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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Alan Dukes

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[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

Statement to the Joint Committee of Inquiry into the Banking Crisis

Alan Dukes

30 July 2015

B1: a
Composition, skills and experience of the board and board subcommittees

In November 2008, Frank Daly (former Chair of the Revenue Commissioners and member of the Civil Service TLAC and then Chair of the Commission on Taxation) and I were appointed as public interest directors on the board of Anglo Irish Bank. On the nationalisation of the bank in January 2009, only Frank Daly, Donal O'Connor (member since June 2008, former Senior Partner of PwC Ireland and member of PwC Global Board, director of Elan Corporation plc and Readymix plc, former Chair DDDA and former Director IAASA) were appointed to the board of the nationalised entity by the Minister for Finance. In late January 2009, the Minister appointed Maurice Keane (former Group Chief Executive and member of the Court of Directors of Bank of Ireland, director DCC and Axis Capital Holdings Limited, member of the National Pension Reserve Fund Commission, former Chairman BUPA Ireland Limited and Bristol and West plc). Frank Daly was appointed to the Chair of NAMA in December 2009 and the board requested the Minister to make some further appointments to strengthen it. In May 2010, the Minister appointed Noel Cawley (former CEO of the Irish Dairy Board and Chairman of Teagasc), Aidan Eames (principal of Eames Solicitors) and Gary Kennedy (chartered accountant, former Group Finance Director of AIB up to 2005 of AIB and director of a number of companies) to the board. Donal O'Connor resigned from the board at end-June 2010 and I was appointed Chair. At the suggestion of the Central Bank, the board sought to recruit two directors with particular knowledge of the finance and property markets in the UK. Following a recommendation made by the bank during the 1st quarter 2011, Oliver Ellingham was appointed in October 2011. (The bank had also recommended a further individual for appointment but he withdrew from the process when he became concerned at reputational effects for him of the ongoing delay by the Department of Finance in making a decision on the bank's proposal). When the mortgage book of INBS was transferred to Anglo Irish Bank in June 2011, the Minister agreed with the bank's proposal to appoint one of the former directors of INBS to the Anglo board, and Roger McGreal was appointed. Finally, in August 2012, the Minister made two further appointments: Alan Ridgway, an experienced bank executive working in Luxembourg with considerable experience in the disposal of the distressed assets of troubled banks and Maurice Horan, a director with extensive experience of banking in the Middle East area.

The subcommittees were, of course, composed of board members. The Audit Committee was chaired first by Frank Daly and subsequently by Gary Kennedy. The Risk and Compliance Committee was chaired by Maurice Keane and the Remuneration and Appointments Committee by Noel Cawley. It was not unusual for directors who were not formally members of a given Committee to attend as observers.

Board membership presented a very wide range of skills and experience in banking, financial services, commercial activity, law, general business experience and public administration. Board discussions were characterised by very careful preparation by members, rigorous analysis of proposals and robust challenge. Committee chairs held frequent consultations with management between meetings and it was common practice for board members to interact with management in relation to matters scheduled for committee and board meetings.

Board meetings were characterised by detailed and rigorous examination of management proposals and of Committee reports. The CEO ensured that relevant senior management with line responsibilities were present to facilitate the examination of proposals. To the maximum extent possible, the CEO ensured that board packs were made available to members in a timely fashion, to facilitate in-depth preparation. Reservations and contrary views expressed by board members or senior management were fully examined.

In 2010, the board made the changes required to the Memorandum and Articles of Association of the bank to ensure that meetings held by teleconference could validly take decisions. This method was typically used in cases where a final board decision depended on the confirmation of a matter of detail. Confirmation that this was in order had been received from the Central Bank. In September 2011, John Moran (then Head of Banking Policy in the Department of Finance) seemed to be unaware that the process was in order.

At around that time, supervisory staff of the Central Bank asked members of the board:
(a) if the CEO had been "over-ruled" by the board on an important issue, and
(b) whether the board from time to time took "un-minuted" decisions.
On the first issue, there was no case in which the CEO had been "over-ruled" by the board. There were cases where an initial proposal from the CEO and senior management was modified during the course of examination by the board and a common position was reached. In no case was a decision taken by a vote at board level.
On the second issue, Central Bank staff seemed to misunderstand a practice adopted by the board to assist in preparing strategic approaches or anticipating important matters for future consideration. From time to time, the directors (including the CEO) held informal orientation discussions without the presence of management staff. No formal decisions were taken at such meetings.

In about June 2011, John Moran (then Head of Banking Policy in the Department of Finance) said to me that he felt that "some" board members should be replaced because, since they had been appointed prior to the decision to put the bank into wind-down mode, they "might not have the necessary mindset". He had not met any of the other board members at that point. I did not accept his point of view, as I had no doubt as to the ability of the board to carry out the policy laid down by Government. He returned to the issue in the following November, indicating to me that he had two people in mind for appointment. I informed him that I had not changed my view. In April 2012, the Minister for Finance raised the matter with me for the first time. I informed him that I had no objection to the appointment of two further members to the board and that I was happy to discuss a plan for reducing the size of the board as the bank's balance sheet was wound down (a suggestion that I had already made to Mr. Moran). Two further members joined the board in August 2012 following the completion of the required procedures with the Central Bank (Mr. Moran appeared to have been of the mistaken view that it was sufficient for the Minister simply to inform the Central Bank).

B1: c
Quality of the business model setting process

Immediately following nationalisation in January 2009, the board's main objective was to stabilise the bank in order to facilitate its operation as a going concern. This gave rise to a number of urgent key tasks.

1. An immediate review of the bank's provisioning policy. This led, at the end of March, to the conclusion that the recapitalisation requirement at that point was €4.5bn. rather than the €1.5bn. estimated by the Department of Finance at the time of nationalisation. It also indicated a substantial downside risk associated with the continuing decline in property values, a key influencer of the bank's asset value and of the quality of the greater part of the outstanding loan book. The Department of Finance commissioned an outside review of the matter, which concurred with the bank's findings.
2. The identification of a series of legacy issues, the institution of processes to investigate and report fully on them, and measures to prevent recurrence.
3. Development of procedures to facilitate and assist the investigations launched in February 2009 by the ODCE and the GBFI.
4. A fundamental review of lending and recovery policies, linked to the initiation of a multi-layered and iterative analysis of the loan book.
5. A full review of risk assessment, management and appetite.
6. Strengthening of internal audit procedures.

While the bank continued to operate as a going concern, the levels of distress in the loan book and the conditions on funding markets meant that new lending on any appreciable scale was out of the question (substantial new lending had, in any case, effectively ceased in mid-2007). UK financial authorities moved strongly to restrict the bank's deposit-taking operations in that market, further exacerbating the bank's funding difficulties. The focus of banking operations shifted to more aggressive relationship management, loan management and recovery. Anglo Irish Bank was the first of the guaranteed institutions to implement an overt change of emphasis to loan recovery: one result was that reconverted staff were subsequently head-hunted by NAMA and by other guaranteed institutions which were in a position to offer longer-term career prospects and higher remuneration than Anglo Irish Bank/IBRC.

The identification of legacy issues and the series of actions flowing from that took up a great deal of management and board attention.

The transfer of assets to NAMA, which began in 2010, introduced a wholly new set of demands on Anglo Irish Bank (and indeed on all the guaranteed institutions). Later in that process, management of blocks of assets transferred to NAMA was outsourced to the originating banks on the basis of performance criteria set out by NAMA.

The bank was required to produce a proposal for a restructuring plan in September 2009, for submission to the European Commission. When that plan was rejected by the EC in March 2010, work began on a revised plan, in conjunction with the Department of Finance, the Central Bank and NTMA. This second plan was agreed at the end of April 2010: it, too, was rejected by the EC in September 2010. It subsequently emerged that the Department of Finance had not supported the plan in discussions with the EC. In October of that year, I learned from a senior EC official engaged in bank restructuring that, uniquely among the

Member States in support programmes, Ireland had not systematically included its distressed banks directly in the discussions with the EC.

In March 2011, the board and management of the bank were instructed by Government to wind the bank down by 2020. The bank accordingly prepared a wind-down schedule for its post-NAMA transfer balance sheet which was agreed and accepted by the authorities for presentation to the EC. During the course of that discussion, I had suggested that, subject to a slightly higher but still acceptable level of implementation risk, a somewhat more rapid wind-down schedule could be advanced. The authorities (Department of Finance, NTMA, Central Bank) preferred to stick to the less rapid schedule, presumably on the basis of the lower level of risk. The Department of Finance subsequently denied any recollection of that discussion. By the time of liquidation in February 2013, the reduction of the bank's balance sheet had proceeded at a faster pace than envisaged in March 2011.

During the period between the wind-down instruction in March 2011 and liquidation in February 2013, senior officials of the Department of Finance urged a speeding-up of the asset disposal process in the course of discussions. Despite such unspecific urgings, no Departmental or Ministerial instruction to that effect was issued. The bank took the view that performing loans due to come to maturity within the wind-down period would not be disposed of, as this could only reduce the overall level of realisations, an outcome which did not accord with the bank's clear understanding of its mandate. In November 2012, the board advised the Second Secretary of the Department of Finance that it expected to complete the wind-down by the end of 2018: the response was that this accorded with the Minister's wishes. By contrast, in evidence to this Inquiry on Thursday 18 June, 2012, the former Secretary General of the Department of Finance, Mr. John Moran, stated that he had "*a different mission for the bank than Mr. Aynsley*" (the CEO). Mr. Moran did not explain what this "different mission" was or in what way it differed from the bank's understanding of its mission, which a colleague of Mr. Moran's said accorded with the Minister's view.

In the period between nationalisation and liquidation (which included the addition of the former INBS mortgage book to the bank's assets), the board and management of the bank undertook a series of reviews of management and governance structures. The bank retained the services of highly-respected external advisors throughout these processes and the Department of Finance was kept fully informed of all recommendations emerging. These reviews were affected by such factors as:

- difficulties in recruitment and retention of senior staff with the skills required to deal with the specific risks and challenges faced by Anglo/IBRC,
- staff retention in competition with superior career opportunities and remuneration offered by other banks (including banks in the UK),
- the operation of two voluntary redundancy programmes dictated by the progressive reduction of the balance sheet and of overall staffing requirements,
- the ongoing and onerous requirements of co-operation with legacy investigations by the ODCE and GBFI,
- market developments affecting the quality of the bank's loan book,
- the evolving situation in the Irish banking and financial sectors generally, and
- the evolution of world financial markets.

The addition of the INBS mortgage book to the bank's assets in 2011 presented a series of new demands and challenges. The transfer process did not allow the bank to carry out a due diligence examination. It emerged that the mortgage book was significantly distressed and

that the underlying data base was deficient in a number of respects. These factors gave rise to a number of difficulties in meeting developments on Government and Central Bank guidelines and policies in relation to the problem m of mortgage arrears.

At one point, the Department of Finance engaged McKinsey to carry out a consultancy on the management and governance structures of the bank. Neither the board nor the management of the bank had sight of the report produced. The one element notified to the bank was a proposal that the functions of Chief Financial Officer and Chief Risk Officer should be amalgamated. The bank rejected this proposal as being totally at variance with the requirements of good governance, a view which the bank believed would be shared by the regulatory authorities. Regrettably, that well-justified rejection of a deeply unwise proposal was regarded as obstructionism by senior officials of the Department of Finance.

The combination of all of these factors necessitated a fundamental transformation of the bank's business model, with a very strong focus on loan recovery issues.

B1: d

Adequacy of board oversight over internal controls to ensure risk is properly identified, managed and monitored

During 2009 and 2010, the bank engaged in an active "stop loss" policy, identifying financial assets which were vulnerable to further market deterioration and exiting from them on the most advantageous terms available.

The Risk and Compliance Committee took an active and detailed approach to the identification and management of risk. A risk matrix system was constructed and kept under regular review and all changes in the risk status of operations were closely interrogated.

The Internal Audit system was regularly reviewed. Close attention was given to the adequacy of its resources and potential sources of conflict were regularly assessed.

B2: a

Appropriateness of property-related lending strategies and risk appetite

The *raison d'etre* of post-nationalisation Anglo/IBRC was to deal with the fallout from inappropriate property-related lending strategies and excessive risk appetite in the pre-guarantee period.

Following the wind-down decision in March 2011, Anglo/IBRC had to conform to stringent conditions set out in the Commitments Letter required by the EC. Performance was monitored by a Monitoring Trustee appointed by the EC, which produced quarterly reports, usually requiring specific actions by the bank. As part of these conditions, a tight absolute overall limit was set on new lending to existing clients, together with strict limits on new lending to individual existing clients. Limited lending to new clients was permitted only where it was necessary to facilitate the re-financing of existing clients.

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

Limits in all of these areas were considerably tightened immediately following nationalisation. Following the wind-down decision in March 2011, all of these areas came within the ambit of the Commitments Letter and the scrutiny of the Monitoring Trustee. See response to **B2: a** above.

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

Post nationalisation, the bank operated no incentive arrangements. Remuneration was governed by the CIROC rules. Senior management remuneration required the agreement of the Department of Finance. On a number of occasions, proposed recruitment of staff to senior positions could not be proceeded with as a result of sanction being refused by the Department.

B5: b
Impact of shareholder or lending relationships in promoting independent challenge by the board and/or executives

Independent challenge by the board and/or executives was, in all cases, motivated by concern to achieve the objectives set out by the shareholder (the Minister for Finance). Challenge motivated by concern about lending relationships was motivated by a concern to secure the maximum return for the bank and, therefore, the State.

C2: c
The liquidity versus solvency debate

The post-nationalisation Anglo/IBRC was a policy taker, operating on the basis of policies decided by Government. It appears that the September 2008 decision was taken on the basis that the Irish banking system had a liquidity problem. That was indeed the case but the recapitalisation actions taken between then and the adoption of the Troika programme in November 2010, with its provisions for further support for the banking system, clearly imply that there was a solvency problem.

C3: b
Appropriateness of the bank guarantee decision

No member of the post-nationalisation bank's board or management was involved in the making of this decision. The execution of that decision was the basis of Government policy on which the bank's mandate was based.

I agree with the view that the decision taken in September 2008 was the available option that would have the least damaging effects on the Irish economy. Evidence which has emerged so far indicates that the possibility of a blanket guarantee had been considered during the months preceding the decision (although it is not known in how much detail). Bank nationalisation legislation had been prepared. At that time, there was no bank resolution legislation or system in Ireland, nor was there any such provision at Eurozone or EU level. As far as I am aware,

there had been no focused discussion at either EU or Eurozone level of the possibilities of concerted action to deal with the emerging banking crisis. It could be argued that the Irish Government should have entered into discussions with the ECB and Eurozone/EU partners with a view to constructing a concerted strategy but news of such discussions would probably have had adverse effects on market sentiment. The Irish Government was, therefore, arguably obliged to act alone.

While Eurozone and EU partners expressed shock and surprise at the fact that the Irish Government had acted alone, the fact is that a number of other Member States also took action: the UK and Germany took action to deal with distressed banks: France, Belgium and the Netherlands engaged in a joint action in relation to Fortis Bank. The principal difference was that, where other Member States took action in relation to specific banks, Ireland took action effectively in relation to the whole of its domestic banking system.

It has been suggested that other options might have been considered which would have had less far-reaching effects and less onerous costs.

1. **Liquidate Anglo and provide a "political guarantee" for the other banks.**

Liquidating Anglo Irish Bank in September 2008 in the absence of a settled banking resolution system in Ireland (or in the Eurozone or EU) would have given rise to a series of defaults and cross-defaults invoked by creditors. It can be surmised that a substantial volume of litigation would have ensued. The state would have had to meet the cost of the guarantee of up to €100,000 for each depositor in the bank. Large numbers of individual and corporate depositors would have suffered losses, some of them very substantial. Recoveries from debtors would have been extremely problematic: many of them would almost certainly been put out of business, with very substantial damage to the economy and to employment. Given that a number of Anglo's substantial debtors were also debtors of other Irish banks, serious difficulties would have been caused for those banks. While it is impossible to be categoric about the effects, it can be surmised that the contagion effect on other banks of the liquidation of Anglo at that point would have reduced the credibility of a "political guarantee" in the eyes of market operators. Given the fact that the State was in the grip of a contemporaneous fiscal crisis, the value of a "political guarantee" could well have been doubtful.

A possible alternative to the straightforward liquidation of Anglo might have been the transfer of its assets and liabilities to other institutions (NAMA did not then exist) and the liquidation of the remaining shell. There would have been a serious risk of default and cross-default proceedings on the basis of "cessation of business" clauses in contracts. Otherwise, in practice, this would have had the same effects as the process actually followed.

Either one of these liquidation strategies would necessarily have led, indirectly or directly, to an examination of asset values and provisioning policies similar to that actually carried out in early 2009 by the post-nationalisation Anglo. This, in turn, would have led to speculation about the possible results of a similar examination of the balance sheets of the other banks. It can be surmised that the outcome of such an examination would have vitiated the effect of a "political guarantee".

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2. Nationalise Anglo and provide a "political guarantee" for the other banks.

Comments above on the possible value and effect of a "political guarantee" apply here also. In a recent commentary (Sunday Independent, 21 June 2015), Dan O'Brien pointed out:

"The day after the guarantee was given, Irish government bond yields didn't move, despite the state explicitly taking on huge additional exposure. But when Anglo was eventually nationalised a few months later, Irish bond yields rose sharply, suggesting that market participants saw nationalisation as worse for the state's creditworthiness than a wide-ranging guarantee."

In the event, the guarantee and the virtual total nationalisation of the banking system had to be accompanied by substantial recapitalisation of the banks.

C4: a:
Decision to nationalise Anglo in 2009 and a review of the alternatives available and/or considered]

See **C3: b** above.

C4: c
Decision to recapitalise Anglo, Allied Irish Banks (AIB), Bank of Ireland, Educational Building Society (EBS), Permanent TSB (PTSB) and the alternatives available and/or considered

Once Anglo was nationalised, it had to be recapitalised or liquidated. As already pointed out, the recapitalisation requirement turned out to be far greater than had been expected at the time of nationalisation. Similar considerations applied to the other guaranteed banks. It is difficult to imagine what other course might have been followed.

Guarantee and nationalisation were considered pre-guarantee. Why not bank resolution legislation?

C7: a
Option for burden sharing during the period 2008-2013

In the absence of bank resolution legislation, the imposition of burden sharing on senior bondholders would have been problematic, particularly in view of the fact that established law and practice was that senior bondholders ranked *pari passu* with depositors.

The bank was informed that burden sharing by senior bondholders was ruled out. In 2009 and 2010, the bank advised the Department of Finance and the Central Bank of its belief that burden sharing could be imposed on subordinated bondholders. The authorities agreed, and two such operations were carried out with a benefit of approximately €3.4 billion (€1.8 billion in 2009 and €1.6 billion in 2010) to the bank and the State. The Department of Finance regarded the bank's first 2009 proposal as "too aggressive" and the bank moderated the terms in response. It took the Department several months to agree on the 2010 proposal.

R1: a
<u>Appropriateness of the regulatory regime</u>

Over the period from January 2009 to February 2013, I observed the gradual development of a new regulatory regime, described by the regulatory authorities as being more robust, more intrusive and more risk-based than the previous regime. My experience was that the challenge from the regulatory authority gradually became more focused and sharper over the period. My impression is that the regulatory authorities now have a much clearer picture and appreciation of the condition of banks' balance sheets and risk status than they had in September 2008. Recently-adopted European rules on banking supervision and resolution mark major steps forward in regulatory systems.

I believe that, in common with all detailed regulatory systems, current banking regulatory rules contain some redundant provisions and that periodic reviews of the functioning of the system could help to improve clarity and focus while reducing the difficulty of compliance.

My personal view is that simple, clear and even brutal rules with a minimum of exceptions are to be preferred to complex, detailed rules with numerous exceptions.

R1: b
<u>Effectiveness and appropriateness of the supervision policy and powers</u>

See **R1: a** above.

R3: b
<u>Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), the Department of Finance and the banking institutions</u>

My observation is that, since the change of regulatory regime, the relationship between the Central Bank (including the Financial Regulator) and the banking institutions is much healthier, more focused, more questioning, more analytical and more adversarial (in a constructive way) than had previously been the case.

I cannot comment on the relationship between the Department of Finance and the banking institutions in general. I can, however, say that the relationship between the nationalised Anglo/IBRC and the most senior officials in the Department of Finance was unnecessarily complicated by the mistaken belief on the part of a former senior official that the bank should be run *"as a subsidiary of the Department of Finance"*. This view, which rests on complete ignorance of the most elementary principles of good governance of a statutory company and regulated entity, dogged dialogue between the bank and the Department from 2010 on. It seems that it was also this belief which lay behind the wish expressed by John Moran around June 2010 to be appointed to the board of the bank. I resisted this on the grounds that he would be seriously conflicted. I later had it on very high authority that the Central Bank would have regarded such an appointment as "*too close for comfort*". This same belief also appears to have underlain the erroneous claim by the Second Secretary of the Department to the PAC on 14 May 2015 that the March 2011 decision to put the bank into wind-down mode justified a change in the previous arm's length relationship between the bank and the Department.

My experience was that the Department expected information to flow to it (which was indeed the case), but was reluctant and tardy in reciprocating. As previously mentioned, for example, the bank was given only one part of the McKinsey conclusions on internal management structures.

It emerges from documentation released by the Department in response to FOI requests (partial information, heavily redacted and without context) that officials had “reservations” about, *inter alia*, the execution of certain transactions and the competence of the CEO. Neither the Minister nor the Department questioned the CEO’s competence in exchanges with me. I would have unhesitatingly rejected any such question. With the exception of two specific transactions, no “reservations” were ever expressed to the bank either by the Minister or by the Department. On one occasion, the Minister said to me that he was running out of patience in relation to the adequacy of information flows to the Department and that he needed to be sure, when dealing with matters in the Dáil, that he had all the necessary back-up. I asked him if he had, on any occasion, been embarrassed in the Dáil by an insufficiency of information supplied by the bank: his answer was in the negative. I could only conclude that the Department had misinformed him.

On two occasions, I found that agreements made with the Minister were not fully reflected in operational documents subsequently produced by the Department.

I have attached three documents which illustrate the kinds of issues which arose in the relationship between Anglo/IBRC and the Department of Finance. They are:

- an aide-memoire which I prepared for my own guidance in preparation for Mr. John Moran’s only meeting with the board on 16 May 2011,
- a letter from CEO Mike Aynsley to the Minister for Finance, dated 6 October 2011, which makes it clear that the bank was aware of the need to update the Relationship Framework and making a concrete proposal in that connection, and
- a letter from me to Mr. John Moran, dated 6 October 2011, dealing with a number of issues which had arisen in the course of correspondence and discussions between us.

These three documents reflect the state of relations between the two bodies and provide a context lacking in the presentation of responses by the Department to a number of FOI requests.

In sum, it seemed to me that the Department, having conceived the perfectly valid strategy of nationalising Anglo Irish Bank, having then concluded that a wind-down was appropriate and having handled the very difficult issues of recapitalisation and continuing support to very positive effect, decided not to have any trust in the institution it had set up. In the process, it wasted a great deal of time and has now created an unnecessary political controversy.

R5: d

Appropriateness of the relationships between the Government, the Oireachtas, the banking sector and the property sector

This issue has been a rich source of modern mythology.

Alan Dukes.
1 July, 2015.