, risk management and operational support functions, working to the same principles across all geographies. In contrast, AIB had historically followed a decentralised business model, with little sharing of finance, risk management and operational infrastructure across Divisions.

*Other risk management challenges*

In 2002-2003, the actions that needed to be taken as a result of the Allfirst treasury fraud added impetus to the required pace of change in putting in place an enterprise wide risk management framework. I recruited externally an experienced Chief Risk Officer, reporting directly to me. A group-wide internal audit function was put in place, headed by an externally recruited executive, as was an enterprise wide compliance function and a single treasury management organisation. During 2002-2004, we commissioned separate independent examinations and reports on treasury, operational and credit risk and controls. We implemented a wide range of recommendations arising.

Subsequently, in 2004 and up to my retirement, I also put some considerable time into trying to understand and mitigate another risk issue – one which has often been mentioned in commentaries and reports on the reasons for the banking crisis. That is the pressure for consensus and the suppression of contrarian views within banks. My experience was that people working in banks were prone to a consensus culture and that this had downsides as well as upsides. The Allfirst fraud in 2002 and the fx/overcharging issues that emerged in 2004 in ROI had common features – both problems had had their origins in the 1990s. Reluctance to speak up and express contrarian views was part of the reason why they did not come to notice earlier. From 2002 onwards, I took a number of steps to create a better culture of two way communication, to make it easier for colleagues to feel safe in escalating any issues and concerns, and to ensure that such issues were rigorously and objectively followed up. Managers' accountabilities were expanded to make the non-escalation of issues a disciplinary matter late in 2004. During 2004, the Chairman and I also launched and promoted a "Speak Up" campaign to which put in place a number of communication channels were put in place through which colleagues could raise any issue troubling them, without fear, including a completely external channel.

*Were there any new risk issues emerging by the time I retired?*

Towards the end of my time as CEO, as risk weighted assets had been growing strongly, and ahead of internal capital generation, we were beginning to see some erosion of our Tier 1 capital ratio, though it was still considerably above regulatory limits. Also, the loan/deposit ratio was rising above 120%. My judgment was that at this sort of level, we needed to put in place a balancing mechanism. I use the term "judgment" because It is important to emphasise that, at that time, there was no regulatory upper limit to a loan/deposit ratio, nor is there any science or formula that would generate an effective and universally applicable percentage for such a limit.

In the second half of 2004, as part of the planning and budgeting process, myself and my management team decided on some actions that were aimed to help deal with those issues..
A proposal was approved by the Board late in 2004 to introduce a loan to deposit threshold of 125% in 2004 and of 130% in 2005, with a requirement for a six-monthly report to the Board. In relation to Tier 1 capital, a preference share issue was approved. Ways of implementing capital rationing by Division began to be discussed, that would also help towards resuming the pattern of year by year internal capital generation. Finally, there was a renewed focus in budgets on strategies to grow non-interest income and deposits. A related issue that was opened up for discussion at this time was the possible organisational transfer of responsibility for the larger lending relationships in the ROI (and GB/NI) business lending teams to the Capital Markets Division. The Capital Markets Division had expertise in syndications and in securitisation, and less of a "buy and hold on our own balance sheet" culture. Those matters formed part of the list of handover items on which I briefed my successor in early 2005.

## 2. THE THEMES AND KEY LINES OF INQUIRY WHICH I HAVE BEEN ASKED TO ADDRESS.

### B1 c. Quality of the Business Model Setting Process

During the first half of 2001, my management team and I reviewed the opportunities, challenges and competitive environment across all of our businesses and geographies, how we were regarded by our shareholders, customers and colleagues, our capital position, whether we were organised in the best way, and what our business model should be.

An important starting point was that some big traditional components of bank interest income revenues had been badly hit by the sharp fall in interest rates, the introduction of the euro and the subsequent flattening of the yield curve. Replacing those traditional income sources was a major challenge.

A second material background factor was that Investors saw AIB as a loose federation of banking franchises without any distinctive common thread. While it saw our main market, ROI, as dynamic, their view was that other banks with a more singular focus on the Irish market had more exciting growth prospects.

Our conclusion was that we needed to:
- develop a distinctive model of how AIB did retail and commercial banking and implement it consistently wherever we operated internationally. That proposition should be focussed on holistically growing the total relationship with our customers, that is to say across a wide range of

banking services, as distinct from having a purely transactional, or narrow, specialised focus, and to
- build an efficient and cost-effective enterprise wide risk and operational support capability, to uniform standards that would also allow us to implement the major regulatory projects to which I have referred. A strategic plan based on those goals was approved by the Board later in 2001, covering the period up to 2005. Subsequently that plan was revised and resubmitted to the Board at least annually.

***How was that business model applied to our approach to the Irish market?***

A rising birth rate, followed by, net inward migration had led to a very rapid rise in the ROI population (from 3.5 million in 1985 to 4.2 million in 2005) and in the labour force (which grew from about 1.4 million in 1994 to over 2.0 million in 2005). Together with the big increase in inward investment following on the implementation of the Single European Market, this had generated an unprecedented need for investment in hard infrastructure (housing, schools, retail, commercial, roads, etc.), together with an increase in the demand for a broad range of financial services from the growing personal and business customer populations. The same factors and perception are what attracted new banking players to enter the Irish market during the second half of the 1990s, and some others to scale up existing businesses here.

In the Republic of Ireland, AIB had always been a universal, i.e. retail, commercial and corporate, bank, with a presence in every local community. We had a 30-40% market share of personal and business customer accounts. But in the context of the size of the bank and, in the light of the demographic factors underpinning demand for financial services, we were clearly underperforming in terms of our market share of deposits, mortgages (where we only had a 16% share), investments, life assurance, business lending etc. We did not have a presence in the growing health insurance market. So, we needed to reshape both our ROI business model and our organisation to become better at capitalising on the potential inherent in our large share both of personal banking current accounts and of business banking working accounts.

The organisational reshaping involved centralising as much as possible of routine transactional and processing services out of branches, using the time thus freed to develop broader and more profitable relationships with our branch customers across the whole gamut of financial products. It involved creating a centralised mortgage processing and decision-making centre, so that credit decisions would be taken against consistently applied criteria. It also involved moving responsibility for all but the smaller end of business lending to new regional business centres where the relevant business credit and relationship expertise could be concentrated, and finally building sectoral lending teams with a national focus, which would have the expertise to deal with the larger business relationships. This strategic change was supported by a big and continuing investment in training, both in credit and in relationship management, as well as a large investment in technology.

It would be entirely wrong to characterise that AIB business model as attempting to emulate other banks. That holistic relationship management business model was about getting much better at what we did across all aspects of financial services, rather than trying to emulate what more narrowly focussed competitors were doing, especially the banks focussed solely on transactional lending. Of course, we were aware that we were in hot competition with transactional and specialised banks for every bit of customer business. But our strength, and the basis for our business model, was that those competitors did not have the capability that we had to offer that holistic relationship service. In many instances, their market entry strategies simply relied on offering limited range of more highly leveraged products (e.g. they introduced 100% mortgages, and more), lower margin loans, and loans with easier security conditions and repayment terms.

I believe that the business model I have outlined was well founded. There was no part of it which required or encouraged colleagues to compete by lowering credit standards.

**B2 b Appropriateness Of Credit Policies, Delegated Authorities And Exception Management.**

As mentioned earlier, a number of independent reviews were undertaken in 2002/3 of policies, structures and controls in the main areas of risk, notably, treasury, operational and credit. Deloitte carried out the credit risk review and reported at the end of 2002.

Their findings were that AIB had “a well-established, strong credit culture…throughout each of the Divisions and at Group level”, as well “established credit processes… within a framework of credit policy and delegated authorities based on skill and experience. There are credit grading and monitoring systems which accommodate the early identification and management of deterioration in loan quality. In addition, the process is underpinned by a system of credit review by units which are independent to the business with local divisional reporting lines. These units also have a functional reporting line to Group Credit Review”. Deloitte also found that each Division had written policies and procedure that were pertinent to its current business and found a clearly defined structure of Credit Committees at Group and Divisional level, chaired by senior executives from the credit/risk management function, as well as a regular credit portfolio review process.

Deloitte’s recommendations for future action focussed on developing a consistent approach to credit grading and processes across the Divisions, and on developing an enterprise wide integrated IT system to support better credit analytics and more automated credit reporting - a very large project which it judged would take 3 years to implement. (This was also required by Basel II so the two projects were merged).

I would add that changes in credit policies, whether at Divisional or Group level, required the sign off and sponsorship of the relevant credit unit. There was a credit report for the Board from the credit function in each monthly Board pack, quarterly and annual credit reviews covering impaired loans and advances movement generally, which were presented to the Board. Large credit exposures were reported monthly to the Board. Any exceptions to Large Exposure Policy also had to be brought to the Board and individually justified, with the support of the relevant senior credit executive. During my four years as CEO, such exceptions were infrequent. I recall that most of them were as a result of underwriting large facilities in the Capital Markets Division, which would subsequently be sold down. There was one exception which was property lending related towards the end of 2004. It was dealt with by a sub-Committee of the Board, for timing reasons, and subsequently reported to the Board.

As far as continuing review of the appropriateness of credit policies is concerned, the Board agenda in my time would have featured periodic review papers on particular areas of credit, including a detailed policy review. For instance, IFSRA required Boards to focus their attention on reviewing mortgage lending growth and associated policies during 2003/4. A review of Property and Construction lending was presented to the Board in late 2004 (see below).

Credit authorities delegate to Divisional credit committees were relatively modest even at the end of my time as CEO. For a mid risk-graded commercial credit the ROI Division Credit Committee had a delegated authority of €60 million and for a higher risk-graded credit the limit was €45 million. Above those limits, the cases would need review and approval by the Group Credit

Committee, which was chaired by the Chief Risk Officer. Any proposed changes in delegated authorities required Board approval and had to be sponsored by the Group Credit Officer and Chief Risk Officer as reasonable and prudent.

### B2 c Analysis of Risk Concentrations in the Base, the Adverse Economic Scenarios and the Impact on Capital Structure.

Risk concentrations began to be focussed on at Group Management and reported at Board level, by geography, by business line and by product and sector during 2003.The main area of focus initially, driven by IFSRA/Central Bank focus, was mortgages. While our mortgage book was growing fast, our concentration levels were lower than our peers. Over the next two years, mortgage concentration in the ROI book was the subject of regular analysis and review both at Group Management team level and at the Board, in detail, by product and by policy per product, and in terms of controls and exceptions.

Property and Construction lending in ROI became over time the second area of focus from a concentration point of view, but more gradually, during 2004. There was also a significant amount of property lending in the GB/NI Division and in Capital Markets. The overall aim was to keep ROI exposure to contractors down to mid-single digit percentage of the total and to have the rest roughly evenly split between Investment (emphasis on quality of anchor tenants on the much larger commercial investment component) and development (split between commerclal and residential).

The Board did not have an overall concentration limit on property related lending, while I was CEO. Of course, concentration limits have now become a standard risk management tool both for regulators and Boards. But to be effective they require good data and good analytics system capability. The priority, following the Deloitte report, was to invest in the IT systems and data analytics tools to enable trends in credit quality to be tracked across the enterprise in a consistent way. Generally speaking, the regulators' view internationally was that implementation of those systems in the context of Basel II would provide the data and tools to enable a more scientific approach to all aspects of capital allocation, including risk appetite and concentration limits. Pending that, I naturally accepted the view I consistently received from the Divisional and Group Credit teams, based on existing analysis, that the concentration risk in AIB ROI's loan book was adequately mitigated by the diversity of the lending in what is a broad sector, by factors such as geography, quality of tenancy, type of lending and loan structure (including covenants and security). (See comments on Topic B2 a below).

Some adverse economic scenario testing was incorporated in the Group 3 Year Plans which were refreshed each year and in the Annual Budgets. But the scenarios considered, were not extreme.

A much more severe downside scenario for the ROI property, construction and residential lending portfolio, based on a very severe fall in property values was analysed and presented to the Board right at the end of my time as CEO, in May 2005. The modelling threw up very substantial fall in the profits of the ROI Division but not a loss, and therefore no impact on the Bank's capital structure.

### B 2 a Appropriateness of Property Related Lending Strategies and Risk Appetite

I have already set out the very strong demographic factors in ROI which underpinned growth in property and construction related lending. I have also emphasised that AIB ROI property related lending products were part of a broader, holistic strategy of maximising the relationship value of our extensive customer bases in the personal and business markets, for whom we operated a high proportion of all working accounts nationally.

As time went on the competitive pressure to engage in higher LTV mortgage lending intensified, driven by the UK based banks. The response which AIB adopted was not to copy them blindly, but to try and identify customer groupings to whom we would be prepared to offer such mortgages, because of identified mitigants; for instance, for certain segments of the young professionals sector, applicants who had clear parental financial support etc. There were regular, granular reviews prepared for my Group Management team and for the Board on any relevant policy adjustments.

In the business sector, our similar strong position with SME's meant that, as we grew those relationships, we increased our property related lending. A requirement to finance property is at some stage an important factor in every expanding or developing small or medium sized business. In addition, we had for decades being dealing with a range of developers who had demonstrated the ability to survive down-times in the economy. It seemed natural and appropriate to grow our lending relationship with such customers who had a long track record with us as they took advantage of the opportunities which the growing demand for built infrastructure presented to them. But the policy was to focus on lending either for investment or for developments where a significant amount was pre-sold or pre-let, as well as to require a higher level of pre-sold or pre-let for higher leveraged development loans. At the time of my retirement, the individual large exposures to property related lending customers were at a fraction of what they ultimately reached.

In that context, I have reviewed a Board presentation on Property and Construction lending (excluding residential mortgages) in ROI made to the Board in October 2004. It recorded that such lending, at €8.8 billion, then amounted to 23% of the ROI loan portfolio, compared to 17% in 2000. It also recorded that a large part of it was concentrated on a smallish number of longstanding, proven customers, with 30 customers accounting for 30% of the portfolio, i.e. an average of about €90 million per customer. It was noted that in the next phase the supply/demand equilibrium needed to be watched carefully. But the representatives of the Group Credit function (the Group Chief Credit Officer and the ROI Divisional Credit Officer) at the presentation expressed themselves as happy with the diversification within the existing portfolio and that credit quality was both stable and strong.

## B5 a- Adequacy of the Incentive and Remuneration Arrangements to Promote Sound Risk Governance

The thinking on this topic has moved on considerably in all countries since the financial and economic crisis. So it is particularly difficult to keep hindsight from intruding on an assessment of what was the case 10-15 years ago.

During my time as CEO of AIB, I believed that the incentive and remuneration arrangements were broadly balanced from a risk governance point of view. Our basic pay tended to be around market rates. Individual maximum bonus potential certainly trended up somewhat during my time, but a very important element in overall remuneration was that medium term incentives such as share options were made available to a wide range of executives and managers. Such incentives are designed to align management's interests with shareholder interests in the medium term to long term, by ensuring that management are focussed on building a sustainable business as distinct from taking excessive short term risks.

The Remuneration Committee, which was made up of independent non-executive Directors, reviewed all those elements of incentive and remuneration arrangements annually and also had discretion to vary bonus pay-outs for performance-relevant factors that emerged during the year but which were not formally captured in the incentive scheme framework. I can recall that this downward discretion was used on a number of occasions during my time as CEO.

Do I think that AIB's remuneration arrangements encouraged riskier behaviour than was desirable? The answer to that question will always be conjectural. I have no evidence that it was a major factor, which was also the view of the Nyberg report.

### R3 b Nature and Appropriateness of the Relationship between the Central Bank (Including the Financial Regulator) Department of Finance and the Banking Institutions.

I had very little contact with the Department of Finance during my time as CEO, and would not have counted it as a "relationship" from a business point of view.

I had regular contact with the Central Bank and with the Financial Regulator, as did my Finance Director, as well as some other executives such the Head of Compliance.

As a regular requirement, each year myself and the AIB Finance Director went to the Central Bank the day before the release of AIB's Interims and Annual Results respectively, and met with senior officials there to go through the results. On none of those occasions was there what might be described as a testing interrogation.

I had a very intensive period of interaction with the Central Bank for about twelve months following the discovery of the Allfirst fraud in February 2002. This included agreeing, jointly with the Central Bank and the Federal Reserve Bank in the USA, a very detailed programme of action to be undertaken by AIB on controls and organisation in the aftermath of the fraud, and subsequently reporting back on progress very frequently.

When the FX/overcharging and other conduct related issues arose in the first quarter of 2004, the Chairman and I had an intense period of interaction with senior executives in the Financial Regulator on the conduct issues arising, the independent investigation of those and on the remediation programme to be put in place as a result of the findings.

In relation to those last two sets of issues, my recollection was that the approach of the Financial Regulator to conduct issues was more intrusive than that of the Central Bank. But in both cases there was also appropriate attention on their part (as there was on our side) to ensuring that there was separation where relevant as between their interaction with the Board and their interaction with management. They also ensured that there was appropriate independence both in the investigation and oversight of any matters which raised issues for them as regulators.

I have already mentioned that here were periodic requests from the Central Bank/ IFSRA, usually addressed to the Chairman of AIB, raising concerns about and asking for reports on the mortgage market and AIBs lending strategy in relation to it. In each case, the matters would be investigated and analysed internally and a paper brought for review by my Group Management team and then by the Board, before an answer would be prepared and sent. I do not recall that there was a similar focus from the Regulators on the broader area of Property and Construction lending during that time.

The only other type of interaction I recall is a meeting which the Governor of the Central Bank called with all banks operating in the ROI market, possibly in 2004, in which there was a general conversation about the market. A remark I made at the meeting was that if the Central Bank felt that the market was becoming overleveraged it should actually do something about it, as distinct from just worrying aloud about it e.g. by introducing leverage limits, or a restriction on income multiples for mortgage calculations.

Overall, my approach to my relationship with the Regulatory authorities in relation to all matters arising during my time as CEO was to be open and cooperative and to ensure that any investigations that needed to be undertaken and any remediation programmes required were defined with appropriate scope and implemented thoroughly, with independent governance.

Michael Buckley

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