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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Fidelma Clarke

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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 on Enquiry into the Banking Crisis

Fidelma Clarke

I have been asked to give evidence on six lines of enquiry relating to my role as Chief Risk Officer / Credit Officer / Company Secretary of EBS Building Society.

I was appointed Chief Risk Officer of EBS and became a member of the executive management team on 1 January 2009. I had been appointed Company Secretary in July 2008, and resigned from that position in June 2009 to concentrate on the demands of the Chief Risk Officer role. EBS appointed an Acting Chief Credit Officer with a separate reporting line from mine from 2010 to 2011 - a role that was independent of, but worked closely with, the Risk function.

Following the second Prudential Capital Assessment Review in Q1 2011, EBS was merged with Allied Irish Banks plc and became EBS Limited, a wholly owned subsidiary of AIB, in July 2011. In December 2011 I joined AIB as a Joint Interim Acting Chief Risk Officer in advance of a permanent Chief Risk Officer's appointment commencing. I subsequently was appointed Head of Governance and Assurance in AIB, Head of Enterprise Risk Management and am currently Head of Risk Analytics, reporting to the Group Chief Risk Officer.

In June 2012 I resigned as Chief Risk Officer of EBS as the position was no longer required. In 2012 I was appointed, and remain, a non-executive director of EBS Limited. I have also been an executive director from 2008 and a non-executive director since 2012 of its covered bond bank subsidiary, EBS Mortgage Finance.

Prior to being appointed as Chief Risk Officer I worked in the risk function as Head of Credit Policy, Credit Review and Enterprise Risk and subsequently Head of Risk, reporting consecutively to two executive directors who were the Chief Risk Officers of EBS amongst other responsibilities.

In addition to providing my witness statement for the period mid 2008 (when I became Company Secretary) to July 2011 (when EBS was merged with AIB), I have included additional contextual information for the period preceding 2009 where I felt it might be of help to the Committee.

With regard to two lines of Inquiry, namely, the appropriateness of the bank guarantee decision (C.3.b) and the decision to recapitalise Anglo, AIB, BOI, EBS, PTSB and alternatives available / considered (C.4.b), as I was not a member of the executive management team until January 2009 and had no involvement in any discussions with the Government in the lead up to the Guarantee or the decision to recapitalise EBS, I am not in a position to be of assistance in these areas.

My statement is based on my best recollection of events and a review of a limited number of historical documents. I hope the information provided will be of some benefit to the Inquiry.

Effectiveness of banks' credit strategies and risk management

- **Appropriateness of property lending strategies and risk appetite (B.2.a)**

In its Restructuring Plan submission to the EU Commission in May 2010 EBS set out the key reasons why it ran into financial difficulty which was exacerbated by the sharp economic downturn and a global credit crunch. These were

1. A decision to step up lending to the land and development sector at the height of the Irish Property boom in response to sustained pressure on net interest margins and a desire to achieve income diversification and insufficient internal controls to manage and monitor this lending.
2. Strong growth in EBS's residential loan book in a time of compressed lending margins.
3. EBS was a moderately capitalised business – albeit within regulatory requirements.
4. An over-reliance on (cheaper) wholesale funding between 1998 and 2007.

Specific controls which had been put in place to mitigate the risks of lending to the land and development (L&D) sector proved to be incapable of protecting the Society in the face of the scale of the financial crisis which ensued. These included

- An overall cap of 3% on the proportion of the balance sheet exposed to the Land and Development sector.
- A cap of 15% on the overall exposure to the commercial property sector including land and development.
- A requirement to recruit lenders with expertise in L&D lending.
- Experienced EBS commercial lending personnel to meet with customers and visit the site of all proposed developments as part of the credit assessment process.
- All sites / property taken as security to be independently valued by experienced chartered surveyors from an EBS appointed panel.

In relation to residential mortgage lending, the increase in demand for and supply of mortgage credit over the course of the 2000s has already been extensively reported on. EBS's policy changes were made on the back of the strong economic climate, improved demographics, higher income levels and improved affordability; they were also influenced by competitor practices. As mortgage lending was its core business, EBS had long-established risk mitigation controls in place, including

- A centralised underwriting unit.
- Underwriters were not incentivised / remunerated on the basis of whether they approved or declined loan applications.
- Stress tests for increases in interest rates from the early 2000s for mortgage and for commercial property loans.
- A bespoke loan affordability model (externally reviewed) incorporated an assessment on a case by case basis of how much money the loan applicants would need to live on after debt repayments.
- Mortgage Indemnity Insurance in place for higher LTV loans which ultimately reduced the losses incurred by the Society.
- Independent property valuations required in all cases.

Significant investments were made in underwriting systems, data quality, credit risk models, provision models, capital models and management information capabilities 2003 - 2007.

Clearly and very regretfully, the level of risk undertaken by the Society increased in parallel with the boom period and the control structure in place to mitigate risk transpired to be insufficient in the face of the economic and property market collapse and external market destabilisation.

Property Lending Strategies from 2008 - Risk Management of Legacy Book

The Society's risk appetite reduced substantially from the height of the boom as a result of the swift deterioration in asset quality on the back of eight ECB interest rate increases from 2005 and the knock on impact on loan affordability.

Economic forecasts at the start of 2008 pointed to a more challenging environment in the coming two years, although it transpired to be significantly more challenging than these forecasts.

The primary focus of property lending strategies and risk appetite from this time on was risk containment, servicing EBS customers in difficulty and credit loss mitigation. Key actions to mitigate risks over the period included;

Commercial Property Book

- From July 2007 EBS had significantly reduced the level of new lending to the Land and Development sector. Under the direction of a new CEO EBS ceased all lending to this sector in April 2008 and ceased lending to the commercial property sector in June 2008.
- In August 2008 EBS established task force teams to manage 'at risk' and non performing residential and commercial loan exposures. These developed into Special Asset Management teams in 2009.
- From Q1 2009 circa 70% of the Society's commercial loan asset exposures were reviewed on a case by case basis each quarter for loan loss provisioning purposes. They were subsequently reviewed by the Chief Risk Officer, Head of Commercial Credit Risk and Head of Finance before being recommended to the executive management team and the Board for approval.
- Recognising that the credit teams were not experienced in distressed credit risk management, EBS brought in credit professionals with experience of downturns to provide an independent view on the quality of the loans, potential losses and guidance on how to manage credit exposures.
- In October 2009 two external experienced credit professionals were retained to review of the provisions status and forecast in the then three year plan, the results of which were shared with the Board. Based on a (high level) review, the findings were that the provision forecasts appeared reasonable but that they could be required earlier than the plan indicated. Recommendations sought and provided for enhanced credit management were implemented over the following months.
- After an extensive search an interim Chief Credit Officer was appointed on secondment from an external firm from August 2010 to November 2011, reporting to the CEO and working closely with the Risk function.

- A project team was established in 2010 to manage the transfer of assets to the National Asset Management Agency (NAMA) and to create a capability to manage the assets post transfer on a third party services arrangement.

Residential Mortgages

- In relation to residential mortgages in the second half of 2009 EBS commissioned an external review of Potential Solutions for Mortgage Debt Management in Ireland, the findings of which were presented by the CEO and me to the Joint Committee on Social and Family Affairs in December 2009. One of the recommendations was the imposition of maximum loan to value exposures – a recent, welcome development.
- EBS subsequently worked closely with the industry bodies and the Expert Working Group in 2010 to identify and agree forbearance measures for customers in difficulty and to review how best to implement them from an operational, accounting and tax perspective.
- To address the lack of arrears management and credit counselling skills experience, training programmes were developed and rolled out.
- EBS insourced the Managing Director of a UK- based arrears management firm to review and enhance the Society's credit management operations.
- An online arrears management system was re-launched in November 2009.
- Teams were augmented with resources that had been in lending and underwriting roles and additional credit resources were recruited.
- An external firm was appointed to manage abandoned properties.
- Engagements with our mortgage indemnity insurance providers increased substantially as arrears levels increased.

The Society's objectives were to put processes in place to ensure customers were treated speedily, fairly, consistently and with respect. I believe these actions taken to contain risk over the period 2008 to 2011 were appropriate for the environment in which we were operating.

New Lending and risk appetite

In terms of the Society's appetite for new lending it was challenging through 2009 and 2010 to balance the, at times seemingly competing, requirements of key stakeholders. The Department of Finance was strongly encouraging institutions covered by the bank guarantee to provide credit to the market as evidenced in repeated statements by the Minister for Finance. Both the Regulator and external economists warned about the detrimental impact on economic recovery if credit was not made available. Having recognised that it could not survive in its current form, EBS was working with the Government and in discussions with the Regulator on a survival strategy based on public or private equity investment with an objective of retaining the Society's status as a mutual organisation if at all possible. The provision of credit was deemed necessary to remain relevant as a mortgage provider. At the same time asset quality was deteriorating at a rapid pace resulting in increases in provisions quarter on quarter and few institutions were lending.

Adding to the challenge was the apparent turning of the tide at the end of 2009 / start of 2010. There was a consensus, voiced by government, the regulatory authorities and external economists that the worst was over. What transpired was very different; the Greek crisis, the shutdown of the wholesale funding market and the consequent need for the EU-IMF bailout in November 2010.

Whilst recognising the negative impacts of a full withdrawal of credit from the market, EBS's risk appetite and its capacity for new lending was low and reduced over the period 2008 to 2011. Lending volumes and risk profiles were reduced through a series of credit policy restrictions. Lending via the broker channel which had been established in December 2007 under a separate brand (Haven) was curtailed then ceased altogether. As a result of these actions the annual growth rate of the residential book reduced from 18% in 2006 to 8% in 2008 to 2% by 2010 and was negative in 2011.

This low risk appetite of the Society was codified in the Society's first formal Risk Appetite Statement, approved by the Board of Directors in July 2010, following a board meeting dedicated to the evaluation of the risks the Society was dealing with. The Risk Appetite Statement set limits in relation to different risk positions the Society was prepared to tolerate. Specifically it included the following statements (inter alia); *'Given the scarcity and cost of credit EBS appetite for new lending is low'*; *'Credit losses on the existing loan book will be minimised by endeavouring to have in place at all times the right resources, skills and experience, systems and processes to manage credit risk'*; *'Arrears management and recovery is a priority focus of each Board meeting'*; *'The preservation of capital is paramount ; no action or decision will be taken which will jeopardise meeting the new minimum capital requirements of the organisation'*.

Adherence to the Board approved Risk Appetite Statement was monitored by the Risk function and reported in the Chief Risk Officers' report to the Board each month. This report also incorporated an assessment of the risk status, the risk outlook, and actions being taken by management to address and or mitigate the risk.

Effectiveness of banks' credit strategies and risk management

b. Appropriateness of credit policies, delegated authorities and exception management.

I concur with the views expressed by Professor Nyberg in relation to the causes of the systemic banking crisis in Ireland insofar as they relate to EBS's credit risk appetite and oversight over the period[1]. Some of the key drivers were the relaxation of credit policies (on the back of strong economic growth and fuelled by competition), the 'slow slide' from lower risk to higher risk lending, higher loan to values, equity releases, interest only mortgages, the increase in buy to let mortgages and, specifically in the case of EBS, weaknesses in the commercial lending function, particularly in the area of Development Finance.[2]

The traditionally conservative approach to lending in EBS unravelled in the period 2000 – 2007. A process of rebuilding credit standards commenced in 2008 with a detailed evaluation of the credit risk position of the organisation and the steps required to manage it. Over the period 2008 – 2011 credit criteria thresholds and standards were raised. By June 2010 more conservative criteria relating

[1] Misjudging risk: Causes of the Systemic Banking Crisis in Ireland pages 12 – 50.
[2] As above, page 35

to the type of lending (residential property only), the quantum of new lending (book growth not to exceed 5%), market share of new lending (not to exceed 17%), residential investment property lending (a maximum of 10% of total lending), weighted average loan to value limits (limited at 75%), mandatory insurance for higher LTV loans were in place, as set out in the Society's Risk Appetite Statement and its credit policies.

In the pre-crisis period exceptions to standard policy guidelines for residential and commercial property lending (which were permitted by policy) were monitored by the Credit Risk Committee and included in risk reports to the executive management and the Board Risk Committee. Exceptions (by value of exposure) were higher for commercial property lending than residential lending given the 'lumpier' nature of that lending.

By 2008 exceptions to standard guidelines (approved by underwriters based on their assessment of the underlying risk) were less than 5% and were reduced to 1% over the following two years.

Delegated Loan Approval and Cheque Issue Authorities had always been incorporated in the Society's credit policies. The application of delegated approval authorities continued post 2009.

Impact of the property valuation methodologies on banks' credit risk management

- **Adequacy of valuation policies and assumptions to accurately assess loan security (B.4.a)**

EBS always required an independent, valuation report on all properties which were being provided as security for a loan.

- For commercial property lending these valuations were required to be undertaken in accordance with the Practice statements of the Society of Chartered Surveyors.
- EBS established a panel of valuers for commercial and residential property valuations.
- Valuation reports were requested by EBS and addressed to EBS and were reviewed as part of the case assessment prior to issuing funds.
- At regular intervals valuers were asked to submit their updated indemnity insurance certificates.
- EBS also commissioned independent firms to provide valuations for a sample of valuations received to back-test for appropriateness.
- The Loan to Value exposure calculation was based on the lower of the valuation amount or purchase price.

From 2008 these valuation standards, which we deemed appropriate, were maintained.

- **Adequacy of internal controls over perfection of security and policy exceptions (B.4.c)**

There were three methods by which security was perfected traditionally.

1. *Reliance on an Undertaking - in an industry agreed format - to certify title directly to the financial institution post funds issuing.*

This was the process in place in the industry from the mid 1990s. In EBS, as in the industry, this was the primary method of taking security for Homeloans in the 1990s, and for Buy to Let loans from the early 2000s.

2. *Certificate of Title provided to an EBS appointed panel solicitor.*

   In EBS this was the process used for commercial property loans up to €1m in exposure from the 1990s[3] and for all Buy to Let lending from 2007 (post the well-publicised alleged Solicitor fraud cases). The borrower's solicitor was obliged to certify title directly to EBS before the loans was drawn down / funds issued. Security was completed (signed charge, registration of charge and remittance of Title Deeds) by an EBS appointed solicitor following the issue of funds.

3. *EBS Solicitor conducted an investigation of title and certification of title.*

   This was the process used for commercial property lending for exposures greater than €1m from the 1990s. Title Deeds were independently verified by an EBS-appointed solicitor who provided a full title report before funds issued. The EBS appointed solicitor completed security post funds issue.

On the back of solicitor fraud events which were publicised in late 2007, EBS reviewed its policy in relation to security and its processes for tracking outstanding Deeds with a focus first on commercial property loans including the land and development book. A new process was built to produce lists of outstanding Deeds for each Solicitor Practice. These lists were issued to Solicitor's office followed by a visit by an EBS official to evaluate the status of Title registration and to agree a timeline on how and when Title would be registered and Deeds remitted.

A similar programme commenced in relation to residential mortgages. Both programmes proved effective in substantially reducing outstanding registrations.[4]

- **Analysis of risk concentration in base and adverse economic scenarios and impact on the capital structure (B.2.c)**

Given its status as a Building Society, EBS loans were secured almost wholly by property, the vast majority of which related to property in Ireland. As a result the balance sheet was highly concentrated.

Regular stress testing was conducted as part of the Society's internal capital adequacy assessment process (ICAAP) from 2008 in line with good practice and regulatory requirements.

[3] EBS entered the Commercial Lending business in 1992 following changes in Building Society legislation.
[4] When EBS transferred its Land and Development related loan assets to the National Asset Management Agency (NAMA) there were no legal 'discounts' applied for missing or incomplete contractual documentation in contrast with some participating institutions.

Internal stress testing incorporated externally published downturn scenarios and internally approved scenarios. For example, the June 2008 stress test incorporated the adverse scenario as set out in the then ESRI Medium Term Review.

In addition, from 2009, there were quarterly increases in provisions which impacted available capital and, as a result, capital adequacy projections. For commercial credits stress testing took the form of management judgement in terms of the potential loss associated with the case in a downturn. For residential loans a statistical model, used for provisioning and loan loss forecasting, was used. The provisioning model was subject to an external review[5] which concluded that EBS was meeting good industry practice in its provisioning approach. What were believed to be conservative 'peak to trough' assumptions relating to property value reductions were incorporated in loan loss forecasts[6], and benchmarking of provisions levels in other institutions was conducted on an ongoing basis.

The appropriateness of provisions was, through this period, one of the most significant judgemental matters in terms of financial reporting and a key area of focus of external audits.

Between 2008 and 2011 EBS, like all institutions, was subject to four extensive external reviews of the financial and capital position of the Society, commissioned by the Financial Regulator culminating in the PCAR II exercise in March 2011.

At that time, it was felt that this was the final assessment of the extent of losses in a base and stress scenario. It transpired that these loss estimates were exceeded. Last year, as a precursor to the establishment of the Single Supervisory Mechanism, the European Central Bank conducted a Comprehensive Assessment of asset quality and capital adequacy for significant banks across Europe - the "European Stress Test" - the results of which were published in October 2014. This brought to an end the evaluation of asset quality, provisions adequacy and the appropriate level of capital – a process which took six years for banks, regulators and auditors, with significant input and challenge by external experts.

Effectiveness of banks' funding, liquidity strategies and risk management

- **Analysis of liquidity risks under adverse scenarios (B.3.b)**

In 1998 EBS's loan book was funded solely by deposits. Between 1999 and 2007 the loan book grew by 300% while deposits grew by 170%. Similar to other institutions the gaps had been funded through (cheaper) wholesale funding and international corporate deposits. As we now know, this was an unsustainable model and new regulatory requirements in relation to loan to deposit, liquidity coverage and net stable funding ratios are in place to prevent a re-occurrence of this situation.

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[5] EY Risk Analytics UK October 2010 reported to EBS and presented to the Central Bank.

[6] 55% from February 2010 for residential property, 54% for EBS commercial property exposures

EBS undertook a quarterly stress testing of liquidity from 2006 in line with its Liquidity policy, based on Sound Practices for Liquidity Management published by the European Banking Authority[7]. These included scenarios specific to the bank (idiosyncratic) and those which were systemic in nature.

Given market conditions the Society's Liquidity Crisis Management process was instigated at the end of 2008 as per its Liquidity Policy.

- The liquidity crisis management team (including the Group Treasurer, the Finance Director and the CRO) met on a weekly basis to review liquidity positions, forecasts and plans to mitigate the impact of further unplanned outflows.
- From January 2009 the Asset and Liability Committee was meeting twice monthly and monitoring the liquidity and funding position of the Society tightly which had been negatively impacted by rating downgrades and concerns regarding sovereign risk.
- Deposit withdrawals were closely monitored and interest rates increased where possible/appropriate to retain them.
- On the treasury side, collateral was utilised as efficiently as possible to create lines of credit with the ECB and EBS issued public then retained bonds to support the Society's liquidity position.[8]
- Liquidity stress tests were run monthly and there was weekly reporting of the liquidity position and projections to the Regulator and, for a period of time, daily reporting of the Society's liquidity position.

Although the liquidity position of EBS had improved by the end of 2009, its ability to access funding and the cost of funding were directly impacted by the closure of markets to Irish institutions in mid 2010 on the back of the Greek crisis. Rating reductions meant that existing pools of collateral used for repo purposes were in some instances no longer eligible.

In October and November 2010 there was also some uncertainty in relation to the continuation of the government's Eligible Liability Guarantee scheme (ELG). The combined impact of these developments was that EBS ran out of contingency options in December 2010 and needed to avail of the European Central Bank's Emergency Liquidity Assistance, and again in 2011.

In summary, funding and liquidity risks were managed tightly throughout the crisis but despite the Society's best efforts, the scale of the crisis rendered these efforts unsuccessful.

- **Interest rate risk appetite setting and monitoring (B.3.d)**

Interest Rate risk in EBS was traditionally low as EBS did not operate a trading book (in accordance with the Building Societies Act). Hedging instruments were used to reduce interest rate risk, not to create it. Interest rate risk was managed by setting upper limits on interest rate sensitivities. The maximum permissible level was set by reference to the gap and sensitivity to a 1% parallel increase in interest rates. It was set at a low level of €12.5m. Throughout my tenure as CRO (and preceding it) it was monitored and reported on each month by an independent Treasury Risk team and reported to the Board in the Chief Risk Officer's report.

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[7] Then the Committee for European Banking Supervisors (CEBS).

[8] EBS had established a covered bond bank in Q4 2008 (EBS Mortgage Finance).

- **Capital structure and loss absorption capacity (B.3.e)**

EBS operated within regulatory capital requirements throughout the pre-crisis years, but its Tier 1 capital ratio of 7.9% at the end of 2008 was inadequate to absorb the unprecedented level of provision losses arising from the crisis.

Following the Q1 2010 PCAR exercise EBS was required to attain a Core Tier 1 capital ratio of at least 8% by December 2010 and 12% from end February 2011. This would require an injection of €875m of capital. The government became a majority shareholder in the Society in May 2010 following the provision of €100m in capital in the form of Special Investment Shares. A further €250m of capital was received in June by way of a Promissory Note with additional capital of €525m pledged.

EBS was required by the Department of Finance to secure the viability of the organisation through a sales process. A shortlist of preferred bidders was confirmed in October 2010 and a third phase of due diligence commenced in November 2010.

On the conclusion of the PLAR and PCAR exercises in March 2011, the level of recapitalisation required for EBS increased to €1.5bn and it was decided to merge EBS with AIB bank.

Clarity and effectiveness of nexus of institutional roles and relationships

- **Relationship between and appropriateness of relationship between the Central Bank, the Department of Finance and the banking institutions. (R.3.b)**

I had little personal interaction with the Department of Finance in the pre or post crisis period. As a covered bank requirements were placed on all institutions in relation to their governance and operations, which required internal review and external audit assurance on a quarterly basis. Requirements were increased following the recapitalisation of the banks in 2010.

In contrast, I have had a high level of interaction with the Central Bank throughout my career. This increased from 2008 given the nature of my role and the change in the approach to supervision. As is well documented, the approach of the Central Bank became more independent, challenging and intrusive following the crisis, as appropriate in the circumstances. The volume and depth of information required by the Regulator increased very significantly, there were more regular on-site reviews and observers from the Central Bank attended EBS Board, Board subcommittee and executive risk management committee meetings. I believe EBS represented itself in a professional, credible manner in the toughest of environments - for all involved.

Conclusion

The sustained success of the economic environment from 2000 to mid-2007 led to an incorrect consensus that early concerns of a housing bubble were misfounded .

The fundamentals of risk assessment that were employed were insufficient; the industry underestimated both the probability of an economic and property market collapse occurring and its impact in terms of loan losses. This was compounded by an international credit crunch.

It has taken more than six years to fully size the impact of the deterioration in asset quality which concluded with the publication of the European Central Bank's Comprehensive Assessment in October last year.

There is a reference in Professor Nyberg's report[9] that *'EBS had a system that was not adequately resourced and seems to have lacked influence within the bank'*. In retrospect, I think there is truth in that statement. The core risk team comprised three individuals in 2002 rising to 18 by end 2008. The risk agenda over this timeframe was very extensive, including compliance with new governance standards, the establishment of Board and executive risk committees, the adoption of new Accounting Standards in 2005, implementing the Basel II Programme 2004-2007 and building out risk modelling, management information and regulatory reporting capabilities in addition to the workings of the core risk function. Independent second line challenge in the form of a dedicated Chief Risk Officer role, a corporate governance requirement today, was not in place. That is not to say that the outcome would necessarily have been different if it was, and corporate governance standards were at an evolving stage. But it was a finding of Mr. Nyberg's review that warrants acknowledgement.

It is a source of great personal sadness and regret that a company I worked so long for and was proud to be a part of failed, and in so doing contributed to the banking crisis. The crisis and its aftermath have been debilitating in terms of Irish people's financial and in many instances personal health. I fully acknowledge my share of responsibility, together with others in EBS in the pre-crisis period, for that failure. As Chief Risk Officer of EBS I worked to the best of my ability with the executive team to minimise where we could its impacts on customers, on EBS and on the economy. I am sorry that I could not do more.

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[9] Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland March 2011 – page 47.