

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

WITNESS STATEMENT

Michael Torpey

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 16 March 2015 (the "Direction").

2. Background – Joining FA and Integration

2.1 Summary

I was recruited for the role of Executive Director, Finance and Treasury in First Active plc ("FA") in mid-2000, joining FA in October 2000 and was appointed to the Board of FA as an Executive Director in December 2000. Prior to joining FA I was a member of the senior management team at Irish Life and Permanent plc and worked previously with Riada Stockbrokers, Allied Irish Investment Bank and the Irish Government Department of Finance. In January 2004 I was appointed Group Finance Director of Ulster Bank Group ("UBG") comprising Ulster Bank Limited ("UBL"), UBIL and FA.

2.2 Transition of FA

FA was First National Building Society until its conversion to a plc and flotation on the Stock Exchange in 1998. Following flotation, FA underperformed market expectations leading to a significant change of management. In particular, Cormac McCarthy was appointed Chief Executive Officer ("CEO") in mid-2000 and I agreed to join shortly thereafter as the only other executive director.

Under Irish law, for a period of five years after conversion, FA enjoyed protection from takeover. When Cormac McCarthy and I assumed management control, there remained three years of this period of protection. It was our goal to use this three year period to rebuild and strengthen the FA business. We enjoyed full management control and were answerable directly to the Board of Directors and ultimately to the shareholders. We enjoyed considerable success, developing and implementing an innovative strategy for the former building society which delivered strong growth in market presence, profitability and shareholder value.

The success at FA did not go unnoticed. By way of a direct approach initiated in person by Fred Goodwin, CEO of Royal Bank of Scotland ("RBS") Group, to Cormac McCarthy, RBS bid for and ultimately acquired FA immediately upon the expiry of the five year protection period. The acquisition was structured as an acquisition of FA by Ulster Bank Limited ("UBL"), itself a wholly owned subsidiary of RBS. The transaction completed on the first working day of 2004. As part of the acquisition, RBS invited Cormac McCarthy to assume the position of CEO and me to become Finance Director (FD) of UBG. A number of non-executive directors of FA were also invited to join the Board of UBL.

Thus, from the beginning of 2004, I was the Finance Director of UBG, a position I retained until the end of 2007. (While I finished working in this role in December 2007, my formal resignation date as FD of UBG was 5 February 2008.)

On joining UBG, the nature of my role changed from a position of management control answerable to the board in a plc, as it was in FA, to what was effectively a

divisional management position of UBG within the RBS Group. The change in my role was as a result of the position of UB as a subsidiary in the much larger group. In essence, policy was determined by the RBS Group with appropriate input from UBG and my role as FD was to implement that policy within UBG insofar as it related to my role.

I reported directly to the CEO, but also reported in a matrix structure to the RBS Group Finance Director. In governance terms, production of Statutory Accounts was channelled through the legal entities of UBL, UBIL and FA, with their boards and normal governance structures. The CEO and Group Secretary of RBS were members of the Board of UBL. Regulatory reporting was also on the basis of the statutory entities. However, management control was ultimately exercised through RBS.

This structure was applied pursuant to the Integrated Group Membership Policy which provided for the integration of Group Companies. The policy provided for the inclusion of Group Companies within the RBS Integrated Group for the purposes of compliance with the FSA's Prudential Sourcebook rules as it related to capital requirements and intra-group exposure limits. The policy required that:

- A. All companies within the Group were deemed to be members of the RBS Integrated Group unless they:
 - (a) were not consolidated for accounting purposes;
 - (b) failed to meet one or more of the criteria set out in B. below; or
 - (c) were ineligible under FSA rules for inclusion within the Integrated Group.
- B. Membership of the RBS Integrated Group required each company to comply at all times with all of the following criteria:
 - (a) it is subject to management and control by senior central or divisional management within the Group, or by local management under the direction of senior central or divisional management within the Group;
 - (b) it is subject to Group central and/or divisional functional¹ and business management policies and procedures approved by the relevant Group and/or divisional controlling bodies or functions, either administered from the Group centre or managing division, or administered locally or by intermediate level parent companies and subject to oversight by central or divisional management and periodic internal audit;
 - (c) it agrees at the request of the relevant Group and/or divisional controlling bodies or functions to provide such financial support to the other members of the RBS Integrated Group as may be required to ensure the continued solvency of those other members, subject to the provision of such support not endangering its own continued solvency and not infringing any legal or regulatory requirement applying to it. The provision of guarantees or other legally binding commitments to that effect are not required;

¹ Functional requirements cover credit risk – both third party and intra-group, market risk, liquidity risk, operational risk, capital adequacy, treasury management, accounting, tax, legal and compliance.

- (d) its separate legal identity, and any legal or regulatory requirements under which management of members of the RBS Integrated Group must respect and observe that separate legal identity, do not represent a significant constraint on the ability of members of the RBS Integrated Group to carry on their affairs with a view to benefiting the RBS Integrated Group as a whole; and
- (e) where a company is itself an authorised firm regulated by the FSA:
 - (i) the company must monitor its exposure to connected counterparties within both the RBS Integrated Group and the wider Group, and report these to the FSA and/or the appropriate Group functions as required;
 - (ii) the company must disclose in its annual accounts that it and other members of the RBS Integrated Group are an Integrated Group for the purposes of the requirements of the FSA's Prudential Sourcebook; and
 - (iii) the company or the appropriate Group management function on its behalf must have notified the FSA of its status as a member of the RBS Integrated Group before any regulatory treatment dependent on such status may be applied.

If any of the above criteria cease to be met, the company or the appropriate Group management function on its behalf must notify the FSA without delay.

As FD of UBG I had three main areas of focus in the period 2004-2007 namely:

- (i) the UB integration project being the integration of the financial systems of UB, UBIL and FA with those of the parent;
- (ii) a high level of engagement with RBS to ensure that as a subsidiary, we met their requirements on an on-going basis.
- (iii) statutory and regulatory reporting for the UB group of companies

2.3 Integration

- (a) An immediate requirement following completion of the acquisition of FA by UBL was the preparation of an integration plan to combine the entities. This plan was prepared by the (new) management at UBG under direction and challenge from RBSG functions, particularly Group Strategy. The final plan was presented by Cormac McCarthy and me to the RBS Group CEO for approval. Following approval, we were to proceed to implementation.
- (b) As would be expected, the Plan included the bringing together of various functions which were duplicated between the old FA and UB. Thus, an amalgamation of Company Secretariat, Risk and Finance functions among others was an integration action entirely to be expected. Lines of accountability into RBS were already in place for UB and it was necessary to fit the FA management structure into this model. In the integrated structure, key functions were to report into

the RBS Group along appropriate divisional lines. Thus Cormac McCarthy became a member of the RBS Group CEO's General Executive Management Committee. I became a member of the RBS Finance Board (a committee of the Finance Directors of RBS divisions along with senior Finance personnel from the RBS Group Centre, chaired by the RBS Group FD). The UB head of HR reported to the RBS Group Head of HR, the UB Head of Risk reported to the RBS Group Head of Risk etc.

- (c) In keeping with the established business model in other jurisdictions, the RBS Group elected to retain the FA brand alongside the UB brand in Ireland. I had proposed retention of a baseline treasury capability in UBG but this proposal was not accepted and ultimately the RBS Group took the view that the treasury and Balance Sheet management function would be managed centrally by the RBS Group Treasury in London with the day to day operational treasury related tasks being handled by the financial markets team in the Corporate Banking and Financial Markets Division of UBG. I was in any event comforted by the reassurances from the RBS Group that the treasury (including capital and funding) needs of UBG would be met by RBS.
- (d) The RBS Group had a strategy to grow the relative positioning of UBG in the Irish marketplace to equal or surpass that of the incumbent full service market leaders. As the UBG customer loan balances grew in pursuit of this objective, the RBS Group approved UBG re-entering the capital markets to engage directly in wholesale funding to supplement RBS treasury activity with locally originated transactions. Please refer to Section 3.3 below for examples.
- (e) In the Finance area, the need to integrate the general ledgers of FA and UB gave rise to a decision at RBS level to integrate both onto the RBS Group general ledger. Both Cormac McCarthy and I expressed concern at the complexity involved in the deliverability of GL integration which ultimately took some 3 years to deliver.

2.4 Role of Finance Director

The FD in UBG headed up the central finance function. Key responsibilities included:

- Decision support to all business areas of UBG (strategy, asset and liability management, capital management, financial systems, financial control and monitoring, financial reporting, statutory and regulatory compliance on prudential matters and taxation).
- Responsibility for reviewing Group accounting policies and practices and assessing compliance with regulatory requirements.
- Chairman of UBG Group Tax Policy & Controls Committee, Group Assets & Liability Committee, Group Reconciliations Committee and Finance Supervisory Committee.

Included in the above is statutory and regulatory reporting. Additionally as described above, the UBG FD had a key role in the Finance integration project following the

acquisition of FA by UBL in 2004 and the subsequent decision by the RBS Group to integrate FA and UBL Finance with RBS Group Finance.

The UBG FD reported to the UBG CEO and reported in a matrix structure to the RBS Group FD. This latter relationship reflected that a large part of the responsibilities above were carried out under RBSG policies and often under direct influence and control.

Given the divisional nature of the operation within the RBS Group, the role of the FD outside the pure finance functions outlined above was very much less than might be encountered in a stand-alone entity.

The FD of UBG was responsible for UBG treasury functions. UBG powers in relation to Group Treasury were exercised through the UB Group Assets and Liabilities Committee (GALCO) which had full powers of decision making for all asset and liability related matters under report to Group Risk Policy & Controls Committee ("GRP&CC") and within RBS Group policy. A member of RBS Group Treasury had right of attendance as a member at the GALCO and to receive all papers. However, the UB GALCO authority and the role of the UBG FD were heavily constrained by the Integrated Group Company requirements previously referenced. Among others, the key treasury areas of market risk, liquidity risk, capital adequacy and treasury management were required to be subject to Group central and/or divisional policy and procedures and either administered by or subject to oversight by central or divisional (as distinct from local) management. This is entirely consistent with the RBS Group position at the time of integration i.e. that UBG did not require a treasury function as treasury needs would be supplied by the Group function. GALCO in UBG was therefore a delivery channel for the RBS Group's policy and procedures for administration locally in UBG.

2.5 Operational Management

- (a) As FD of a Group company, I had little if any involvement in operational matters in the business which did not directly involve delivery by the Finance function. In particular, the UB Finance function had no involvement in credit policy and strategy as illustrated by the absence of any UBG finance presence on the Group Risk Credit Policy and Strategy Committee ("GRCP&SC"), the committee responsible for maintaining asset quality, determining policy, ensuring adequate controls etc. (See HLC 2004, s2.9.). Further, having regard to the fact that UBG was an Integrated Group Company, the management of UBG was closely monitored and controlled by the RBS Group along functional lines. I note that in the UBG High Level Controls (HLC) Report for 2004, the first line of the detailed responsibilities of the Board reads:

1. Determine and review Group Strategy and:
 - a. Strive to meet RBSG's key financial objectives including
 - i. prudential and other capital ratios; and
 - ii. target rates of return on capital and on other assets.

The last item listed in the detailed responsibilities was to ensure compliance with the RBS Group's policies and procedures.

- (b) As an Integrated Group Company, finance operations formed part of the RBS Group finance operational function and were determined by the RBS Group's operational requirements. Policies and reporting rules had to be followed strictly and in a way which did not allow the exercise of discretion at subsidiary level. At the top level, UBG prepared and updated annually its strategic plan containing both base case financial projections for the next five years and initiatives or action plans above and beyond the base case to drive towards achievement of RBS Group strategy for the business. These projections contained a full suite of financials, including P&L, balance sheet, capital impacts and relevant financial ratios. The process required that, after agreement at UB management level, these strategic plans were submitted to RBS for review and challenge and ultimately, approval. Following RBS approval they were submitted to UBIL and UBL Boards for approval. The budget setting process for UBG was similarly controlled by RBS. The first year of the five year plan each year was adopted as the budget. As part of the planning process, therefore, a detailed build up of plans to arrive at the year one numbers in the strategic plan was undertaken. These were subject to scrutiny and challenge by the Group Financial Planning and Analysis (GFP&A) area of RBS.
- (c) Performance against plan was closely monitored by the RBS Group. Performance was reported monthly to the RBS Group, with initial 'flash' reports about a week after month end followed by more detailed reporting. At three-monthly intervals, a more detailed reporting and re-forecasting exercise was delivered to the RBS Group and was the subject of close and detailed engagement by the CEO and FD of UBG with the CEO and FD of the RBS Group together with their Head of GFP&A and was subject to approval by RBSG. Performance was also reported to the UBIL and UBL Boards quarterly.

3. Lines of Inquiry

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

B1:b, B2:c, B3:a, B4:a and C2:c.

3.1 Integrity of financial reporting [B1:b]

Following the acquisition of First Active (FA) by the RBS Group, the accounting and financial reporting for UBG was initially consolidated into one overall finance function located in both Dublin and Belfast. This was followed by a project to migrate the general ledgers of UBG to the RBS Group under the Ulster Integration Programme, which resulted in the main accounting functions, including statutory accounts production, regulatory reporting and accounts payable moving from UBG to the RBS Group by 2007.

Up to and including the year 2004, UBIL prepared its financial statements in accordance with accounting standards generally accepted in Ireland, in compliance with the specific provisions in Irish statute relating to banking groups contained in the Companies Acts, 1963 to 2003 and the European Communities (Credit Institutions: Accounts) Regulations, 1992.

In 2005 the financial statements were prepared, for the first time, in accordance with International Financial Reporting Standards (IFRS). The date of transition to IFRS for the bank and the date of its opening IFRS balance sheet was 1 January 2004. The 2004 comparative amounts were restated to an IFRS basis for all retrospectively applied standards.

(a) Accounting for Loan Impairment Provisions:

Throughout the period 2004-2007 UB complied with the RBS Group accounting policies and the relevant Irish GAAP or IFRS.

The loan impairment provisioning methodology followed during this period complied with both the RBS Group provisioning policies and the accounting standards in place during the periods.

(b) Irish GAAP – Loans & Advances Accounting Policy (excerpt 2004 UBIL statutory accounts):

Specific provisions are made against loans and advances when, as a result of a detailed appraisal of the portfolio, it is considered that recovery is doubtful. The general provision is made to cover bad and doubtful debts that have not been separately identified at the balance sheet date but are known to be present in any portfolio of advances. The level of general provision is determined in the light of past experience, current economic and other factors affecting the business environment and the Group's monitoring and control procedures, including the scope of specific provisioning procedures.

(c) International Financial Reporting Standards – Impairment of Financial Assets Accounting Policy (excerpt 2005 UBIL Statutory Accounts)

If there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables has been incurred, the bank measured the amount of the loss as the difference between the carrying amount of the asset or group of assets discounted at the effective interest rate of the instrument at initial recognition. Impairment losses were assessed individually for financial assets that may be individually significant and collectively for assets that are not individually significant. In making collective assessment of impairment, financial assets were grouped into portfolios on the basis of similar risk characteristics. Future cash flows from these portfolios are estimated on the basis of the contractual cash flows and historic loss experience for assets with similar credit risk characteristics. Historical loss experience was adjusted, on the basis of current observable data, reflecting the effects of current conditions not affecting the period of historical significance.

(d) Differences – Irish GAAP v IFRS

Under Irish GAAP provisions for bad and doubtful debts are made so as to record impaired loans at their ultimate net realisable value. Specific provisions are established against individual advances or portfolios of smaller homogeneous advances and the general provision covers advances

impaired at the balance sheet date but which have not been identified as such.

IFRS requires impairment losses on financial assets carried at amortised cost to be measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. There is no concept of specific and general provision – under IFRS impairment is assessed individually for individually significant assets but can be assessed collectively for other assets. This collective component is made up of two elements: loan impairment provisions for impaired loans that are below individual assessment thresholds (collectively assessed provisions) and for loan losses that have been incurred but have not been separately identified at the balance sheet date (latent loss provisions).

IAS 39 Financial Instruments: Recognition and Measurement recognised impairment of financial assets using an 'incurred loss model'. An incurred loss model assumes that all loans will be repaid until evidence to the contrary (known as a loss or trigger event) is identified. Only at that point is the impaired loan (or portfolio of loans) written down to a lower value.

In 2010 the Oireachtas Library & Research Service commissioned Dr John McCallig and Professor Ciarán Ó hÓgartaigh, both of UCD, to discuss accounting standards and the implications of forthcoming changes in standards. A relevant comment was quoted in this report from Professor Patrick Honohan on the impact of using an incurred loss model that it 'Reduced the degree to which expected but not yet incurred loan losses could be provisioned. It had the effect of understating expected losses and potentially reducing the transparency of accounts as an indicator of future regulatory problems. For example, the gap between provisions and expected losses would tend to grow at the beginning of an economic slowdown'. This perceived weakness is currently being addressed by the International Accounting Standards Board by the introduction of IFRS 9.

The 2010 report further outlined that 'under current accounting rules, the IASB (2002, paras. 58-59) only allows the recognition of loan losses when there is 'objective evidence' based on 'observable data' that the loan will not be recovered. 'Losses expected as a result of future events, no matter how likely, are not recognised'. To give 'a true and fair view' as required by law, these are the accounting standards which the directors apply and on which the auditors base their opinion.'

(e) **Governance**

UBIL's and FA's statutory accounts were audited by Deloitte during the period 2004-2007. During this time there were no qualifications issued on any of the UBIL or FA accounts. The adequacy of impairment provisioning was considered as part of the year end statutory accounts review by Group Audit Committee, UBIL's board and the external auditors. There were no issues raised in any of these years to suggest that any matters in relation to significant accounting estimates and judgements or the establishment of appropriate loan impairment values were not appropriately considered and accounted for.

I was and remain satisfied that the processes and procedures employed to deliver the UBG accounts are such that the integrity of the financial reporting is assured.

3.2 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. There was a Sectoral Lending Committee which sat below GRP&CC which had no Finance involvement.

Pre 2005, Sector Concentrations were monitored quarterly by GRP&CC. Concentration Analysis was high level with graphical representation of principal sector exposures and comparative prior quarter and prior year data. Throughout 2004 and 2005 residential lending, commercial real estate and construction accounted for over 60% of the bank's lending portfolio.

A sector exposure management 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 and the RBS Group policy. Outputs included Sector Reviews, Credit Appetite Statements (with "Sector Traffic Lights" classification) and Lending Assessment Guidelines. Only one property related cap was proposed – a speculative lending cap. GRP&CC was tasked, inter alia, with monthly monitoring of high level MI around movements in core sectors including property and mortgages.

Stress testing was carried out as part of a CB&FSAI bi annual - 2004, 2006, 2008 - process which examined Baseline v Shock scenarios provided by CB&FSAI. Outputs vis a vis capital were high level and focused primarily on Tier 1 and Total capital ratios.

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 (Pillar 2 Capital add-on) in H2 2007, close to the time of my leaving UBG.

As a member of GRP&CC, I was able to satisfy myself as to the functioning of these areas through the knowledge that the correct policies and procedures were being followed, and approval obtained from the RBS Group for the activities of GRP&CC and GRPC&SC. Reports from GRP&CC meetings were presented to the Board for noting with detailed minutes/papers available on request.

3.3 Appropriateness of funding sources – the mix, maturity profile and cost [B3:a]

This is discussed above at 2.3(c) and 2.4(c).

In light of the position of RBS Group, the mix, maturity profile and cost of funds (other than customer deposits) to UBG was determined ultimately by RBS Group Treasury and UBG was a "taker" in this regard. In the same way that a domestic bank will look to its overall balance sheet in these matters (and not address them at

branch level), RBS addressed them from an overall Group level, without necessarily having a particular regard to the specific entity that was/is UBIL. The same considerations applied to capital. As a wholly owned subsidiary, UB looked to RBS as its provider of capital. Budgets and strategic plans were subject to approval by RBS, such that forecast capital needs of UB were at all times shared with and known to the shareholder. Individual entity capital was managed in consultation with and subject to approval by RBS Group through capital injections and/or risk transfers between entities as deemed appropriate.

It was only as UBG customer loan balances grew in pursuit of the RBS strategy for UBG that RBS approved UBG re-entering the capital markets to engage directly in wholesale funding to supplement the RBS treasury activity with locally originated transactions. Of note in this context is the resumption of regular mortgage securitisations from late 2005 onwards and Floating Rate Note issues of €1.5bn each in June 2005, March 2006 and May 2007.

Ultimately, given the RBS role and assurances in relation to the funding of UB, I am satisfied that the funding arrangements were appropriate.

3.4 Adequacy of the valuation policies and assumptions to accurately assess loan security [B4:a]

My ability to deal with this line of inquiry is somewhat limited due to the fact that I was not a member of the GRPC&SC. In this regard, the extent of my interaction as Group FD was noting any GRPC&SC papers and reports that were provided to the Board of UBIL. In that role I was able to satisfy myself as to the appropriateness of valuation policies and assumptions through my knowledge of the structures around the policy setting as qualified and responsible persons who reported directly to and had to get (and did get) sign off from RBS on all policy matters, sat on GRPC&SC.

3.5 The liquidity versus solvency debate [C2:c]

In the run into my departure from the Bank in December 2007 there were emerging signs of a liquidity crisis in the international markets.

Solvency can be a) excess of assets over liabilities, i.e. balance sheet solvency or b) ability to meet debt obligations as they fall due (cash flow solvency). Liquidity is akin to cash flow solvency.

Irish banks were balance sheet solvent until the carrying value of assets deteriorated to a sufficient extent to wipe out their capital. For as long as the security value could be realised at a level to cover the loan outstandings, valuations were valid and banks were solvent. But when liquidity became scarce, the ability of potential purchasers to buy was compromised and the value of security collateral fell. Where reliance to support loan repayment was placed on collateral which had fallen in value to below the outstanding loan amount, the loan became impaired. Where this was widespread, it drove banks towards insolvency.

The liquidity shortage appears to have originated internationally. To the extent that Ireland was heavily reliant on international funding (particularly funding with short-term maturities) it was severely impacted when funding became more scarce. Banks with the heaviest dependence on short term external funds would have been most vulnerable. In such circumstances, a bank is likely to have been forced to lend less and/or call in demand facilities, which actions are likely to have impacted on the real economy by way of a fall in property demand. This will have likely resulted in a decrease in property values with the knock on impact on the value of security held against loan assets.

Generally speaking, liquidity stresses will become apparent before solvency issues. Liquidity was monitored constantly and formally reported to the regulator and in addition, the Central Bank had visibility on liquidity movements in the system on a constant basis.

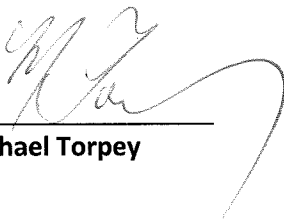
4. **Confirmations**

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:



Michael Torpey