Tithe an Oireachtais
Houses of the Oireachtas

# Joint Committee of Inquiry into the Banking Crisis

## Witness Statement of

## David Gantly

## Session 60

## 03 September 2015 (p.m.)

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**STATEMENT OF DAVID GANTLY**

**TO**

**THE JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS**

**DATED 18 AUGUST 2015**

**OIR REF: DGA01 [DGA-i-03]**

Mr. Chairman,

I have been asked by the committee to provide a written statement on the following lines of inquiry B1(e); B2(c); B3(a),(b),(c),(d),(e); B5(a); B7(a),(b); C2 (c); C3(b),(c); C4(b); R2(c) and R3(b).

I have begun this statement with a brief background and then addressed each line of inquiry under its separate heading.

**Background**

I worked in Capital Markets/ Treasury in Ireland for almost thirty years until early 2009. I spent seven years in Investment Bank of Ireland Treasury, dealing in Foreign Exchange, interbank cash markets and Sovereign and Corporate bonds. I joined Riada Stockbrokers in 1987 where I worked on the Government Bond desk. In 1992 I joined Davy stockbrokers in a similar capacity and in 1994 I took up a position as Chief Dealer with the then Irish Permanent Building Society.

Irish Permanent demutualized in 1994, became a PLC and listed on the Irish stock exchange. Irish Permanent plc merged with Irish Life in 1999 and the group subsequently acquired TSB in 2001. The Treasury activities of TSB were integrated with the Irish Life and Permanent Group Treasury ("**IL and P"**). I was appointed Group Treasurer in 2000 and worked in that capacity until I left the bank in February 2009.

In my capacity as Treasurer I was responsible for the Treasury function that related almost entirely to the Group's banking activities. The Treasury function was located in Dublin's International Financial Services Centre, separate from both the life assurance business at Abbey Street Dublin 1, and the retail banking business located at St. Stephen's Green in Dublin 2.

My principal responsibilities included liquidity management; funding, interest rate and F/X risk management. I also had extensive dialogue with banking counterparties, ratings agencies and global debt investors with regard to funding. Part of my duties resulted in regular routine operational contact with the Financial Regulator and the Central Bank.

I was a member of the Asset and Liability Committee ("**ALCO**") from 1994. In addition I was a member of the Group Top Team from 2000. The Group Top Team was comprised of the Group CEO, Group Finance Director, Chief Financial Officer, Group Treasurer, Group Head of HR , Group Head of IT , Group Risk Manager, CEO of the Bank, CEO of Irish Life Assurance Company (ILAC), CEO of Irish Life Investment Managers (ILIM) and CEO of Corporate Business.

I was a member of the Group Risk Committee from mid 2007. The Bank had its own top team, as had ILAC, ILIM and Irish Life Corporate Business.

I was not a director of the group and I was not a member of the bank executive top team or any of the other divisional top teams. A new strategy team was set up by the Group CEO in early 2007 and I was not a member of that group.

My direct reporting line in my capacity as Treasurer was to the Group Finance Director.

**B 1 e Q <u>"Appropriateness, management and control of Client Relationship activities"</u>**

Group Treasury did not have engagement in the normal course with clients of either the retail banking or life assurance activities of the group.

The Treasury function of IL and P was physically located in the International Financial Services Centre in Dublin and functioned separately from the retail bank and the Life Company.

Treasury was the principal routine point of contact with bank treasury and debt capital markets counterparties. It supported the group's investor relation's activities and engagement with the credit rating's agencies. Treasury also had regular operational contact with the Financial Regulator and the Central Bank of Ireland.

**B 2 c Q <u>"Analysis of risk concentration in the base, the adverse economic scenarios and the impact on capital structure"</u>**

As Treasurer, I was not involved with the production of any group wide scenario analysis and the potential impact on the bank's capital ratios. I am therefore unable to offer an informed view on this line of inquiry.

The bank's executive, and the finance function handled these issues. As stated previously I was not a member of the bank executive.

Within Treasury, the Treasury risk manager was responsible for monitoring and reporting market risk arising from retail and treasury activities. The treasury risk manager had a direct reporting line to the CFO in line with best practice in risk management and corporate governance. We invested heavily in systems and people to support the risk area and our systems were, I believe, best in class by industry standards.

**B 3 a). <u>Q "Appropriateness of funding sources-the mix, maturity profile and cost"</u>**

When I joined Irish Permanent in 1994 the bank was required to hold a 25% liquidity ratio. (Licensing and Supervision Requirements and Standards for Credit Institutions 1995).

This approach was changed in 2007 following the issuance of a final paper by IFSRA in July 2006. The changes were proposed to reflect more sophisticated approaches and to reflect the then current best practice. The new approach was two pronged, qualitative and quantitative.

Amongst the qualitative requirements it was stated that it was the Board's responsibility to;

1) develop a strategy for liquidity risk;
2) establish management structure including ALCO; and
3) review ALCO policy and Liquidity Policy at least annually.

On the quantitative side the previous 25% stock policy was abolished and was replaced with a maturity mismatch approach. Institutions were required to hold liquid assets such that they could meet 100% of their first 8 days obligations and 90% of obligations from 8 to 30 days.

In 2003 we had introduced a new liquidity policy as part of Treasury Policy in IL and P which we ran alongside the 25% regime. This policy reflected the new regime adopted by IFSRA in 2007, so effectively best practice was in place since 2003.

Our funding strategy, (Source: IL an P Board Presentation January 2007), was-

1) to fund growth through retail and wholesale flows in a cost efficient manner;

2) bank funding centralized in Treasury;

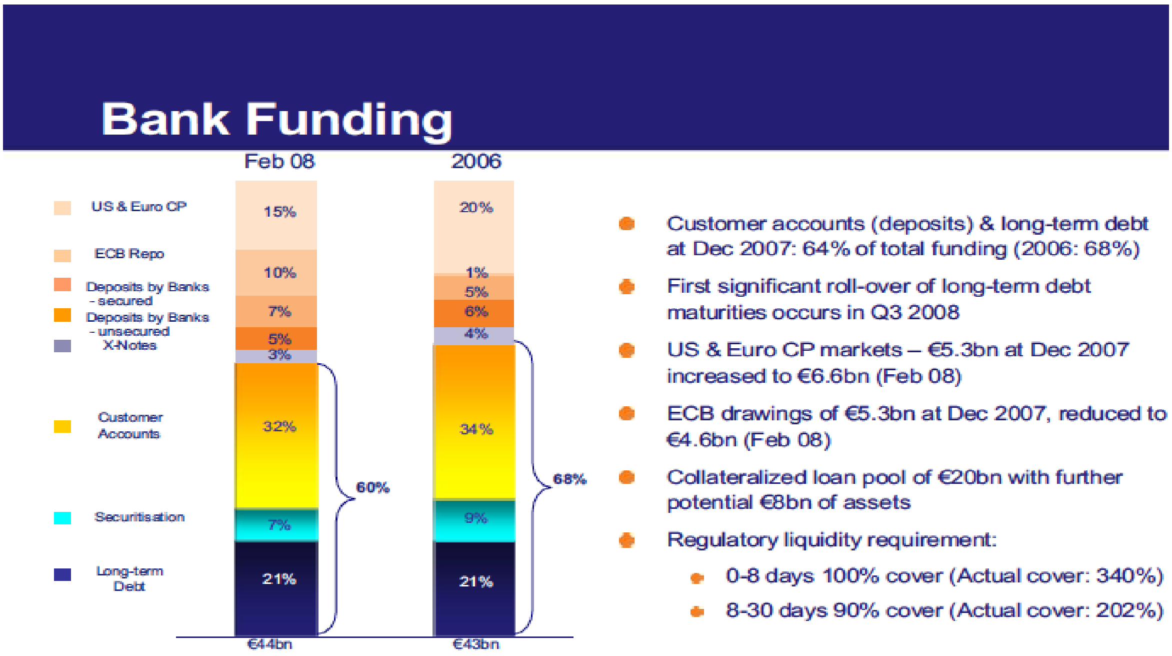
3) adoption of annual funding plan to mitigate risk;

4) diversification of funding sources by product and geographical mix.

This document also noted that 85% of the banking assets were residential mortgages and that Mortgage Backed Promissory Notes ranked as Tier 1 collateral for ECB for refinancing operations.

It is worth noting that at the time Moody's gave IL and P a prime short term rating as it "reflects the diversified mix of funding sources comprising retail, market and inter-bank funding."

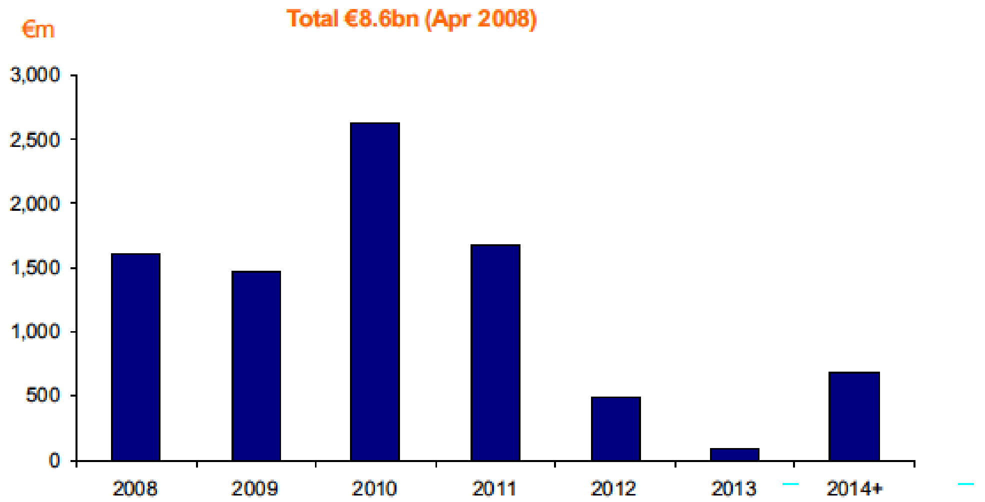
In broad terms we adopted a policy where our funding was split in three thirds, between long- term debt, customer accounts and short- term wholesale debt, as can be seen in the following table;




(Source: Debt Investor Presentation July 2008)

As at February 2008, customer accounts and long- term debt accounted for 64% of our funding. While our short term funding is approximately the same between 2006 and February 2008, the composition changed significantly with ECB drawings accounting for 10% of Treasury short term funding. In anticipation of further liquidity disruption we had collateralized a loan pool of €20 bn. and were working on increasing this pool by an additional €8 bn. Our 0-8 day liquidity cover was 340% versus the 100% regulatory requirement. Our 8-30 day cover was 202% versus 90% target.

# Long Term Debt Maturity




(Source: Long Term Debt Maturity and Funding Duration- Standard and Poor's Rating Review, "Treasury and Funding May 2008")

Treasury sought to smooth the banks long term funding in order to decrease refinancing risk, as can be seen in the graph above. Senior public issuance was typically issued with a duration of three to five years.

# Funding Duration

| Weighted Average Days | Dec-07 | Apr-08 |
|---|---|---|
| ■ US CP | 60 | 41 |
| ■ European CP | 64 | 40 |
| ■ French CDs | 87 | 40 |
| ■ Corporate Deposits | 43 | 41 |

(Source: Long Term Debt Maturity and Funding Duration- Standard and Poor's Rating Review, "Treasury and Funding May 2008")

The table above outlines the funding duration of our main short term sources of funding. Typical maturity of the US CP market was in the week to two week range. We consistently sought to run significantly longer maturities to mitigate liquidity risk. The reduction in the duration of the funding from December 07 to April 08 reflects investor appetite to shorten the term in response to liquidity concerns in the market in general.

I believe that our funding strategy was balanced and robust, while pointing out that it is virtually impossible to plan or anticipate a one in a hundred year event. Conventional wisdom had it that a liquidity event would be short lived and this thinking proved to be incorrect when faced with an enormous systemic shock.

Wholesale funding sourced by Treasury had an associated cost. This funding cost was calculated by producing a blended rate across all of the funding sources. This rate was then charged to retail by Fund Transfer Pricing (FTP). The FTP rate used in 2007 and into early 2008 was 12.5 basis points. FTP was set by ALCO. It is worth noting that credit market spreads were at the tightest levels I had seen throughout my career in the months prior to the debt crisis. On reflection, this was a strong indicator that credit was very freely available which contributed to rising asset prices.

**B3 b <u>Q "Analysis of liquidity risks under adverse scenarios"</u>**

A critical function provided by a banking system is maturity transformation. Banks fund long-term assets with shorter-term liabilities. This provides long term liabilities to households and corporates, which facilitate long term capital investment with obvious economic and social benefits. The provision of maturity transformation creates liquidity risk for banks.

IL and P introduced an updated Liquidity Policy in October 2003. The Basle Committee on Banking Supervision had produced a paper, "Sound Practices for Managing Liquidity in Banking Organisations, February 2000", and we adopted the template they had outlined in that publication.

The Treasury policy for the purpose of contingency funding planning, stated three scenarios would be considered.

1. **A moderate entity specific crisis**

   "This was defined as an unexpected cash-flow problem, which was only likely to last a few days. It was presumed under this scenario that wholesale and retail deposits, and short term paper funding programs would remain intact, and that, funding would be provided primarily by using the stock of liquid assets."

2. **A severe entity- specific crisis which affects IL and P ratings**

> "This is defined as a major ratings downgrade, (2 notches on long term and one on short term). It is assumed that unsecured sources would be severely affected and that the scenario could take weeks to possibly three months to stabilize. It was anticipated that in addition to using the stock of liquid assets for funding replacement other sources would be needed such as securitization."

3. **An industry wide crisis**

> "Assumption that there are liquidity problems in the banking system as a whole, which cause widespread disruption to markets. The best defense is described as maximizing IL and P's ability to deal with stress under scenario two. It is assumed the regulatory authorities will be aggressive in providing support to the system, making central bank borrowing the leading source of replacement funding."

The results of three tests described above were submitted to ALCO monthly.

We also assessed the impact of incremental changes to interest rates on our Net Interest Income and produced a present value of the portfolio. This was produced by our Asset and Liability Model ("**ALM**") and was submitted to ALCO on a monthly basis.

**B 3c Q "Interest rate risk appetite setting and monitoring"**

The Board set interest rate risk appetite and limits. Within Treasury, the Treasury risk manager was responsible for data recording and reporting. The ALCO was responsible for setting and monitoring interest rate risk.

IL and P employed the Value at Risk ("**VAR**") model to manage interest rate risk. "VAR is a statistically based estimate of potential loss on a given portfolio from adverse market movements, which summarises the predicted maximum loss over a target time horizon and a given confidence level". (Source: IL and P Annual Report, 2007).

This methodology was designed by JP Morgan Risk Metric's and is industry standard. IL and P used a ten-day time horizon and a 99% confidence level. That is, there was a one in a hundred chance of the predicted limit being exceeded over a ten day time period.

The VAR limit was set by the Board at 5 million Euros. This reflects a prudent and appropriate limit in line with the board's objectives.

The internal controls were clearly set out in Treasury Policy and they were set and reviewed by the Board on an annual basis. In addition there were strict controls and procedures in place and these were monitored by the ALCO, which was chaired by the Group Finance Director and also included the Group CEO in its membership.

**B 3 d Q "Appropriateness of investment of liquid assets in government and/or other securities"**

At the end of 2007 the bank's liquidity portfolio amounted to €4.2 bln. The portfolio was rated 73% AAA, 20% AA and 7 % single A. The principal holding comprised Euro government bond's, 59%, highly rated bank Floating Rate Notes, 28% and prime euro denominated Residential Mortgage Backed Securities. (Source: Debt Investor Presentation July 2008)

The composition of the liquid assets was prudent and of high quality, which ensured that the portfolio could be liquidated with relative ease, which is a requirement of an effective liquidity portfolio.

**B 3 e Q "Capital structure and loss absorption capacity"**

Given that the group was a bank assurer, its capital structure was relatively complicated. The finance function at group level, under the direction of the Group Finance Director managed and reported the group's capital structure. The Group Treasury role was to monitor debt capital funding opportunities in the market, advise Finance as to availability, and to execute the transaction as instructed.

As can be seen in successive annual reports, the group's capital ratios were consistently maintained at or in excess of regulatory requirements.

**B5 a Q "Adequacy of the incentive and remuneration arrangements to promote sound risk governance"**

Senior Executive Remuneration was determined by the Remuneration and Compensation Committee, and was in compliance with the Combined Code of Corporate Governance. (Source: I L and P 2006 Annual Report). The committee, referencing overall profit performance by the group, and taking account of the performance criteria, which it set, determined bonus awards.

Treasury remuneration arrangements were determined at group level and they included fixed and variable components. All staff worked towards agreed goals and objectives across a range of metrics including funding, liquidity, risk and controls. Individual performance was assessed annually against agreed goals and any variable compensation granted was dependent on group, business unit and individual performance.

Within Treasury I am satisfied that the remuneration arrangements in place were conducive to the promotion of an appropriate risk environment that facilitated sound risk governance.

**B7 a Q "Impact of prevailing accounting standards in recognizing risks"**

My own function was totally independent of the Financial Accounting area and I had no role in that area. I was however, well aware of the restrictions which IAS 39 imposed. The pro-cyclical nature of the standard and the resultant inability to create general provisions essentially removed a potential "buffer" which could have been created and would have mitigated risk in the future. That said the provision did not impact directly on treasury activities.

**B7 b Q <u>"Effectiveness of the external audit processes to identify and report to the board and management, any concerns related to significant risk exposures, including property, funding and liquidity</u>**

I would typically meet the external auditors twice yearly with most emphasis on the year-end discussion around Treasury issues, performance, funding etc.

I am satisfied that external audit had full access to management, staff and all records within group treasury. Treasury meetings with the external auditors were open with a focus on risk limit's, profitability and funding. I had no access to the external audit reports to the Board. I would not have expected to have access to these reports from the External Auditors, unless they had raised concerns or specific issues with the Board. If issues were brought to the attention of the Board I would have expected to have heard from them directly seeking explanation. I have no record or memory of any queries from the board during my time in treasury.

Treasury was also subject to regular and stringent review by Internal Audit and the reports of Internal Audit were available to the external auditors.

**R 2 c Q <u>"Adequacy of the assessment and communication of both solvency risk and liquidity risks in the banking institutions and sector"</u>**

The Treasury Risk Manager was responsible for the accurate collation of liquidity exposures and the delivery of accurate reporting internally and externally.

The banking group invested heavily over the years to enhance our systems and I am satisfied that our liquidity assessment was accurate. Treasury routinely provided accurate and timely reporting of our liquidity risk externally and internally as requested. As is evidenced from regular Treasury reporting to ALCO, underlying market developments and risks were clearly and comprehensively articulated on an ongoing basis. When the liquidity risk position deteriorated due to market developments through the second half of 2007, the scale of the issue and its potential impact was escalated by me through e-mail correspondence and dialogue with the CEO and GFD and formally in my presentation to the Group Risk Committee in December 2007.

Throughout my time in IL and P the group operated consistently within the regulatory liquidity requirements. However, the composition of the group's liquidity changed significantly between 2007 and September 2008 driven by market developments. By late 2007 a significant amount of our short-term funding sources had either dried up or were severely restricted.

In a presentation to the Risk Committee, on 7/12/2007, I pointed out that most short-term funding sources were by then effectively closed. This included US Commercial Paper, Euro Commercial Paper, X notes (longer term US Commercial Paper), French Certificates' of Deposit and interbank deposits. In addition I pointed out that commercial deposits were very restricted and conventional securitization was effectively closed. I further pointed out that basis risk has increased significantly and that the use of the ECB benchmark rate for setting retail products was inappropriate. I made the point that "*the business model of the last five to ten years is seriously threatened*" and that "*funding and capital are now scarce resources with substantially higher associated costs*". (Source: Presentation to the Group Risk Committee December 2007) While I pointed out that credit spreads were likely to rise I did not envisage that would widen to the extent they did.

Treasury was not involved in any assessment of the banks solvency.

**R 3 b Q <u>"Nature and appropriateness of the relationship between the Central Bank,(including the Financial Regulator), Department Of Finance and the banking institution"</u>**

Treasury enjoyed a very business-like and professional relationship with the Central Bank and Financial Regulator, with respect to liquidity reporting and operational activities. I had very limited, almost zero, dialogue with the Department of Finance and accordingly cannot offer any insight into that aspect.

**C2 c Q <u>"The Liquidity versus solvency debate"</u>**

Liquidity can be described as the ability of an institution to meet its due obligations on a timely basis. If the value of banks liabilities exceeds the value of its assets and the bank does not have a sufficient capital "buffer", the bank is then insolvent.

IL and P's assets were primarily made up of residential mortgages, which qualified as a liquid asset for regulatory reporting. In late 2007, in response to my concerns regarding funding in the wholesale markets, I initiated a programme, whereby we created liquid pools of mortgage assets. This is exactly what we would have done if we were to prepare a portion of the mortgage portfolio for a conventional securitization. The market appetite for securitized assets had at this stage disappeared but we were able to use these pools as security against drawings from the ECB.

**C3 b Q <u>"Appropriateness of the bank guarantee decision"</u>**

The markets were entirely dysfunctional by late 2008. During September the markets were awash with rumours of banks having serious liquidity problems. Problems in the market had dragged on for over a year and it was apparent that the Irish banking market was facing a severe liquidity position. It was therefore inevitable that some action was required to keep the banking system functioning.

I was not aware of the actual details of the overall Irish market condition. I have no knowledge of the discussions that took place between the various parties in the run up to and on the night of the guarantee. A failure to take any action on the night would likely have had major negative consequences for Ireland and I view the decision in that light.

**C3 c Q "Effectiveness of reviews of bank's loan books and capital adequacy"**

I had no visibility of or involvement in the retail bank's loan book or of the review process which it was subject to. As noted earlier, Treasury was physically remote from the bank and I was not a member of the bank executive.

**C4 b Q "Establishment, operation and effectiveness of National Asset Management Agency (NAMA)"**

NAMA was established in December 2008 and I left the bank in February 2009. I had no direct contact with NAMA and I also understand that IL and P had no assets transferred to NAMA as it was not engaged in property and commercial lending.

I have no clear insight into what other options were available or how NAMA has gone about its business. Therefore I have no experience of NAMA upon which to base any comment.