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Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Jim O'Leary

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Statement to Banking Inquiry
Jim O'Leary (Former Director AIB Group)

Introduction

I was a member of the Board of AIB Group from January 2002 to April 2008. During that time I served on the Board's Remuneration Committee (from early 2003 to end-2007) and on the Audit Committee (from early 2004 to April 2008). I also spent a period (2007-2009) as a member of the Supervisory Board of BZWBK, AIB's Polish subsidiary.

The Group Board met monthly (more frequently during periods of stress); the Audit Committee met about 10 times a year, and the Remuneration Committee met perhaps 6 times annually. I was an assiduous director in terms of reading and trying to absorb the voluminous material circulated in advance of each meeting. All told, allowing for the attendance at and preparation for meetings, and other occasional Bank-related engagements, I estimate that the discharge of my duties at AIB required a commitment of at least 40 days a year. This is comfortably within the kind of range now regarded as consistent with best practice by corporate governance experts.

During my term the Board was composed of people who took their duties seriously, who were well motivated, who brought valuable skills and experience to the table and who were in general not lacking in the character traits required to question and challenge management. The Board did some good work, not least in overseeing the considerable enhancement of the Bank's risk and compliance processes. But the Board also made some big and very costly mistakes. The biggest and most costly of them was to pay insufficient attention to the Bank's large and growing property loan portfolio, and to accept too readily management assurances that the risks attaching to this portfolio were being properly measured, monitored and managed.

As a member of the Board during the critical period I accept my share of responsibility for those mistakes and wish to put on the record my profound sorrow for the consequences that have ensued for this country and its citizens. My sorrow is amplified by the fact that I am an economist by training and should on that account have been much more alert to the mounting evidence of a credit-fuelled property boom during my term as a director and much more vigilant about the associated risks to the Bank.

I am happy to assist the Inquiry. I have endeavoured to answer the questions put to me as accurately and thoughtfully as possible. To that end I have reread a significant volume of documentation that I would have first read as a Director and have consulted an admittedly sparse set of contemporary notes. Despite that, in some cases the passage of time (it is now more than 7 years since my last AIB Board meeting and more than 13 since my first), means that my answers may not be as helpful as I would wish them to be..

Answers to Questions

Q1

At the time of my appointment to the AIB Board, I had no experience of banking and little more than an educated layman's knowledge of the industry. As for qualifications relating to the broader financial services sector, I was a Member of the Securities Institute (MSI). This qualification was acquired, not on foot of any formal course of study, but as a result of working as an in a stockbroking firm for an extended period.

Q2

I have a Masters degree in economics (NUI, 1979). Prior to joining the AIB Board, I had worked for 14 years as an economist with Davy Stockbrokers, and before that held positions in a number of public sector organisations, including the ESRI and the NESC.

Throughout my career my work was in the area of macroeconomics, especially the analysis of macroeconomic indicators, the preparation of macro forecasts and the assessment of macro policies (particularly fiscal policy). My principal focus was the Irish economy. During my time at Davy, the scope of my work also included the analysis of international economic trends and of Irish and international currency, money and government bond markets.

Before joining the AIB board, I had gained some boardroom experience. I was a non-executive director of Aer Lingus from 1995 to 2000, a member of the National Statistics Board in the mid-1990s and a member of the Public Sector Benchmarking Body 2000-2002.

Q3

When I joined the Board induction principally took the form of an information pack and meetings with key management personnel. My recollection is that there was a degree of informality about it. There was also a degree of voluntarism: it was, as I recall, left up to the new director to initiate meetings, albeit with the help of the Company Secretary.

With the passage of time, it became clear that the induction process needed to be strengthened. Accordingly, a small sub-committee of the Board (of which I was a member) was formed to produce a set of recommendations. It reported to the Board in June 2006. It didn't alter the main elements of the induction process (briefing sessions and reading materials were to remain at the core), but it expanded and made more explicit both the list of key management personnel to be met and the topics to be covered and did likewise in relation to the contents of the 'induction folder'. It also recommended that non-executives who judged their understanding of financial issues to be deficient be assisted by the Secretary's office in accessing additional training. The recommendations of the sub-committee were adopted by the Board and, to the best of my knowledge, implemented.

In relation to ongoing training I might add that members of the Group Finance team were always willing to provide out-of-course 'tutorials' to INEDs on the more complex aspects of financial accounting. I remember a series of accounting seminars in late 2006 or early 2007 for members of the audit committee. I also recall that INEDs were encouraged to participate in externally-provided corporate governance courses.

In general, ongoing training was a matter for INEDs to take the initiative on. I never heard of a case where a director was denied a request for assistance/facilitation in this regard.

Q4

I note that this and the following two questions are couched in the past tense and I will answer accordingly without the overlay of hindsight. I have no recollection of ever feeling during my term as an INED that the information needed to understand the risks and exposures incurred by the Bank (i) was not being provided or, (ii) if not already provided, would not be forthcoming if requested.

During this period, the quantum of information on risk furnished to the Board increased greatly. By the end of my term the Board was receiving a twice-yearly Enterprise-Wide Risk Review which reported *inter alia* on the range of significant risks to which the Group was exposed and the actions being taken to mitigate them. On a monthly basis, the Board was receiving summary information on credit risk, operational risk and market risk in the CEO's report.

In addition, the Audit Committee received a monthly report from the executive Risk Management Committee (RMC) meetings. Towards the end of my term, the Audit Committee had started to receive reports from the Credit Risk Measurement Committee, an executive committee established in March 2007 to take responsibility for the approval of all material aspects of credit risk measurement systems and processes across the Group.

Q5

I have no recollection of being anything other than satisfied that the information required to discern the full financial position of the Group was available to me at all times.

Group Management Accounts were presented to the Board on a monthly basis. These accounts gave details of costs, revenues and profits by Division, as well as variances *vis-a-vis* budget, changes in deposit and loan volumes and margins. At the half-year and end-year points, there was a more comprehensive presentation of the financial results for the relevant accounting periods. In addition to data pertaining to the P&L accounts for the Group and the Divisions, these results contained performance data for the main Business Units as well as Balance Sheet data and Total Shareholder Return metrics. The Credit Review, which analysed bad and doubtful debts and related provisions, was presented on a quarterly basis.

Q6

I don't ever remember feeling during my term as an INED that that the financial and other information provided to the Board was of insufficient quality to enable me to effectively challenge Management.

Q7

Discussion of strategy and the Bank's business model took place under a number of different agenda headings. First, there were agenda items explicitly concerned with strategy where strategic issues were approached from a Group perspective. Second, there were items where the focus was the performance of a particular division or business unit. Third, there were items concerned with the acquisition or the disposal of a business. Fourth, there were items that related to cost reduction programmes, the deployment of new technologies, the centralisation of activities etc. In addition, there were also periodic presentations on strategy from external experts/consultants.

From this brief (and probably incomplete) listing, it is clear that what might loosely be termed 'strategy and the business model' is a very broad category. As such, it would have accounted for a significant proportion of the Board's agenda.

However, it arguably commanded less Board time than would have been desirable, the main reason being that the agenda became heavily populated with issues relating to risk, compliance, regulation and control. In part this pattern reflected the fact that during the 2002-08 period the Bank was obliged to become involved in a number of very big regulatory projects (IFRS, SOX, Basel II), each of which required close Board oversight. In part it was a consequence of a number of high-profile internal control failures (Rusnak, Faldor, Forex) and the need for a comprehensive response in each case.

Q8

Competitive pressures can best be understood by thinking in terms of two separate dimensions: (i) the macro or Group level and (ii) the level of individual businesses.

(i) The macro level: At the macro level, the Bank was under pressure to perform well relative to its peer group which consisted not just of the other Irish banks but also other

European banks. In this respect, the most obvious measure of performance and the one of greatest interest to actual and prospective shareholders was the share price. A key factor determining the share price, and the one most amenable to control/influence by management, was earnings per share (eps).

Simply put, relatively strong eps growth meant relatively good share price performance, and was therefore associated with enhanced prospects of raising new capital, of expanding the business and reduced vulnerability to takeover. Hence eps growth was the ultimate driver of business strategy.

Competition at this level did not force banks to behave in the same way in the sense of adopting the same strategy. Thus Anglo remained essentially a monoline bank with limited diversification away from property-related lending. In contrast, AIB was a full service bank and one of the differentiating features of AIB Group was that it had a Polish subsidiary that made a significant contribution to earnings.

(ii) Individual businesses: AIB Group comprised five Divisions with each Division in turn comprising a number of different though related businesses (e.g. deposit gathering, mortgage lending, lending to the building and construction sector).

At the level of the individual businesses it was typically the case that competition was intense. At Board level there would have been a high degree of awareness of the activities of competitors, such as changes in the pricing of their products, changes in underwriting criteria, notable successes in winning business and so on. This sort of intelligence was routinely communicated to the Board via the monthly reports of the Division heads and the reviews of individual businesses that were carried out on a less frequent basis.

There is no doubt that the activities of competitors influenced decisions made by AIB. The Bank was not indifferent to downward pressure on its market share. This was especially true of products that were seen as core to the Bank's franchise such as mortgage lending and lending to the SME sector.

In the area of mortgage lending, for example, in order to protect market share, AIB felt compelled to relax its underwriting standards (most obviously in respect of LTV ratios) over time, in response to aggressive competition. I think at least some of these moves were made reluctantly. A similar response, motivated by similar considerations, occurred in other business areas including building and construction lending and would have resulted in the Bank taking on more risk.

Q9

The reason there is limited evidence of comments from the Directors in Board minutes is that the convention around minute-taking was that their purpose was to record decisions and the rationale behind those decisions, not to provide a detailed account of discussion/debate.

As stated in answer to Question 17, my recollection of the style of engagement between Board and Management is that it was collegiate and respectful. I guess I would have taken my cue from that. If I was sceptical or unconvinced by a management proposal I was much more likely to adopt a questioning stance than a position of outright opposition.

At this remove I don't have many specific memories of personally challenging proposals during Board meetings. However, I do remember consistently questioning the relaxation of mortgage underwriting standards throughout my term, and especially the measures approved in April 2007 which included the removal of the pre-existing 92% LTV cap thereby clearing the way for 100% mortgages.

Q10

Yes, there were several occasions during my tenure when the Board and/or the Group Executive Committee commissioned external advice on strategy. I have a record of three occasions (there may have been more) on which reputable international banking consultants made presentations to the Board and/or a senior management conference:

- Charles Roxburgh of McKinsey & Co presented on the topic 'Winning in European Banking' in April 2004
- Mercer Oliver Wyman presented under the heading 'Poised on the edge of greatness' in March 2007
- Charles Roxburgh again presented, this time under the heading 'Capturing the Opportunity', in May 2007

I have no reason to doubt that in each case what the consultants had to say provoked thought and discussion and was given due consideration.

Q11

The rationale for targeting a strong pace of earnings growth has been outlined above in answer to Question 8. Perhaps it is worth adding to what I've said there that the basis for seeking double-digit eps growth included the explicit ambition to be amongst the top quartile of European banks in terms of performance.

The 15% growth in eps referred to in the question did not endure as a target. It was the target that guided strategy in the early 2000s. In January 2005, the target adopted for 2005-10 was set at a more modest 12% (on an annual average basis) and by October of that year this target was revised down to 10%.

Frankly, I don't recall if I viewed this as overly ambitious at the time but, looking back on it, and in the context of what was actually achieved by AIB, by the other Irish banks and indeed by a large number of European banks, I doubt that I regarded it as especially remarkable. Taking the 2005-07 period, AIB actually grew its eps at an annual average rate well ahead of target (over 17%). The corresponding eps growth rates achieved by Bank of Ireland and Anglo were 15% and 32% respectively.

Looking across the broader European spectrum a great many banks (including those operating in more mature markets than Ireland) comfortably achieved double-digit eps growth over this period and many recorded growth faster than AIB. Taking European banks as an aggregate, eps growth of 24.4% was achieved in 2005, followed by 17.2% in 2006, albeit this slowed to a standstill in 2007 (average for the three years: 13.4%). So, achieving a performance consistent with a top quartile ranking amongst European banks required eps growth well into double digits.

It can be argued therefore that the targets *per se* were not overly ambitious – they were greatly outstripped. It can also be argued that it was not the targets *per se* that produced the concentration on property lending that eventuated – a significantly slower pace of growth in property lending would have been consistent with 10% eps growth between 2005 and 2007..

Q12

At this remove, I cannot recall with clarity what was on my mind when I proposed a review of lending to the Building and Construction sector in January 2004. However, I think I can say with reasonable certainty that I was not especially motivated by concern about the bank's policy or practices at the time nor by anxiety about the current state of the property market. Rather I suspect that I was signalling an interest in the area and a desire to know more about it.

Two other points occur to me. First, lending to building and construction had not been a separate agenda item since I joined the Board in January 2002, whereas mortgage lending had been on the agenda on a couple of occasions over that period. So, I may have felt it was timely to conduct a review of the former. Second, a review of mortgage lending was presented at the January 2004 meeting; this may have been the trigger for my proposal.

Q13

Three major manifestations of control failures in the AIB Group came to light during my term on the Board. The first, the Rusnak fraud, reported in February 2002, concerned large-scale fraudulent trading by a foreign exchange dealer at Allfirst Bank, AIB's then US subsidiary. The second, the Faldor affair, which came to light in 2003, concerned irregular practices at AIBIM, the Banks' investment management arm. The third, the so-called 'Forex overcharging scandal' which surfaced in 2004, concerned the fact that AIB was charging a margin on certain foreign exchange transactions that was higher than the margin communicated to the regulator.

I don't recall having a strong view at the time as to the cause(s) of these events or on the question of whether internal culture was a common factor. What I do recall is that each event prompted a thorough externally-validated investigation and a wide-ranging programme of remedial actions some of which were designed to address Board concerns about the corporate culture.

Reflecting these concerns, Dr Peter Scott-Morgan, a renowned international expert on the subject, was engaged to carry out an analysis of the culture at AIB in 2004. One issue that emerged related to the reluctance of staff members to speak out when they thought that something was wrong. A determined attempt to deal with this cultural weakness was made and took the form of (i) a 'Speak Up' campaign and (ii) the creation of a confidential channel through which staff members could raise issues of concern.

Yes, ethics and values were defined. A code of business ethics for all employees was launched in early 2004. A code of leadership behaviours for senior executives launched later that year. These were written codes. Their operation was reviewed annually by the Audit Committee.

At this remove I'm afraid I cannot remember much about the code of leadership behaviours beyond the fact that it existed so I can't definitively testify that the behaviours were practiced by senior management. Nor can I comment on whether and how the code of ethics was formally included in the personal objectives set for individual members of management or staff.

What I can say though is that I never witnessed or heard about unethical behaviour on the part of any member of the senior management team or the Board during my tenure.

Q14

Absolutely. This was an area to which the Board accorded high priority and devoted a great deal of time. Looking back at Board minutes for just two years of my tenure (2004 and 2005) items relating to risk management and internal controls and the closely related themes of regulation and compliance, heavily populated the agenda, accounting for almost 25% of all agenda items by my estimation (and almost certainly a much higher proportion of Audit Committee time).

There were two sets of reasons for this: (i) regulatory change generated the need for the Bank to embark on a number of major projects (notably in respect of Sarbanes-Oxley, Basel II and IFRS) each of which required close oversight by the Board, and (ii) internal control failures which manifested themselves in the three high profile debacles already referred to (Rusnak, Faldor, Forex overcharging) and prompted wide-ranging remedial actions in respect of risk management and control and compliance.

Q15

If what is being asked here essentially is whether the governance of risk would have been improved by the existence of a separate Board risk committee, then I think the answer, certainly with the benefit of hindsight, is yes. The committee of the Board that actually dealt with risk, as well as a multiplicity of issues pertaining to the financial statements and controls, ethics and compliance, regulation and so on, was the Audit Committee. Its agenda became increasingly crowded during my term and increasingly populated by risk-related items.

That said, the fact that there wasn't a separate Board committee during the 2002-2008 period did not constitute a departure from what were considered good corporate governance standards at the time. I believe that it was common practice across banks for audit committees to handle risk; the existence of separate risk committees was nowhere near as widespread as it has since become.

Q16

There were improvements and enhancements made to the MIS reports and data provided to the Board during my term which implies that gaps were being filled and deficiencies addressed. However I don't recall being conscious at any stage during my term (which ended in early 2008), that the MIS reports and data made available to the Board were deficient in a systematic or persistent way. I realise now, of course, with the benefit of hindsight and the analysis done by the likes of Promontory/Mazars, that there were serious deficiencies. Some of these – relating in particular to the monitoring and management of distressed loans - would have become apparent to the Board in real time, but only I believe in the period after I stepped down from the Board.

Q17

My recollection is that the atmosphere at Board was collegial and the style of engagement was polite, respectful and non-confrontational. I think the INEDs placed a high degree of trust in senior management. In fairness I should add that this wasn't a mere reflex. The INEDs were not a bunch of impressionable ingénues. Judged from the perspective of the time, the trust was earned through what was perceived to be an open informative style on the part of the top management team, their apparent command of their respective briefs and, not least, the impressive performance of the Group throughout the period in terms of profit growth, share price appreciation and so on.

Looking back on it now through the prism of crisis, it is easy to conclude (obvious almost) that in general the INEDs were too respectful of senior management, too willing to accept management explanations, and too trusting of management assurances (in particular those assurances that were provided in respect of the monitoring and management of risk).

Did the Board exercise a sufficiently robust level of challenge? This question begs another: sufficiently robust to achieve what? If the objective was to avert disaster, then plainly the answer is a resounding no. But this is an impracticable standard to apply in real time, and I'm not sure that I know how the adequacy of a board's challenge to its management team in real time can reasonably be measured.

Certainly during my period on the AIB Board, it was not the case that management proposals went through 'on the nod'. Typically there was discussion, there were questions, clarifications and elaborations were sought and given, implications were teased out and so on. Reflecting the prevailing style of engagement, this was all done in a harmonious rather than a fractious spirit. While it was rare for a management proposal to be rejected or materially amended but it was also rare for a business proposal not to attracit a reasonable amount of probing.

Q18

The conclusions of the Promontory/Mazars Report of January 2011 spring from an analysis conducted through the prism of crisis and with the benefit of hindsight. It is inevitable in such circumstances that what governance and organisational weaknesses existed at AIB pre-crisis will have been thrown into particularly sharp relief. Moreover, the standards of corporate governance and internal control sought in financial institutions were raised sharply on foot of the international banking crisis. The judgements made in the Promontory/Mazars Report would also have been coloured by this.

Even absent the banking crisis, strengthening corporate governance and internal controls at AIB would have remained a work in progress. The bank hadn't much in the way of a risk governance structure in the early 2000s. As already alluded to, substantial time and effort was expended on developing such a structure during the period I'm familiar with, and a large fraction of the Board's time was devoted to projects in the risk/control/compliance areas. When I left the Board I was probably aware that, for all the progress had been made up to that point, there was still some unfinished business.

However, the observation that 'there was considerable reluctance among senior management to give priority to robust governance and risk practices' in the 2005-08 period does not chime with my experience. I do not recall seeing/hearing evidence of such reluctance during my time on the Board.

One other thing is worth mentioning here. It is that the Promontory Group (co-authors of the 2011 report) were commissioned to conduct a review of risk governance at AIB in 2006 and presented their report at the June meeting. While the minutes of the meeting record a range of recommendations under headings such as Compliance Risk Management, Credit Risk, Internal Audit and so on, I do not recall that the tone of that report was especially critical. I understand that most of the Promontory recommendations were subsequently implemented.

Q19

Yes, I was concerned about the increasing concentration in the building and construction sectors but my concerns were assuaged, if not entirely eliminated, by a number of factors, including:

- the diversification of the Group's property exposure across property types (residential vs commercial; investment vs development) and geographies, and the argument that this diversification effectively spread risk.
- the results of a number of stress tests conducted over the 2005-07 period (especially those carried out using the sophisticated methodology that had been developed for Basel II), each of which suggested that the Group's capital position was robust even in the face of what seemed like a severe shock.
- The apparent indifference of the Regulator to the reported breach by the Bank of property concentration guidelines in 2006 and subsequently.

I think I would also have taken some comfort throughout this period from the fact that the property concentrations of Irish banks generally had not occasioned much in the way of warning from banking analysts or from international agencies that carried out surveillance in respect of financial stability (e.g. the IMF).

I cannot recall specific conversations I had about this issue with other Directors or with members of the senior management team. In any event, it is clear from minutes of meetings that the degree of property concentration became the focus of a good deal of Board attention from about the middle of 2006, starting with the May meeting when the increase in concentration was a point of discussion in the context of the Quarterly Credit Review. The breach of the guidelines was first reported to the Board at the July meeting. The concentration question was revisited at Board meetings in September and November of that year and in February and April of the following year.

This escalation of the Board's attention to the property concentration issue culminated in a paper ('Property Portfolio Management Framework'), presented to the Board at the April 2007 meeting, which reviewed the portfolio, quantified its risks (including the results of a stress test) and proposed an updated risk appetite framework.

Q20

a. I'm not sure what practices are comprehended by the phrase 'outside the stated lending policy' or 'outside the stated underwriting policy'. If the reference here is to exceptions to the Group Large Exposure Policy (GLEP), I was aware of their frequency and scale, at least after October 2006 when a change in reporting policy occurred. However, I was unaware of the existence of any other practices that might be described as outside stated lending or underwriting policy.

Regarding exceptions to the GLEP, the thresholds demarcating credit approval authority changed over time. I think the last iteration that occurred during my term was in October 2006 when three categories of exception were defined: (i) exposures of €250-500m where the approval authority was the Group Credit Committee; (ii) exposures of €500-750m which required approval of the Group CEO, and (iii) exposures of more than €750m which required prior approval of the Board. Incidentally, the thresholds here related to cumulative exposure to a borrower not the amount of a particular loan.

Exceptions requiring the prior approval of the Board were, in almost all cases and for reasons of efficiency, dealt with by meetings of a sub-committee called the Chairman's Committee, the minutes of which were circulated to the main Board. Following the October 2006 changes, all exceptions above €250m were reported to the Board by way of an addendum to the Group CEO's monthly report.

b. Logically, there were two related but separate dimensions of potential concern here. One was the sheer size of the exposures to individual borrowers, which I address in my answer to Question 24. The other had to do with governance, specifically the question of whether it was consistent with good governance that an increasing number of large exposures were coming to the Board for approval.

c./d./e. I'm not sure at this remove how concerned I was about this. I think I was probably uncomfortable with the situation and I think other non-executive directors may have been too. I have an indistinct memory of wondering aloud about how meaningful was a threshold that was crossed so frequently. I guess the reply was along the lines that we were talking about thresholds not limits, and their purpose was to provide an escalation mechanism rather than to restrict the amount of business being written.

Hindsight prompts an even more fundamental governance question here and it is this: should any exposures have come to the Board for approval? In addressing the issue of exceptions to GLEP at the October 2006 Board meeting, the Group Chief Risk Officer pointed out that it was unusual amongst peer banks for credits to require Board sanction. At that meeting he also indicated that a new GLEP was being prepared. There was a subsequent reference to a new or modified GLEP at the April 2007 meeting but the documents I've been able to consult in connection with preparing this Statement do not indicate that any further substantive change occurred between then and my departure from the Board.

Q21

As a non-executive director I did not have line of sight of the interaction between the commercial bankers and the credit committees so I cannot offer an informed opinion on the degree of independence demonstrated by the latter.

As to whether issues were passed up the line to the Board, I've already commented on the situation regarding the only exceptions to policy that I was aware of during my term, namely exceptions to GLEP. Credit risk evaluations would not have made it to Board, other than in respect of those large exposures for which Board approval was required in which cases it was the Chairman's Committee that would have seen the evaluations. The issue of risk register monitoring means little to me.

I simply cannot remember at this remove what the policy position was *vis-a-vis* the use of equity in other projects as a form of collateral or how exactly such assets might have been valued.

Q22/23

First of all, let's be clear: there was a number of stress tests carried out during my term on the Board so references to '<u>the</u> stress test' or '<u>the</u> actual stress test' are erroneous. To my knowledge the following stress tests were conducted in the 2005-07 period (there may also have been others subsequent to the last mentioned):

- A stress test that formed the centrepiece of a paper presented to the Board in May 2005 and entitled 'Irish House Price Scenario'. It provided estimates of the effects of a sharp house price correction (40%) on the Bank's P&L account. This stress test was carried out at my prompting. At the January meeting I had queried how robust the Strategic Plan for 2005-10 would be in the face of a sharp correction in the housing market.
- A stress test carried out at the request of IFSRA as part of an industry-wide exercise in February 2006, the results of which were shared with the Board at its May meeting.
- A stress test the results of which were presented to the Board at its May 2007 meeting. This test was carried out as part of the internal capital adequacy assessment (ICAAP) process under Basel II. I think this may have been one of a sequence of stress tests carried out under the auspices of Basel II around that time.

Internal Audit did not to my knowledge perform a review of any of these stress tests. At no stage would it have occurred to me that this was a sensible idea. The design and execution of stress tests is a very complex technical exercise. I doubt that Internal Audit would have had the skills to meaningfully review/assess any of the tests.

Nor did the Bank employ an independent expert to review the tests. This would not have struck me as an action that would have added value to the exercise. For one thing, the people in the organisation who were designing and carrying out the tests (in particular the tests that were part of the ICAAP process) were amongst the brightest and most technically proficient in the organisation. Moreover, the team in question drew on highly qualified quantitative modellers from across the Group, including Poland, and was augmented by a number of external consultants. Besides, the stress test methodology was a work in progress. If I recall correctly, the team responsible for it was refining and improving the methodology through 2007.

Another relevant point is that, with the exception of the first one listed above, the tests had to pass an external validation process. In the case of the test requested by IFSRA, it had to pass muster with the domestic regulator; in the case of the testing methodology developed under Basel II, my understanding is that it had to be approved by each of the regulators in the geographies where AIB Group was active.

As regards adequacy of information, I was fully informed about the results and their significance. I actually took a particular interest in the development of the Bank's stress-testing capability and would have arranged a number of out-of-course meetings with some of the key personnel involved partly to better understand the work they were doing and partly to show my support for it.

Q24

a. I don't recall any review of the adequacy of reporting to the Board of key credit risks *per se* but, during my term, there were several external reviews of overall risk governance in AIB Group, including the Deloitte & Touche report commissioned in the aftermath of the Allfirst fraud, a Promontory report presented to the Board in November 2004, and the Promontory report of 2006 already referred to in answering Question 18. I haven't had the time to check if any/all of these reports specifically opined on the adequacy of credit risk reporting to the Board, but I would expect that if the consultants identified what they considered to be deficiencies in this regard they would have flagged them.

b. By my recollection, concentration ratios in respect of sectors or customers were not routinely reported to the Board until mid-2006. At that point, the sectoral concentration issue started to attract significant attention, prompted in part by the discovery that the Bank was in breach of the relevant guidelines.

With the benefit of hindsight, it seems clear that the flow of concentration data to the Board was inadequate, particularly before mid-2006. A particular inadequacy, again with the benefit of hindsight, was that paucity of routinely provided data on the split within the overall building and construction loan book between the different components. That said, to the extent that the ultimate real time source of reassurance to the Board in relation to credit risk was the results of stress tests, it is not obvious that the provision of a greater or more timely flow of concentration data would have substantially altered the Board's stance.

c. As stated in answer to Question 18, I had concerns about the increasing concentration of the loan portfolio in property and construction which were assuaged by stress test results, its degree of diversification and so on. I'm not sure that I was especially concerned about the property development subset of this portfolio, although in hindsight it's clear that I should have been.

Turning to concentration in a small number of customers, this was an area where as a non-executive director I was conscious of the need to strike a reasonable balance between exercising one's responsibility in the matter of oversight on the one hand and deferring to the expertise of experienced credit professionals on the other. What concerns I had about the size of individual exposures were offset by my confidence that the corresponding loan approvals had gone through a rigorous assessment process.

d. With the benefit of hindsight, it seems clear that the risks associated with the high degree of concentration in property development and on a small number of customers were neither adequately reported to nor discussed by the Board. A deficiency that is especially apparent at this remove is the absence of a clearly defined risk appetite which would have set hard limits for sectors and individuals.

Q25

I'm afraid I'm not in a position to offer the Inquiry much help in relation to the problems NAMA has reported with loan security.

My understanding of the genesis of such problems is that long delays in the Land Registry caused by the sheer volume of transactions meant that banks had to rely on solicitors' undertakings to achieve the perfection of security in property-related loan transactions. Amongst the risks that this situation gave rise to was exposure to rogue solicitors.

Towards the end of my term as a director I would have become aware that there were issues here. I note a reference to reliance on solicitors' undertakings in the Audit Committee minutes of May 2007 and the subsequent presentation of a paper on the same topic at the November meeting. That paper set out the terms of reference for a fundamental review of the process of security registration and reliance on letters of undertaking. The records I have consulted do not indicate that the review had been completed before I left the Board.

Q26

a. Remuneration for senior management typically comprised three main elements: (i) a basic salary; (ii) a cash bonus and (iii) what came to be known as 'performance shares'. The cash bonus was determined by Divisional profit outcomes relative to target. The performance share element was determined by a formula that included earnings per share growth for the Group over a three-year period relative to the Consumer Price Index, and Total Shareholder Return relative to a widely-defined peer group of European banks.

So, insofar as remuneration was target-driven, the targets were denominated in terms of profit, not sales volumes or market share.

b. I don't remember an explicit weighting being given to risk modifiers. However, one could argue that the performance share element of remuneration was designed to act as a risk modifier to a degree. This element crystallised only if eps targets were achieved over a three-year period and its purpose was to encourage management to think beyond the short-term consequences of their decisions and thereby to introduce some element of sustainability, albeit over a not very long horizon, into the incentive structure.

c. There were non-cash components in senior management remuneration packages, including company cars and health insurance cover. However, these were not performance related and to that extent cannot be classified as incentives.

d. Not explicitly. In any event, non-performing loans were not an issue during my period on the Board.

e. Not to my knowledge but I have no doubt that anyone who consistently generated bad loans during the benign credit cycle that characterised my period on the Board would have been re-assigned/removed/demoted.

f./g./h. These questions relate to decisions taken after my term as director.

Q27

A review of risk governance at the Bank was carried out by Promontory Financial Group in 2006 and the ensuing report was presented to the Board in June. I guess that given its scope, this review would have at least implicitly addressed the issue of risk culture. I don’t recall if it explicitly addressed risk appetite. In any event, it contained recommendations spanning a range of topics including compliance risk management, operational risk, credit risk, internal audit and internal risk reviews.

Management’s response to the Promontory Review was set out in a paper presented to the Board the following October. Most of the Promontory recommendations had been accepted by Management and a programme of implementation had been put in place.

Much of the work of Internal Audit related to risk in its various guises and implicit in at least some of it would have been considerations pertaining to risk culture. I don’t recall that Internal Audit carried out any explicit review of risk appetite during my term and the documents I’ve had an opportunity to consult do not provide any record of such.

Q28

The adoption of IAS 39 was discussed at the Board. There was an initial presentation on the implications of the new financial reporting standards for the Bank in March 2005. I think there may have been a more detailed presentation at the Board seminar in May of that year. My recollection is that it cropped up as a topic of on several occasions thereafter. It was also discussed on a number of occasions at Audit Committee.

I think the Board had a good understanding of the implications that its adoption would have for the Bank's financial statements. Even for a non-accounting specialist, the consequences for the measurement of bad debt provisions were not difficult to grasp, at least in terms of their general thrust. Besides there were several experienced chartered accountants on the Board throughout the relevant period. Perhaps it was for this reason that the Board never thought to seek the assistance of an external accounting specialist.

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Yes, I think Board members had concerns about the implications of IAS 39 and, if memory serves, these concerns were expressed more than once at Board and Audit Committee meetings and were shared by management. I cannot recall hearing if these concerns were raised with the Regulator/Central Bank, but I seem to remember that the banking industry at European level unsuccessfully contested the EU decision to adopt the new IFRS of which IAS 39 was an element.

A better designed accounting standard would have allowed for higher provisioning than was permitted by IAS 39 during the benign years of the credit cycle, especially 2005 through 2007. That was my opinion then; that is my opinion now. However, it is important not to overstate the importance of this. In the years 2005 through 2007 the actual provision charge to the AIB Group P&L account averaged 0.12% (of total loans). The Bank's own estimate at the time of the average expected provisions charge across the credit cycle was 0.35%. The difference amounts to about €240m in absolute terms, a small if non-trivial proportion of average profits during the period.

The debate about IAS 39 concerns the use of actual (incurred) losses rather than expected losses as the basis of estimating the provisions charge. As stated above, the Bank's estimate of expected losses across the cycle was 0.35%, which according to Nick Treble in his 2009 paper 'Why has the Credit Crisis hit AIB so Hard?' implied a charge of 0.66% on average for the years 2008-2010. In the event, the average provisions charge for the 2008-2010 period was 4.7%, 7 times greater! In other words, it was unexpected loan losses not expected losses that brought the Bank down.

Q29

I was not a member of the Board on the night of the Guarantee and wouldn't have had access to the data required to make such a judgement at that point. However, I can state clearly and unambiguously that I had no doubts about the solvency of AIB Group when I stepped down from the Board at the 2008 AGM in April.

Q30

I have no recollection of the use of interest roll-up becoming an issue during my term and have not managed to unearth any references to it in the minutes of Board or Audit Committee meetings during late 2007/early 2008.

Q31-33

These questions relate to events that occurred and decisions that were made after I left the AIB Board.

Jim O'Leary
July 2015