JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

WITNESS STATEMENT

Robert Gallagher

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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**

In September 2005 I was recruited into the Royal Bank of Scotland Group ("RBSG") as Chief Executive Corporate Markets from Allied Banks plc ("AIB") (where I held the role of Head of Corporate Banking International) . I held that role until September 2011 when I resigned. Prior to joining AIB, I worked with Citibank Australia Limited and KPMG. I hold a Bachelor of Science Degree and am a Chartered Accountant.

3. **Background / Context**

My responsibilities in Ulster Bank ("UB") included managing the relationship teams for Corporate Banking, Business and Commercial Banking, Commercial Property Finance and Capital Markets in the Republic of Ireland and Northern Ireland (collectively, "Corporate Markets"). Corporate Markets had circa 1700 staff operating from George's Quay Dublin, Donegal Square East Belfast and 32 business centres across the whole Island.

In 2005 the Royal Bank of Scotland Group ("RBSG") was a very substantial and highly regarded global bank. The acquisition of NatWest was seen as a great success and its "Make it Happen" branding reflected the pro-business ethos of its leadership. RBSG had very ambitious plans for UB in Ireland and wanted to create a strong alternative to AIB and Bank of Ireland (BOI). Within RBSG there was a conviction that delivering the RBS product suite to Irish business customers in a proactive manner would result in market share growth. This product capability included trade finance, international cash management, private placements, international debt syndication, treasury etc. The significant presence which the RBSG had in Europe, the United States and Asia could also be leveraged to the benefit of Irish companies seeking to expand in those markets. UB at the time had, in the business marketplace, a c 30% market share in Northern Ireland and c 15% share in the Republic of Ireland. The rationale for joining, from my perspective, was the opportunity to bring this capability and global reach to the Corporate and Business customers in Ireland.

Underpinning this new business agenda within UB was a control and reporting framework which was aligned and consistent with the wider RBSG. The Credit Approval Framework was approved by RBSG. The Risk, Credit, Finance, Operations, Internal Audit, Human Resources and Treasury functions all reported into the RBSG on matrixed basis. The concept of first and second lines of defence was deeply embedded in the RBS approach to control environments. The Risk Management division of UB, which was independent of Corporate Markets was structured, resourced (circa 250 staff) and managed in a consistent manner to other RBS divisional Risk Management functions. RBS executives were Board members of UB Limited. The capital and liquidity requirements of the UB growth plans were underpinned by RBSG.

In early 2006 it was communicated to the teams in Corporate Markets that the business needed to change from a reliance on lending led income to a business with greater diversity in its sources of income, that utilised the broader capability of RBSG and grew its domestic deposit book. From circa 2002 onwards UB had been building its loan books, substantially in the commercial property and mortgage lending areas.

Consistent with this approach, approval was sought from RBSG to make a substantial investment of circa £45M in an information technology programme ("Corporate Migration"). The objective of this investment was for the Corporate and Business banking activities of UB to operate off RBS Platforms. Completion of this programme was challenging and took 6 months. Upon completion in early 2007, UB had a materially enhanced cash management and international trade finance capability.

In parallel there was:

- a material expansion and upgrading of the UB business network with 12 new Business centres opened; and,

- a substantial investment in training and development of staff, particularly on financial and cash-flow analysis.

Throughout 2006 and the first half of 2007, real progress was being delivered in broadening the sources of income, expanding the customer base and delivering RBS product capability. In the domestic economy, however, in the same period, commercial property sale/purchases and development dominated economic activity and the UB loan book reflected this. The sectoral reports, prepared by UB Risk Management, continued to report to RBS this weighting to property in both commercial and residential development. In mid-2007 weakness in the Irish property market was very evident and the level of new loan commitments to property within UB decreased very significantly.

In the period post 2008 the Executive Management team of UB, presented an action plan to RBS to deal with the challenges which UB was then facing and which was approved by RBS. The key aspects of this plan were:

(a) Allocation of substantially increased resources to managing the deteriorating portfolio. There was significant collaboration with and oversight by RBS in this process. Within Corporate Markets c. 300 staff were reassigned to the Intensive Credit Unit.

(b) Reduce the Intragroup Lending ("IGL") limit. This had grown from STG£6.9 billion to £STG14.8 billion post the introduction of the Bank Guarantee as deposits left UBG.

(c) Reduce the cost base of the organisation and resize to reflect the new economic reality.

The period 2008- 2011 was very challenging. Credit quality of the portfolio continued to deteriorate and increasing provisions were required. In 2009/2010 STG£15 billion of assets were transferred to UB from the RBS Non-Core Unit. The UB leadership worked very closely with our RBS colleagues in this period. In that period the cost base of the organisation and IGL Limit were reduced.

4. Lines of Inquiry

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

B2:b, B4:a, B4:b, B4:c, C2:c and C3:b.

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

Lending to the property sector was governed by the Bank's High Level Controls Framework and subject to the Bank's Credit Policies (including delegated authorities and exception management) as follows:

Credit Policies

Credit Risk Policies were approved by the Group Risk Credit Policy and Strategy Committee ('GRCP&SC') which operated as a committee of the Bank's principal risk committee (the Group Risk Policy & Controls Committee ('GRP&CC')). Policies were structured around rules and guidelines and were designed to comply with the RBS policy framework. Key Credit Policies for the Corporate Bank included the Ulster Bank Credit Approval Process Policy ('CAPP') and the UBG Credit Committee Policy ('CCP') which was part of the RBS Delegated Authority Policy framework.

The UBG CAPP involved the development, assessment, approval and management of credit relationships by different departments in UBG and sought to:

- Facilitate decision making;
- Facilitate high level portfolio analysis/ management of credit risk assessment;
- Ensure Credit Authorities were complied with;
- Meet regulatory requirements; and,
- Communicate credit appetite.

The second key Credit Policy for Corporate Markets was the UBG CCP. A fundamental basis of this framework was that credits (other than those under €10 million) were approved by Credit Committee.

Delegated Authorities

The UBG CCP operated within the RBS Delegated Authority Policy whereby discretion and delegated authority were based on a combination of the aggregable amount of facilities and the credit grade of the borrower. Credit Committees consisted of three individuals comprising a Chairman and two committee members with each committee comprising at least one Credit Representative and one Business Representative. The Chairman could either be a Credit or Business Representative and in addition representatives from RBSG Risk could also sit on UB Credit Committees.

Importantly individuals from within Corporate Markets did not have the authority to sanction loans in their own right. Credit Risk (ROI) and Property Credit Risk which were part of UB Risk Management held delegated authorities of £10/€15 million.

All Credit Policies were subject to annual review and the level of sanctioning authority enjoyed by the various Credit Committees changed from time to time, however for illustrative purposes authorities for investment grade facilities were as follows as of 30 June 2006:

UBG Credit Committee Delegated Authority:

- New Business: £25 million
- Existing Business: £35 million

Above these amounts approval was required at an RBS committee.

RBS Group Credit Committee (2) Delegated Authority:

- New Business: £50 million
- Existing Business: £75 million

RBS Group Credit Committee (1) Delegated Authority:

- New Business: £500 million
- Existing Business: £1000 million

Exceptions Management

Exceptions management within the Bank was governed by the Credit Policy Exceptions Approval and Reporting Policy ('CPEARP'). Under the CPEARP the relevant Credit and Lending Unit was required to ensure that any policy rule exceptions were identified before a sanctioning decision was made. All policy rule exceptions were recorded by the Credit and Lending Unit using a template and approved by the appropriate Credit authority (e.g. Credit Committee) as set out by CCP.

4.2 **Theme B4 - Impact of the property valuation methodologies on the banks' credit risk management, to include:**

(a) B4:a: Adequacy of the valuation policies and assumptions to accurately assess loan security;

(b) B4:b: Independence of the professional advisors in valuing property related assets; and,

(c) B4:c Adequacy of internal controls over perfection of security and policy exceptions.

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

The Bank's approach to the taking of security was governed by the Security Criteria Policy. Criteria under this Policy included:

(i) A requirement that all professional valuations were addressed to the Bank; Valuations were required to be carried out by Bank panel members; Valuations were required (subject to limited exceptions) for new or increased sanctions greater than £5 million.

(ii) A Loan to Value ("LTV") of 70% was required for Commercial property; A LTV of 70% was also set for investment property with consideration to be given to the quality/ cross section of tenants/ tenancy agreements. Other factors to be considered included lease period, rent reviews, break clauses and other conditions.

In October, 2007 the Security Criteria Policy was amended (Security Criteria Policy - Credit Risk Mitigation) to include the introduction and use of Recovery Rate Models which used valuations and other inputs to generate Loss Given Defaults. As part of this process the assumptions used by a Valuer had to be assessed and lower write down valuations applied if appropriate. In particular any onerous conditions including: access rights; development restrictions; environmental restrictions; environmental issues; change of use; structural problems; and, loss of licence were all factors to be considered as potentially leading to a lower valuation. In addition under this policy the valuation had to be at or less than market value.

B4:b: Independence of the professional advisors in valuing property related assets

Under the Bank's Security Criteria Policy relationship managers were required to obtain independent professional valuations addressed to the Bank to support their assessment of the security value of property asses being financed by the Bank. To facilitate this process the Bank operated a panel of independent Valuers which was further split between Panel A and Panel B firms.

Panel A 'national names' firms could be used for loans of any amount. Panel B 'local/ regional' firms could be used for loans of up to €20 million. The Credit Risk team (part of Risk Management function) had the right to challenge the Valuers used and the Panel (A & B) was subject to continuous review by the Business and Credit Risk. Any additions to the Panel were conditional on the firm's professional indemnity cover and experience with the Bank. Under the revised Security Criteria Policy - Credit Risk Mitigation, all professional valuations had to be undertaken pursuant to RICS, IAVI, or IPAV guidelines.

B4:c: Adequacy of internal controls over perfection of security and policy exceptions

The Bank's Security Criteria Policy in the years 2004 -2008 set out in detail Credit Stewardship Responsibilities.

From a perfection of security perspective, these guidelines included the following responsibilities for the role of Relationship Managers:

- ensure appropriate security documentation is requested from Lending Operations or External Solicitors;
- ensure all security documentation completed accurately;
- where Solicitors' Undertakings were being accepted these must be on the Banks standard form;
- an Undertaking from a Company must be registered in the Companies Registration Office;
- obtain credit approval to changes in or release of any security; and,
- ensure all security correctly noted and updated on the Relationship Management Platform.

Exceptions to this policy were approved by the Head of Credit Risk Unit or their authorised deputies.

During the period 2004 -2008 there was some indication that in the business centre network (i.e. cases less than €10m) the growth in the business led to challenges in the timeliness of execution of solicitor undertakings and thus the perfection of security. To the best of my knowledge this was not evident in the Property Finance business.

I am not aware however that Ulster Bank has had any systemic failures in terms of enforcing its security to date which arise from non-compliance with these guidelines.

4.3 Insofar as I have been requested to address the adequacy or appropriateness of matters in the lines of inquiry above, I was satisfied that in the context of the UB business within RBS, the policies and methodologies that were in place at the time were adequate and / or appropriate.

4.4 **The liquidity versus solvency debate [C2:c]**

<u>Funding position</u>

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

From September 2007, access to the securitisation market 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 issuance and Certificates of Deposits. During this period RBS also provided more funding to UB 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 introduction of the guarantee there were significant corporate and wholesale deposit outflows as UB was outside the Bank Guarantee and retail deposits also reduced to a lesser extent. After the initial depositor reaction there was a reversal and by December 2008 the non-wholesale deposit base had recovered despite UB remaining outside the Bank Guarantee.

After September 2008 UB began to release liquidity from the residential mortgage book by pledging securitised assets to ECB in their open market operations and also borrowed further from RBS.

Liquidity

Through maintaining the non-wholesale deposit base and mostly through increased access to ECB and RBS funding, UB continued to meet funding and regulatory liquidity requirements in the run up to and after the guarantee. Post the guarantee, without access to RBS and ECB, UB would not have been able to maintain liquidity requirements. The liquidity issue in the financial markets was a factor for more than a year before it became a crisis, starting with the withdrawal of term funding markets and previously reliable wholesale deposits, particularly interbank. As these funding sources were replaced with shorter term funding which also eventually fell away, liquidity became more fragile and ultimately had to be supported by borrowing from RBS.

Solvency

It was not apparent that loan performance at the time of the guarantee had deteriorated materially. Capital was required to be held on the basis of the, then normal, low levels of provisions and expected losses. There was very little surplus capital held above that required. At the time of the guarantee, term funding markets had been closed for some time and short term funding was being withdrawn rapidly as market participants became concerned about the value of banks' assets. However, solvency calculation could only be based on observed loan performance and value of underlying assets, not market concerns. As the lack of liquidity became a lack of credit and economic conditions deteriorated, increasing loan defaults and falling asset values quickly led to the need to recognise impairments. Only when asset prices fell and loan impairment could be recognised did solvency became a problem with significant levels of capital support required.

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

(a) The UB Board and management were unaware of the decision until it was announced to media.

(b) Both RBS and UB Board proactively sought to have UBIL included in the guarantee scheme.

(c) The impact of the guarantee on UB was material outflow of deposits and a necessary increase in IGL.

(d) The UB Board required and received assurances from RBS of continued support through IGL.

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:

Robert Gallagher