JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

WITNESS STATEMENT

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Cormac McCarthy

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1. **Introduction**

I refer to the Direction to Attend and Make a Statement in Writing Pursuant to Section 67(1) of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013 as received by me on 24 March 2015 (the "Direction").

2. **Biographical Information**

I graduated from UCD in 1983 with a B.Comm and qualified as a Chartered Accountant with Stokes Kennedy Crowley (now KPMG) in 1987. I left KPMG in 1990 and joined Woodchester Investments plc where I worked for 8 years in a number of senior finance roles. In 1998 I joined First National Building Society (later First Active plc, ('FA')) as Head of Finance. I served as Chief Executive Officer ('CEO') of FA from 2000 until my appointment as CEO of the enlarged Ulster Bank Group ('UBG') in January 2004. I remained as CEO until I left in May 2011.

3. **Background / Context**

FA converted from a mutual building society to a public company in September 1998 and floated on the Irish and London stock exchanges.

In January 1999 Ireland joined the Euro, as a result of which Irish base interest rates fell rapidly to historic low levels and cross border flows of the new Euro currency opened up. In early 1999 Bank of Scotland plc acquired Equity Bank, renamed the business Bank of Scotland Ireland ('BOSI') and, using access to cheap and plentiful Euro funding, commenced offering Euro denominated mortgages in Ireland at rates that were significantly lower than those on offer by the 'Irish' banks. These 'Irish' banks, in an effort to compensate for the margin they had lost on deposit and current accounts following the switch to the Euro, had not passed on the full amount of the fall in base rates to their mortgage customers. Following significant media and political pressure, and in an effort to discourage other 'foreign' banks from entering the Irish market, the 'Irish' Banks reduced mortgage rates to a level that was competitive with those on offer by BOSI.

Because the other 'Irish' banks were either still mutual (Educational Building Society, Irish Nationwide) or had broader based businesses than FA (Irish Life & Permanent, Allied Irish Banks ('AIB'), Bank of Ireland ('BOI'), Ulster Bank ('UB')) the negative impact of this reduction in mortgage rates, while material, was manageable. In the case of FA, as a monoline (mortgages and savings) public company with an inefficient cost base, the impact was significant and led to a major restructuring of the business and ultimately to my appointment as CEO in July 2000. Absent legislative take over protection for five years post flotation it is probable that FA would have been acquired by another institution before my appointment as CEO.

Over the next three years, due to growth in the Irish economy and a series of changes to the business model and cost reductions, the profitability of FA and its share price was improved. During this period and, following the acquisition of its parent bank NatWest plc by Royal Bank of Scotland plc ('RBS') in 2000, UB had been seen to change appreciably and increase its competitiveness in the Irish market, particularly in property and mortgage lending.

In April 2003, six months before the five-year takeover protection period for FA elapsed, RBS approached FA with a view to it being acquired by UB. The desired intention was to combine the businesses to take on AIB and BOI and become the then much talked about 'third force' in Irish banking. Given the narrowness of the FA business model, the regard in which RBS and its management team was held, the growth strategy of RBS, the experiences that FA had gone through in 1999 and 2000, and appreciating the increasing importance of scale in modern banking, the FA Board agreed to enter into discussions with RBS. In the Autumn of 2003, following FA shareholder approval, a deal with RBS was agreed and completed in January 2004.

Immediately following completion of the deal, I was appointed CEO of Ulster Bank Group ('UBG') (which includes UBL, UBIL and FA) in Ireland, reporting directly to the RBS Group CEO, and I joined the boards of both Ulster Bank Limited ('UBL') and Ulster Bank Ireland Ltd ('UBIL') (collectively 'UB'). I also became a member of the RBS Group ('RBSG') Executive Management Committee ('GEMC').

As CEO of UBG I was tasked with:

- Creating a combined management team from UB and FA management.

- Effecting the business and management integration of UB and FA, while at the same time maintaining the two brands.

- Working with RBS to move the UB and FA technology platforms on to those of RBS.

- Developing and executing a strategy to take advantage of the growing Irish economy and create a real alternative to the two main indigenous Irish banks, AIB and BOI.

I was in complete agreement with, and enthused by this opportunity, believing that in being part of RBS, the UB and FA combinations could bring something to the Irish market that was both needed and unique.

In January 2004 when I took over as CEO of UBG and commenced integrating FA into the broader UBG, the following are worth noting:

- RBS was one of the largest banks in the world. In 2004 RBS generated £6.9bn of pre-tax profits and at the year-end (31 December) it had total assets of £583bn, dwarfing even the aggregated profits and balance sheets of the indigenous Irish banks.

- There had been much talk about the need for a 'third force' in Irish banking to balance the market leadership of just two banks, namely AIB and BOI. This was RBS's stated intent in acquiring FA.

- Economic conditions in Ireland were good and the outlook was for continued growth. GDP grew by 3% in 2003 and was forecast to continue to grow by between 3% and 5% for the foreseeable future. Unemployment stood at 4.6%, effectively full employment, and interest rates were at all time lows and forecast, because of the Euro 'effect', to stay low for some time to come.

- The UK economy was very healthy at the time (GDP 4.3%, unemployment 5.0%, inflation 1.4%, house price inflation 15%) and the mood in Northern Ireland, where UB was the leading bank, was positive as it sought to benefit from both the improvement of the economy across the border and the 'dividend' arising from the peace process.

In 2003, the year before I took over as CEO of UBG, UB contributed £273m (c.€350m) pre tax profit to RBS earnings that year and had total customer loans outstanding at the year end of £11.6bn (c.€14.9bn). These sums amounted to less than 5% of the corresponding RBS figures.

In the closest comparable periods, AIB made €1.01bn of pre-tax profits and had €50.5bn of customer loans outstanding, and BOI made €1.17bn of pre tax profits and had €67.5bn of customer loans outstanding. Although these AIB and BOI numbers are group numbers, and therefore include their international business, well over 50% of both AIB and BOI earnings and assets related to the island of Ireland. On this basis the enlarged UB appeared to be punching well below its weight and to have a clear opportunity to challenge the 'dominance' of AIB and BOI.

Over the following four years to the end of 2007, with the benefit of continued economic growth in both Ireland and the UK, low interest rates and a plentiful supply of liquidity, the strategy remained the same. In that period UBG grew its pre-tax earnings by 74% to £513m and its advances to customers by 172%% to £47.1bn. In roughly the same period, AIB and BOI grew their group earnings by 148% and 65% and their loans by 149% and 99% respectively. Anglo Irish Bank and Permanent TSB grew their earnings by 258% and 70% and their loans by 265% and 128% respectively. Competition was intense and was exemplified by the constant relative comparison of the annual and semi annual results of all the banks, by the market and the media to assess 'winners' and 'losers'. Despite UBG's significant growth during this period it is probably fair to say that the Bank's competitive position at the end of this period was, in reality, no different to that which it found itself in at the start.

In the context of my appointment as CEO of UBG I believe that the following structural and operational points are important:

- I was assured by RBS that capital and funding support would be made available to support growth. In this regard capital and liquidity management were not considered to be a critical local UB priority.

- The RBS governance model that applied to UB prior to the FA acquisition remained unchanged and the balance of the management team that I put in place was heavily biased towards the UB senior management team that I inherited.

- There had been, and continued post my appointment to be, significant RBS oversight of and involvement in the UB business particularly where risk matters (credit, regulatory and operational) were concerned, with the UB senior management in those areas having strong solid and dotted lines into senior RBS personnel.

- A matrix model also operated in Human Resources (HR) with the UBG Head of HR having a double solid reporting line into the RBS Director of HR and myself.

- The UBG Chief Financial Officer ('CFO') had a strong dotted line in to the RBS CFO and all accounting (including provisioning) policies were aligned with those of RBS. The UBG Head of Internal Audit similarly had a strong dotted line to the RBS Group Head of Internal Audit who attended UBL Audit Committee meetings at least once a year.

- Members of RBS senior management were either formal members of UBG Boards and committees or had rights of attendance. This included the UBL Board and Audit Committee.

4. Lines of Inquiry

Further to the Direction, I note that the Inquiry wishes to pursue the following lines of inquiry with me:

B1:c, B2:a, B2:b, B2:c, B5:a, C2:c and C3:b.

Some of the above background and contextual content already addresses these lines of inquiry and should be viewed in that context.

In respect of some of the lines of inquiry, the question as to appropriateness or adequacy arises and such that it does, I was satisfied as CEO that appropriate and / or adequate governance frameworks and policies were in place which fully reflected UBG's position within the RBS Group.

4.1 Quality of the business model setting process [B1:c]

Each legal entity in UBG (UB, UBIL, FA) had a separate Board of Directors, chaired by an independent non-executive director, and board membership comprised executive and non-executive directors and senior RBS representatives. The Boards were supported by an Audit Committee of independent non-executive directors. The Group's High Level Controls (HLC) framework documents, which have been provided to the Inquiry, contain the full detail of the organisational structure.

The approach to formulation of strategy is set out in the HLC framework. This included *inter alia* an annual strategy offsite session at which the UBL Board reviewed and considered the proposed business strategies and plans for the next five years, with the agreed strategies then being translated into detailed operational and financial plans in each of the business units.

There was a significant degree of RBS involvement in and oversight of the UBG strategic planning and budgetary process. RBS operated a detailed budgetary and forecasting process which involved the annual preparation and updating of the UBG strategic and financial plans. These projections included profit and loss accounts, balance sheets and cash flow and capital forecasts. These detailed plans were submitted to RBS for review, challenge and ultimate approval. The annual budget setting process for UBG operated in a similar way. The first year of the five year plan each year was adopted as the budget and a series of meetings were held with RBS personnel culminating in an annual budget meeting with the RBS CEO and CFO. The UBG budgets were presented to the relevant boards for final approval.

Performance against plan was closely monitored by RBS. Performance was reported monthly to RBS and at quarterly intervals a more detailed reporting and re-forecasting exercise was submitted to RBS. This was then the subject of close and detailed engagement between myself and the UBG CFO and the RBS CEO and CFO.

Performance was also reported to and discussed at GEMC monthly and to the UBL Board quarterly.

I was required to present to the RBS Board annually on the UB performance and strategy and I attended annual GEMC strategy offsite meetings (typically held in January) and annual RBS Board strategy offsite meetings (typically held in the Summer). At each of these offsite meetings I was required to present on the UBG performance and strategy.

4.2 Appropriateness of property-related lending strategies and risk appetite [B2:a]

Business divisions in UBG were given general, non sector specific, growth targets that were to be achieved within acceptable risk policies, appetite parameters and lending caps, and therefore did not set out any sector specific strategy focus. Strategic plans covered a wide range of initiatives across Products, Presence, People, Customers and Brand, within an overall strategic theme of being a "full service bank". The Corporate Markets ('CM') property lending unit had a mandate from UBG and RBS to finance the UK property activities of its Irish customers.

The UBG approach to property related lending also has to be seen in both the context of the prevailing market and the expectations of RBS and its positive view of the growth prospects of the Irish economy, evidenced by its acquisition of FA. It is notable, for example, that all economic indicators from 2003 through to 2007 regarding the demand for housing over the medium term were positive, This included underlying demographics particularly in the household formation age bracket, numbers per household (which were trending over time to European norms), economic growth, migration and interest rates. It was estimated in 2003 that at a minimum 40,000 housing units a year would be required through the period to 2010 following which there would be a lower but still significant ongoing requirement. In the case of RBS in the four years to the end of 2006, RBS grew loans and advances to customers from £223bn to £467bn, an average annual growth rate of 20%, and pre-tax profits from £4.8bn to £9.2bn, an average annual growth rate of 18%.

Sector risk appetite over the period was set out initially at a high level. Appetite did not set limits but articulated the Bank's view of a sector which influenced business development. Over time sector reviews and appetite statements became more detailed and prescriptive as is highlighted by two Property Sector Reviews which took place in 2007 and 2008. The only property related portfolio cap was in respect of speculative lending which was set as set at 3% of total loans. The Irish Financial Services Regulatory Authority (the "Financial Regulator") also set a Commercial Real Estate cap at 250% of the capital base. In July 2007 the Financial Regulator agreed to a cap of 500%.

4.3 Appropriateness of credit policies, delegated authorities and exception management [B2:b]

From mid 2003 UB started to develop a suite of Retail and Corporate policies that conformed to the RBS policy framework. The UB Risk Credit Policy & Strategy Committee ("GRCP&SC") was established in June 2003 to approve credit risk policies and was a subcommittee of the UB Risk Policy & Controls Committee ("GRP&CC"). Policies were structured around rules and guidelines. Rules had to be followed and, if breached, were subject to exception reporting and higher level approval. Guidelines were guides and, if exceeded, had to be justified. Policies also covered risks that had to be assessed. All credit policies were subject to annual review. By 2007 RBS had 241 Corporate and Retail policies of which UB had adopted 226.

Under the UB Credit Committee and Delegated Authority Policy the most significant CM credit risks were presented to the most senior Credit Committee ('CC') for approval. New business was deemed riskier and carried lower delegated authority. Individual discretions and delegated authorities were based on a combination of the aggregable amount of facilities and the borrower's credit grade. Credit Authorities for UB CC were approved by the RBS Risk Committee. CC's comprised of three people with at least one person from Credit and one from the Business. The committee Chair made the decision. CC members were nominated by business and credit heads and had to be ratified by RBS Group Risk. Above certain thresholds cases were required to be submitted to an RBS Group Credit Committee for approval.

In Retail, UB branches had no lending authority and everything was referred to Credit. FA branch managers and broker consultants had authority to a defined level if the proposal met policy rules.

A reporting process for exception management was introduced in July 2005 in line with a new Credit Policy Exceptions Approval and Reporting Policy. The relevant Credit and Lending Unit management were required to ensure that any policy rule exceptions were identified before a sanctioning decision was made. All policy rule exceptions were proposed and recorded by the Credit/Lending Unit using a template and were approved by the appropriate Credit authority (sanctioner, Credit Committee, etc.) as set out in the relevant Credit Policy. Exceptions within Retail were reported monthly to GRCP&SC and RBS Group Credit Risk and from December 2005 were also presented to the UBL and UBIL Boards for noting.

4.4 Analysis of risk concentrations in the base, the adverse economic scenarios and the impact on capital structure [B2:c]

Responsibility for monitoring sector concentration risk rested with the UB GRP&CC. Reports from GRP&CC meetings were presented to the UBL and UBIL Boards for noting with detailed minutes/papers available on request.

The nature and purpose of concentration analysis evolved in the years leading up to 2008. Before 2005, sector concentrations were monitored quarterly by GRP&CC. Throughout 2004 and 2005 residential lending, commercial real estate and construction accounted for over 60% of the bank's lending portfolio.

A sector exposure framework was introduced in 2005 in response to the need for a more systematic approach to concentration analysis and to bring the approach in line with Basel II and RBS Group policy requirements.

Outputs from this framework included sector reviews, credit appetite statements (with "sector traffic lights" classification) and lending assessment guidelines. Outputs were also mapped to loan management systems and influenced Basel II related

Probability of Default scores. As already noted, only one property related cap was proposed – a speculative lending cap of 3% (of total loans) in respect of commercial real estate lending. GRP&CC was tasked with monthly monitoring of movements in core sectors including property and mortgage lending.

In 2006, a policy of producing quarterly operational reports was introduced by CM. The objective of these reports was to provide a risk focused approach to the management of sector concentrations in the corporate lending book. Such analysis was also supplemented by periodic sectoral reviews such as a commercial real estate sector review in the first half of 2007. This review was approved by UBG executive management as well as by the RBS Head of Group Credit Risk and the RBS Risk Committee. A follow up review was completed in June 2008.

Stress testing was carried out as part of a Central Bank ('CB') and Financial Regulator bi-annual (2004, 2006, 2008) process which examined baseline v shock scenarios provided by the CB and the Financial Regulator. Outputs were high level and focused primarily on Tier 1 and Total Capital ratios. The UBIL return of July 2008 – with shock scenarios including UB assumed house price inflation of -14%, -5%, -2% and +2% for the years 2008-2011 – showed minimum Tier 1 and Total Capital ratios of 7.9% and 8.8% compared to base case ratios of 8.6% and 9.9% respectively.

A more advanced approach to the assessment of the capital impact of concentration risks commenced with the introduction of Basel II and Internal Capital Adequacy Assessment Policy ('ICAAP') (Pillar 2 Capital add-on) in the second half of 2007. ICAAP submissions were required by the Financial Regulator and also the Financial Services Authority ('FSA') in the UK. These submissions were detailed and involved considerable input from RBS Risk personnel. Macroeconomic stress testing for UBIL was undertaken as part of this process involving input from UB Group Economics with the assistance of John Fitzgerald of the ESRI. UB Group Economics provided the ESRI with three global shock scenarios - mild, medium and severe recessions - and John FitzGerald used the ESRI Hermes Model to simulate the impact on Ireland. The simulations covered a five-year period 2006 to 2010. The results of the medium scenario (in accordance with RBS and FSA regulatory guidelines for stress testing credit risk for capital requirements) were used as the basis for the UB 2007 ICAAP return to the Financial Regulator.

4.5 Adequacy of the incentive and remuneration arrangements to promote sound risk governance [B5:a]

All personnel in UBG had individual specific and measurable objectives structured on a balanced business scorecard approach and set annually. Performance (or underperformance) was assessed against individual objectives and a performance rating assigned at year end. This performance rating was a key element affecting staff fixed and variable remuneration. Fixed and variable remuneration was structured and controlled through approved pay matrices or bonus/incentive schemes with the aim of rewarding the delivery of overall business and individual performance.

Individual performance ratings determined the pay, bonus or incentive award. Any staff assessed as underperforming overall when measured against the balanced business scorecard categories would not have received any performance related remuneration.

The Republic of Ireland ('ROI') National Wage Agreements (NWA's) which were in place during the period 2000 – 2008 were paid to UBIL and FA personnel in addition to any performance related pay element. Pay increases, in particular, were assessed against the market position for the Financial Services industry, however during this period NWA's were a key driver of market positioning along with competitor activity in particular business segments e.g Retail and Corporate. All discretionary bonus and incentive schemes were RBS approved and funding levels were agreed with RBS annually based on the business performance of RBS and UBG.

Executive remuneration for UBG was my responsibility with support provided by the UBG HR Director. A similar approach to executive remuneration was in place throughout RBS and all executive remuneration was subject to RBS oversight. Executive remuneration had regard to both business and individual performance which determined an annual individual performance rating. This rating was used to assess the appropriate remuneration for each executive with lending forming only one measure of the review components. My annual performance and remuneration was determined by the RBS CEO and was subject to RBS Board Remuneration Committee sign off.

4.6 The liquidity versus solvency debate [C2:c]

<u>Funding position</u>

During the period from 2004 to 2008, UBG's growth was funded through a mix of deposit growth, RBS Intragroup Lending ('IGL') and wholesale term funding. These were all considered to be stable long term sources of funding. Securitisation was the largest source of UBG new funding.

From September 2007, access to the securitisation markets effectively closed. Similarly, other term funding (such as Floating Rate Notes ('FRNs')) was no longer available. As the closure of term funding sources extended into 2008, wholesale funding became more dependent on shorter term instruments such as European Commercial Paper and Certificates of Deposits. During this period RBS also provided more funding to UBG as term funding instruments matured. In the run up to and after September 2008, short term wholesale funding reduced significantly. In the weeks immediately after the Irish Government Bank Guarantee ('the Guarantee'), UBG suffered significant corporate and wholesale deposit outflows as it was not included in the Guarantee and retail deposits also reduced to a lesser extent. After the initial depositor reaction and the support provided to RBS by the UK Government in October there was a reversal and by December 2008 the non-wholesale deposit base had recovered, notwithstanding the fact that UBG had not availed of the Guarantee.

After September 2008 UBG was able to release liquidity from its residential mortgage book by pledging securitised assets to the ECB in their open market operations. Borrowing from RBS also increased.

<u>Liquidity</u>

Through maintaining the non-wholesale deposit base and mostly through increased access to ECB and RBS funding, UBG continued to meet funding and regulatory liquidity requirements in the run up to and after the Guarantee. In the aftermath of the Guarantee, without access to RBS and the ECB, UBG would not have been able to maintain liquidity requirements. The liquidity 'issue' in the financial markets started over a year before it became a crisis, commencing with the withdrawal of term funding from those markets and the tightening of previously reliable wholesale deposits, particularly in the interbank market. As these funding sources were replaced with shorter term funding, which also eventually fell away, UBG liquidity became increasingly fragile and ultimately had to be supported by borrowing from RBS.

Solvency

At the time of the Guarantee there was no apparent deterioration in the performance of the UBG loan portfolio. Capital was required to be held on the basis of the, then normal, low levels of provisions and expected losses. Very little surplus capital was held above that required. At the time of the Guarantee, notwithstanding severe liquidity stress in part caused by market concerns about the value of banks' assets, solvency calculations could only be based on observed loan performance and the value of underlying assets, not market concerns. As the lack of liquidity transformed into a lack of credit and economic conditions deteriorated, increasing loan defaults and falling asset values rapidly led to an increase in the need to recognise impairments. As time passed, post the Guarantee, credit became increasingly scarce, asset prices continued to fall and loan impairment could be recognised, solvency became a problem with significant levels of capital support required.

4.7 **The appropriateness of the bank guarantee decision [C3:b]**

The impact of the Guarantee on the UBG funding base was immediate and significant. The bank suffered accelerated deposit outflows requiring a significant increase in the RBS IGL on 1 October. In addition to deposit leakage occurring through customer initiated actions and, as was experienced by RBS and other UK banks, certain of our Irish bank competitors persuaded a significant number of our depositors to move their money from UBG to avail of the suggested greater security provided by the Guarantee.

On 8 October 2008 the UK Government announced a £500bn bank rescue package and this was followed on 13 October by the bail out of RBS and Lloyds Bank. This had the effect of significantly alleviating the near term stress that the Guarantee had caused UBG.

4.8 **Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the banking institutions [R3:b]**

The relationship with our regulators was formal and involved regular and constant engagement including annual inspections, themed reviews and ad hoc surveys.

Consumer related matters featured highly with focus on prudential control matters increasing from 2004 following the establishment of the new Irish Regulator in 2003.

UBG's records evidence the increased focus on the controls in place around lending (retail and commercial), loss provisioning and funding, as well as the introduction of stress testing of credit institutions from 2004.

5. **Confirmations**

I am advised by UB and believe that the documents referred to in my statement are true and correct and are not in the public domain.

I am further advised by UB that the documents referred to herein have or are being submitted to the Inquiry by UB in accordance with the protocols required by the Inquiry.

Dated this 9th day of April, 2015

Signed: ______________

Cormac McCarthy

Appendix

Index of Acronyms

Name	**Acronym**
Ulster Bank Ireland Limited	UBIL
Ulster Bank	UB
Ulster Bank Limited	UBL
Ulster Bank Group	UBG
First Active plc	FA
Royal Bank of Scotland plc	RBS
Bank of Scotland Ireland	BOSI
RBS Group	RBSG
Allied Irish Bank	AIB
Bank of Ireland	BOI
Permanent TSB	PTSB
Chief Executive Officer	CEO
Executive Management Committee	GEMC
Chief Financial Officer	CFO
Human Resources	HR
High Level Controls	HLC
Corporate Markets	CM
Risk Credit Policy & Strategy Committee	GRCP&SC
Risk Policy & Controls Committee	GRP&CC
Credit Committee	CC
Central Bank	CB
Probability of Default	PD
Internal Capital Adequacy Assessment Policy	ICAAP
Financial Services Authority	FSA
Credit Cycle Risk	CCR
Republic of Ireland	ROI
National Wage Agreements	NWA’s
RBS Intragroup Lending	IGL
Floating Rate Notes	FRN’s