Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

John O'Donovan

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

QUESTIONS AND ANSWERS OF JOHN O'DONOVAN

I was Group Chief Financial Officer in Bank of Ireland for the period 19 November 2001 to 3 December 2011. I have set out my answers below to each of the 29 questions raised by the Joint Committee in turn.

QUESTION 1

B1c Quality of business model setting process

Culture

Prior to and within the period of time examined by the Banking inquiry there were a number of prominent episodes suggesting problems with the internal culture of individual credit institutions in Ireland (DIRT, rogue trader, Forex and other issues). Please discuss your own views on why such events happened and whether the internal culture of the institutions played a role?

Can you comment on the culture in your organisation during this time:

- **were ethics and values defined?**
- **were written policies in place?**
- **where they were in place were these polices practiced by the MD, Directors and senior management?**
- **were they included in personal objectives for all personnel to adhere to?**

The issues referred to in this question were either before my employment commenced with Bank of Ireland (19th November 2001) or did not apply to Bank of Ireland as an institution. Hence I do not have an informed personal view, as to why such events occurred and whether the internal culture of financial institutions played a role.

The Bank of Ireland Group Code of Conduct (which applies to all employees and directors of the Group) is the standard that Bank of Ireland sets for its employees in their relationships with customers, suppliers, fellow employees, shareholders, Government and regulators. The Code of Conduct sets out standards of behaviour and gives guidance on how these standards should apply to Group activities.

In addition, Bank of Ireland Group's Leadership Model defined leadership competencies and associated behaviours expected of senior executives in their interaction with each other and all other stakeholders.

Leadership excellence was acknowledged as a key pillar of Bank of Ireland Group's business strategy with Leadership Behaviours seen as providing an opportunity for Bank of Ireland to differentiate itself and best serve its stakeholders.

Values and Code of Conduct were seen as major strategic drivers and were regularly discussed and reviewed by the Court of Directors.

The overall focus of the *"leadership behaviours goal"* within the Performance Management Process was to exemplify leadership behaviours and ensure that leadership behaviours were understood, accepted and enacted by key leaders within one's team.

Leadership Behaviour performance ratings did impact overall performance ratings, exercising a moderating impact on overall performance ratings.

<u>QUESTIONS 2 AND 3</u>

B1e Appropriateness, management and control of Client Relationship activities

<u>Corporate Entertainment</u>

Given that your bank was actively involved in the sponsorship of major sporting events, please detail:

(a) Any instances that you are aware of where your bank entertained property developers or bank customers who had large loan exposures (i.e. greater than €10m)?

(b) Any instances that staff in your bank were entertained by property developers or bank customers (who had large loan exposures)?

(c) What do you feel is an appropriate allowable entertainment value receivable by staff before it must be declared

Are you satisfied that your Bank's Corporate Hospitality / Entertainment / Marketing expenditure relating to clients, contacts in the property sector and/or organisations, to include politicians, was appropriate and in line with your Group policies on gifts, sponsorship, invitations and inducements?

In general relating to these Questions 2 and 3, I refer to correspondence dated 02 March 2015 to Mr. Ciaran Lynch TD from Ms. Helen Nolan (Group Secretary, Bank of Ireland).

In particular:

Q2 (a) I have no knowledge of any customer entertainment provided by the Bank to property developers or bank customers with large loan exposures.

Q2 (b) I have no knowledge of any Bank staff being entertained by property developers or bank customers who had large loan exposures.

Q2 (c) The Group Code of Conduct (2.3(e)), inter alia, gives guidance in the area of monetary value of Gifts / Sponsorships / Invitations.

I concur with the general rule namely – "meals, refreshments, entertainment, accommodation or travel of reasonable value, should only be accepted on the basis that the expense would be deemed to be an appropriate business expense if it were charged to the Group".

In addition to the above, I concur with the general tenor of 2.3(e) in the Code of Conduct.

Q3, I again refer to Ms. Nolan's letter to Mr. Ciaran Lynch TD dated 02 March 2015. It never came to my attention, during my 10 years as CFO of Bank of Ireland, that any inappropriate expenditure took place in the Banks Corporate Hospitality/ Entertainment/Marketing areas.

QUESTIONS 4 AND 7

B3a Appropriateness of funding sources, mix, maturity profile and cost

Loans to Deposits Ratio (LDR)

Loan/Deposit Ratio (LDR) is now targeting 120% - 100% and lower. Why was this not a target during the 2004-2008 period when it reached highs of over 170% across a number of the Irish Banks? Do you think the level of LDR in your institution was appropriate?

Wholesale Funding

Was the level of Wholesale funding in your Institution a concern for you and did you feel the possible risks attached to such funding were clearly understood at both Senior Management and Director level?

Traditionally, retail depositors provided significant funding for banks. Due to the changing preferences of retail depositors towards equity products and other alternative saving products, together with significant growth in financial institutions' balance sheet funding requirements, there was a significant shift, in the early/mid noughties, industry wide, in the funding mix of banks towards wholesale funding.

In Bank of Ireland, in March 2008, the Group Balance Sheet of circa €185 billion was funded through 41% debt sourced from the wholesale markets, 47% from customer deposits with the balance provided by capital and other liabilities. Consequently, the Bank had a Loan to Deposit Ratio of 158%. This compares to a Group Balance Sheet of circa €74 billion in March 2001, of which 23% came from wholesale funding and 62% from customer deposits, with a Loan to Deposit ratio of 112%.

As BoI expanded its loan book outside its Irish retail franchise heavier reliance was placed on wholesale funding.

Very significant growth in its UK Mortgage books together with growth in areas like shipping finance, media and film finance and investment grade lending led to greater reliance on wholesale funding as these loan books did not generate any supporting deposits.

As the level of wholesale funding increased from €16.7bn (March 2001) to €75bn (March 2008) the Bank diversified its sources of wholesale funding by geography and product line whilst also extending the maturity profile of its funding.

The extension of the maturity profile of wholesale funding was seen by the Bank as being a significant risk mitigant to refinancing risk. At March 2008, 33% of the Bank's wholesale funding had a remaining maturity greater than 1 year. In addition at March 2008, 84% of customer loans were funded by a combination of customer deposits and term wholesale funding (funding with remaining maturity greater than 1 year).

In addition to rapid loan growth, several internal factors, relating to deposits, served to increase BoI's dependence on wholesale funding – the sale of Bristol & West deposits in 2006 as part of the disposal of the Bristol & West branch network and some of BoI's international deposits proved less "sticky" (i.e. of more uncertain duration) than deposits garnered from BoI's core customer franchises. BoI had a structural funding imbalance in its UK banking books, i.e. UK loans significantly exceeded UK deposits. This funding gap, in the UK, was met with funds raised from international financial markets. The closure of these markets, led to severe stress in BoI's liquidity position albeit that the UK mortgage book provided a valuable source of contingent collateral during the crisis.

In hindsight, the initiatives undertaken by the Bank to diversify its wholesale funding programs and extend the maturity profile did not happen early enough and in sufficient quantum to cope with the challenges brought about by the prolonged, systemic closure of wholesale markets which occurred as a result of events in the summer and early autumn of 2008.

Again in hindsight, a more conservative LDR would have been appropriate and more focus on the strategic liquidity value of customer deposits should have been in place.

The quantum and composition of Bank of Ireland's wholesale funding of its Balance Sheet was clearly shared with and I believe understood by, both the Bank's senior management and the Board together with debt and equity markets/investors. However, in hindsight, the funding position was not sustainable in an environment where funding markets worldwide froze over for an extended period of time.

<u>QUESTION 5</u>

B3b Analysis of liquidity risks under adverse scenarios

<u>Liquidity</u>

In evidence to this committee a number of witnesses have stated that the Guarantee was needed due to Liquidity issues faced by a number of institutions. What is your view on this and what stress testing had been put in place at your institution to ensure such an event would not happen?

See my answer to Q20(c) in which I detail my understanding of the liquidity issues face by Anglo Irish Bank, IL&P and INBS in late September 2008 and the choices facing the Government on the night of the 29th September 2008.

Liquidity stress testing was introduced in Bank of Ireland in early 2007 as a management tool to identify the possible affect of adverse events on the Group's ability to fund itself, both financing of assets and/or meeting contractual obligations, on a timely basis and at a reasonable cost.

The Group stress tests were conducted quarterly and the results of same reported to Group ALCO, GRPC and to the Board. These stress tests included stress testing and scenario analysis to evaluate the impact of stresses on the Group's liquidity position. These stress tests incorporated Group specific risks and systemic risks and were run at three levels of severity. Tactical actions and strategies available to mitigate the stress scenarios were evaluated as to appropriateness and acted upon.

QUESTION 6

B3b Liquidity & Crisis Planning

What crisis plans did you have in place and what emphasis was placed on Liquidity?

The Bank of Ireland Group had a Contingency Liquidity Plan, which was approved by the Group Risk Policy Committee (GRPC), in both 2007 and 2008, to deal with liquidity events.

A summary of the Plan was included in the "High Level Policy Governing Liquidity and Funding" which was approved by the Court of Directors in 2007 and 2008. The Plan was comprehensive and dealt with necessary actions (and who was to implement those actions) at each stage of a liquidity crisis.

During the financial crisis which took hold in 2007/2008 the Group activated its Contingency Liquidity Plan and moved within the different stages as envisaged under the Plan.

QUESTION 7 – answered at question 4 above

QUESTION 8

B3c Interest rate risk appetite setting and monitoring

Interest Rate Risks Appetite

What was the Interest Rate Risk appetite of your institution, how was it managed and who monitored the resulting net position?

Interest rate risk arises from the structure of a financial institution's balance sheet, it's business mix and discretionary risk taking.

Bank of Ireland Group has always had a low appetite for interest rate risk. Interest rate risk was managed as part of the Group's approach to market risk management in general, in that limits were set by the Board and Group ALCO approved and monitored the utilisation of these limits by Bank of

Ireland Global Markets (BOIGM). Interest rate risk was centralised in BOIGM and BOIGM was the sole business unit, within the Group, permitted to take discretionary interest rate risk.

The Group employed a Value at Risk (VaR) approach to measure and set limits on discretionary interest rate risk. This applied to interest rate risk taken due to naturally arising risk that was left unhedged or risk that was pro-actively assumed. These VaR positions were very closely monitored by senior Group management on a daily basis and reported to Group ALCO, GRPC and the Board on a regular basis.

QUESTION 9

B3c Interest Rate Risks Appetite

The Banking Inquiry has heard evidence and obtained documentation examining the risks that products such as tracker mortgages posed for the credit institutions. Did the senior management and the directors of the bank fully understand these risks and levels of exposure?

In my view, senior management technically understood the fundamental risk of having to cover higher funding costs for "tracker mortgages" but did not expect such higher funding costs to arise.

Historically, over a long period of time, there was a direct link between interest rates set by Monetary Authorities and a financial institution's cost of funds. Trackers, as a product, relied on the assumption that this direct relationship between "Monetary Authorities set interest rates" and a bank's blended cost of funds (wholesale and retail) would remain stable. This historic relationship broke down, when wholesale money markets froze over during the financial crisis and when banks competed aggressively on price both to retain and seek out new deposits.

The Bank of Ireland Group's position in Tracker Mortgages was not reported, as a market risk position to either senior management or the Board until the crisis broke and higher funding costs arose in a falling interest rate environment.

QUESTION 10

B3d Appropriateness of investment of liquid assets in government and/or other securities

Liquid Assets

Was appropriate analysis carried out of the risk attaching to non-Irish government bonds, such as other European peripheral countries, which subsequently were not as liquid as originally envisaged and lead to mark-to- market problems?

Bank of Ireland had € 1.4 billion in government bonds in its Liquid Asset Portfolio of €25 billion at the 30 September 2008.

Of this €1.4 billion, greater than 97% were AAA rated, with no impairment and a cumulative Mark to Market negative impact of €4 million through reserves. Fair value expressed, as a % of Underlying Nominal was 102.7%

GRPC approved bank and country credit limit policy, in respect of the Bank's Liquid Asset Portfolio (LAP), which was managed by BOI Global Markets (BOIGM).

The strategy for the asset allocation of the LAP was to actively manage the composition of the portfolio using the key criteria of liquidity, risk, return and capital impact. Within this asset allocation strategy, Sovereigns (Cash and Bonds) were targeted to comprise 5-15% of the LAP.

Whilst sovereign bonds were generally seen as lower risk, two further considerations were taken into account:

- Cost - the incremental cost of holding sovereign debt, due to its lower risk, was significant;
- Capital Volatility - this arises as the majority of sovereign bonds were fixed rate, and adverse Mark to Market (MTM) movements were a direct deduction from Tier 1 Capital.

In April 2007 Group ALCO advised BOIGM to reduce the Bank's holdings of sovereign bonds due to the negative capital implications, if there was a negative MTM position. Sovereign bond holdings were reduced from c€ 6 billion in April 2007 to € 1.4 billion in September 2008, of which zero was in European peripheral countries bonds.

At September 2008, sovereign debt amounted to 5.6% of the total LAP compared to an Asset Allocation Guideline for sovereign debt of 5-15%. As a result, Bank of Ireland suffered minimal negative MTM's on its total non-Irish sovereign bond holdings during the financial crisis.

QUESTION 11

B3e Capital structure / loss absorption capacity

Capital Structure

Banks appear to have set capital target levels higher than the regulatory limits. What was your view on this?

Was there a markets related expectation to exceed the regulatory levels?

Banks generally set and run with capital target levels higher than the set regulatory minima. In addition to the attention paid to bank capital by Regulators, two other key audiences have an interest/influence on bank capital levels. These are rating agencies and equity/debt market participants. Banks also operate with capital levels in excess of regulatory minima to allow for earnings volatility.

Rating agencies (Standard and Poors, Moodys, Fitch) rate the credit worthiness of banks and as part of this appraisal process both the quantum and classification (i.e. Equity, Tier 1 Capital Instruments, Tier 2 Capital Instruments etc.) of capital is relevant. Rating agencies determine a bank's credit rating which ultimately determines the cost and availability of capital (and indeed funding). Debt investors (both Senior and Junior) pay reference to a Bank's credit rating when considering investing in a bank's financial instruments. The higher the rating the more likely that investors will invest.

In a similar vein equity investors pay reference to a bank's capital position when considering investing therein - equity investors like to see "adequate" capital in a bank to absorb losses from normal and/or unseen irregular events and to withstand volatility in earnings. Hence banks with higher capital ratios will be of more interest to investors/prospective investors, all other things being equal.

QUESTION 12

B6a Effectiveness of internal audit oversight and communication of issues related to governance, property-related lending strategies and risks and funding and liquidity risks

Effectiveness of Internal Audit

(a) Please detail the criteria used in order to measure the effectiveness of your Key Performance Indicators (KPIs) or annual targets, upon which your annual salary and/or bonus was determined?

(b) Was there any risk or area which Internal Audit felt should have been reviewed but was not included in the Internal Audit annual plan?

(c) During the period 2004 to 2008 (inclusive), did Internal Audit have staff with sufficient skills and experience to enable them to perform reviews on all risks relating to commercial lending (both customer and sectorial concentration levels) and funding risks?

(d) Were these risks reviewed by Internal Audit and if not why not?

Q12 (a)

As CFO of Bank of Ireland, I was a member of the Group Executive and as such, along with other Group Executive colleagues, my salary, variable compensation and terms and conditions were decided by the Group CEO and approved by the Remuneration Committee of the Court of Directors, which was comprised entirely of Non-Executive Directors.

The key measurements used by the Bank to assess my performance (say in years ending March '06, March '07, March '08) included:-

(a) Financial Targets

The financial performance of the Group i.e. Profit and/or Earnings per Share, cost performance and/or cost savings in the Group. The Bank had undertaken a number of strategic cost saving initiatives which were critical for delivery of sustainable profit growth into the future.

(b) Personal Goals

These personal goals included key deliverables within the finance area e.g. creating a finance shared services capability within the Group, delivering on the transition by the Group from Irish GAAP to IFRS, achieving Sox 404 compliance for the Group's 20F US Filing.

(c) Employee Engagement/Leadership Standards

Particular emphasis was placed on performance in this area. The Group saw employee engagement (EE) and leadership standards (LS) as being particularly important in developing and delivering on an inclusive and compliant culture within one's area of responsibility. Both EE and LS were measured and a poor performance in either had a significant impact (irrespective of one's performance in other areas) on one's personal performance rating with consequent impact on variable pay.

(d) Risk Factors

Management of risk in one's area of responsibility was also an important factor in performance management e.g. in Group Finance, areas of risk management included achieving satisfactory outcomes from Internal Audits carried out in the area and satisfactory outcome(s) from the Annual Statutory External Audit; ensuring accounting standards were met and exceeded and minimising operational risk in the finance area.

In my view the above model utilised by the Bank strongly influenced Senior Management behaviour (and indeed management behaviour generally) and was the major tool used to influence behaviours. Employees strove to do things properly, to be compliant, to manage operational and other risks and not to "drop the ball".

Q12 (b)

Group Internal Audit (GIA) carried out a detailed risk assessment each year across all areas of the Bank of Ireland Group. Based on the results of this risk assessment, which was shared with the Group Audit Committee (GAC), a detailed Annual Audit Plan (AAP) was prepared and presented to the GAC, who approved same.

GIA's risk based planning process and the independent approval of the AAP by the GAC were identified as key controls for the purposes of Sarbanes-Oxley Section 404. The AAP was reassessed during the year, based again on risk analysis and emerging matters and any proposed changes to the AAP were presented to the GAC for approval.

In these circumstances, I do not believe that there was any risk or area that Internal Audit felt should have been reviewed but was not included in the AAP.

Q12 (c)

It was not the responsibility of GIA to perform reviews on all risks relating to commercial lending. The responsibility for this area lay with Group Credit Review (GCR), which in effect was an independent audit function within Group Credit.

In my view GCR had the required skills and personnel to deliver on its responsibilities.

GIA, in my view, had the requisite skills to perform audits/reviews on funding risk.

12(d)

GIA did not perform reviews/audits of risk relating to commercial lending - responsibility for this work lay with GCR who carried out regular reviews and reported its findings to the Group Risk Policy Committee (GRPC). GIA audited the work of GCR on an on-going basis focussing on control evaluation and compliance testing.

Referring to whether GIA reviewed the Group's funding risks, GIA reviewed various aspects of funding risks, these included, for example;

- Management of liquidity and funding (audits of Bank of Ireland Global Markets (BOIGM) Funding Desk/BOIGM Liquidity Desk/BOIGM USD, GBP and Global Money Market Desks);
- Intra group funding and reflection of cost of funding in product pricing;
- The accuracy of information supplied to Group ALCO on which funding decisions were based;
- The management of securitisation deals.

QUESTION 13

Effectiveness of Internal Audit

Were there material issues identified during an audit which were reported as outstanding at the end of the year and were not addressed the following year (i.e. were any issues carried forward as outstanding for a number of years)?

If yes, how frequently did this occur?

GIA reported its findings on IA assignments to management and to the GAC and categorised matters arising on a Red, Amber, Green basis. GIA also had an extensive tracking mechanism to monitor and report on outstanding issues, which were also reported to the GAC on a regular basis for review.

I am taking "Material issues identified" in this question to mean category Red under Bank of Ireland classification, namely any major issue not significantly mitigated or a significant issue overdue for solution delivery by more than 60 days.

At the end of March 2007, there were 29 "Red" issues outstanding of which 18 were outstanding since the previous fiscal year, whilst in March 2009, there were 9 "Red" issues outstanding, of which 6 were outstanding since the previous fiscal year. The vast majority of these items outstanding, since the previous fiscal year, required systems development to close the issues.

QUESTION 14

Effectiveness of Internal Audit

Did Group Internal Audit review the risks associated with customer concentration levels and short term funding to service long term lending?

Group Internal Audit (GIA) did not review loan advances concentration levels.

The risk associated with concentration levels across the Group's loan portfolio was reviewed by the Portfolio Review Committee, which reported to the Group Risk Policy Committee (GRPC).

The risk associated with customer concentration levels was reviewed by Group Credit Control who produced regular reports on this issue for review by GRPC.

It was not possible to match fund all assets on the Bank of Ireland Balance Sheet, principally because of the quantum of residential mortgage lending on its balance sheet (44% of Group Loans and Advances to Customers at September 2008) which by definition had a 20 to 30 year life. This structural imbalance (common to very many financial institutions) led to greater reliance on securitisation with consequent difficulties when money markets froze. This *"mismatch"* risk of short term funding to service long term lending, was monitored and reviewed by GRPC/ALCO and not by GIA.

QUESTION 15

B6b Effectiveness of oversight of prevailing risk culture

Risk Culture

Was a review of the risk culture and appetite of the Bank ever carried out by either external consultants or Internal Audit? If yes what was the outcome and any action taken afterwards?

While aspects of risk culture and appetite were reviewed by Group Internal Audit (GIA) in a range of audits, no single review focussed exclusively on these matters, prior to the financial crisis.

Comprehensive reviews were carried out by external consultants, Oliver Wyman - Review of Risk Governance (May 2009), Boston Consulting Group - Bank of Ireland Governance and Risk Management Review (November 2010) and Promontory Financial Group - Review of Bank of Ireland's Risk Governance (April 2012). None of these reviews are in the public domain but have, I understand, been provided to the Committee.

Oliver Wyman reviewed Bank of Ireland's risk governance and made recommendations for improvement and enhancement - this review of risk governance primarily considered the Bank's risk governance strengths and weaknesses in the run up to, and during, the financial crisis and economic downturn. A major program of work was undertaken by the Bank to address the very significant issues raised and recommendations made in the Oliver Wyman Report.

The Boston Consulting Group assignment, which was completed in November 2010, assessed the then current adequacy of BOI's corporate governance arrangements, the then current risk management arrangements in BOI and the management of credit risk in BOI, in the period January 2009 to June 2010. This BCG Review was in many respects an evaluation of the delivery by the Bank of the very extensive recommendations made in the OW Report of May 2009. The BCG Report concluded that many of the recommendations in the Oliver Wyman Report had been implemented or where in the process of implementation. The BCG Report made further recommendations to further improve corporate governance and risk management in BOI and these recommendations have been implemented by the Bank.

In addition, the Promontory Financial Group Report (April 2012) and a Group Internal Audit Report (February 2013) both identified the very significant progress that Bank of Ireland had made in its management, reporting and governance in relation to risk.

QUESTION 16

B7a Impact of prevailing accounting standards in recognising risks

IAS39

(a) Was the adoption of the IAS 39 standard discussed at Board meetings?

(b) Did the Board fully understand the implications that the adoption of this standard had on the financial statements of the Bank?

(c) Did the board seek an accounting specialist to advise on the implications of this standard and explain how this measurement of the Bad Debt Provision differs from the amounts calculated under the previous accounting methodology?

(d) If you, or any of the board members, had concerns with the adoption of IAS 39 were these concerns raised with the Regulator / Central Bank?

(e) Did you feel that the amount thereafter provided for the "Provision for Bad Debts" was adequate and in hindsight do you feel that the amount provided should have been different?

Q16 (a)

In July 2002, the European Union adopted a regulation compelling EU listed companies to prepare Group Financial Statements in conformity with IFRS (also known as International Accounting Standards (IAS)), for all financial years beginning on, or after, 01 January 2005. Bank of Ireland was therefore required to produce Financial Statements, compiled under IFRS, for the year commencing 01 April 2005. Whilst the EU adopted IFRS by regulation in July 2002, IAS 39 was finally adopted by the EU in October 2004.

Bank of Ireland, in 2003, carried out a diagnostic study of the implications of IFRS on its Financial Statements and set up a project team to prepare for the transition to IFRS. This was a large and extensive project staffed with Bank finance personnel, with significant support from PwC's Technical Department.

The Bank (including its Board and Senior Management) were extensively briefed to gain a thorough understanding of the detail of the transition to IFRS (including IAS 39) and its impact on the Group's financial statements.

The Group Audit Committee (GAC) (composed of Non-Executive Directors) monitored progress on the project and the GAC and the Court of Directors were briefed in detail on the *implications of IFRS/IAS 39 in December 2004. It should be noted that the Group's external* auditors, PwC, attended all Bank of Ireland GAC meetings, and the GAC members engaged with PwC personnel, as well as with the senior financial management of the Bank, when IAS 39 was discussed. The Court of Directors were also presented with detailed papers outlining the impact of IRFS/IAS 39. This oversight of the GAC / Court of Directors continued up to the introduction of IFRS/IAS 39 in the Group's Interim Financial Statements to 30 September 2005, and in the Group's Annual Report and Accounts to 31 March 2006.

In particular, the detail and impact of IAS 39 on loan loss provisioning, and moving to an incurred loss approach, was understood by the Court of Directors.

Q16 (b)

In my view the Court understood the implications of the adoption of IAS 39 on the Group's Financial Statements, in particular the pro cyclical nature of loan loss provisioning under the Standard and the move away from Irish GAAP and the ability to have "general provisioning", to an "incurred loss" model under IAS 39. The Court understood that it was not possible under IAS 39 to create general provisions for expected loan losses or to provide based on worst case outcomes or most importantly based on future events.

Q16 (c)

Bank of Ireland had significant accounting technical knowledge in its Group Finance staff. This expertise was supplemented by the Technical Department of PwC.

This combined expertise was made available, both to the GAC and the Court and both the GAC and the Court were clearly aware of the change in methodology as it related to the calculation of loan loss provisions.

Q16 (d)

Once the EU adopted IFRS and by extension IAS 39, Bank of Ireland had no choice, as a listed entity, but to apply the new standard. Bank of Ireland understood the pro cyclical nature of loan loss provisioning under IAS 39, was not entirely comfortable with its outcomes but there was nothing the Regulator/Central Bank or indeed the Court or management of Bank of Ireland could do to change what had been adopted by the EU.

Q16 (e)

I understood the pro cyclical nature of provisioning under IAS 39 and I and the market were clearly aware that loan losses in the low teens basis points (e.g. 11 BPS y/e 31 March 2006 : 9BPS y/e 31 March 2007 and 14BPS (excl SIVS) y/e 31 March 2008) were not representative of likely "through the cycle" loan losses.

Bank of Ireland always applied best practice in the preparation of its Financial Statements and under the applicable accounting rules it was provisioning appropriately. The amounts provided could not have been different as the loan losses reflected in the Financial Statements were reflective of the Accounting Standards which were in place (and indeed are still in place until 2018) and which were properly applied by the Bank.

<u>Question 17</u>

C2c Liquidity v Solvency Debate

<u>Liquidity and Solvency</u>

On the night of the Guarantee what was your view on the solvency of your institution?

In my view on the night of the Guarantee (29th September 2008) there was no solvency issue with Bank of Ireland, the Bank was solvent.

The issue was totally related to liquidity - wholesale money markets had frozen over and funding timelines had shortened significantly.

The issues relating to solvency/capital arose later as property assets values dropped significantly and economic performance across the world economies slowed significantly. In addition as the global financial crisis deepened in late 2008, regulatory authorities outside of Ireland (e.g. UK) raised capital target levels which resulted in BOI's capital ratios being below accepted market norms, thus requiring extra capital for the Bank in late 2008, early 2009. The capital position of the Bank was also impacted by the losses sustained on the transfer of assets to Nama by the Bank in 2010/2011.

Question 18

Restructured Facilities

Can you discuss how the facilities made available to large clients between 2006 and 2008 were restructured and, in particular, the use of interest roll-up as a feature? In your view, could potential insolvencies have been recognised at an earlier point in the cycle and could appropriate preventive actions have been taken at that time?

Interest roll up is a feature of landbank finance and also of development finance where an amount of interest roll up would be allowed for, at origination, as part of the costs of a development.

Interest roll up was not a feature of Investment Property lending, which at September 2008 comprised two thirds of the Group's total property and construction portfolio of c €38bn.

Of the Group's €5.4bn landbank exposure, in September 2008, under half was subject to interest roll up. The amount of interest roll up was incorporated when calculating *"Loan to Cost"* and *"Loan to Value"*.

While property values in Ireland began to fall in 2008, more significant value falls occurred in 2009 and continued into 2011. The level of value falls in 2008 was of itself insufficient to trigger insolvencies at any material level. It is important to distinguish between actual insolvencies and liquidity pressures. Property market liquidity slowed in 2008 and this led to cash flow issues for a number of the larger property players but did not necessarily lead to insolvency.

The Bank of Ireland Corporate Banking approach for dealing with maturing facilities that were not in a position to repay capital due to slower than anticipated sales included requiring the customer to fund interest where feasible, making a formal call under interest shortfall and/or capital guarantees (where relevant), investigating what other routes may be available as risk mitigation e.g. additional security. Where impairment was evident at that time it was recognised in the Group Financial Statements.

Insolvencies in an illiquid, non-functioning property market are not in the best interest of a lender and avoiding early insolvencies didn't impact the ultimate outcome of the cash recovered from property developers' loans. All appropriate actions were taken during the downturn to maximise returns from these property development loans.

Question 19

C3b Appropriateness of the bank Guarantee decision

Guarantee

(a) Were you aware of, or did you participate in, any correspondence between AIB and BOI in relation to the Government Guarantee Scheme?

(b) **If so, what was agreed or discussed by the two banks?**

(c) **Were you aware of or did you participate in any correspondence or meetings that your bank had with either the Central Bank or Department of Finance during the day and night of the bank Guarantee? If so please detail.**

Q19 (a)

I am neither aware of, nor participated in, any correspondence between Bank of Ireland and AIB in relation to the Government Guarantee Scheme (other than in respect of the cost of the Guarantee as referred to at the answer to question 21 below).

Q19 (b)

Not applicable - see answer to Q19 (a)

Q19 (c)

I am aware that (a) the Governor of the Bank of Ireland met John Hurley of the Central Bank on the afternoon of the 29th September 2008 to discuss the possibility of widening ECB collateral eligibility rules (b) Brian Goggin (and probably myself) met with the Central Bank on the morning of 29th September 2008 at which the possible takeover of IL&P by Bank of Ireland was discussed and (c) it was decided by Bank of Ireland (Richard Burrows & Brian Goggin) to approach AIB in late afternoon of the 29th September 2008 to establish whether AIB wished to make a joint approach to the Department of Finance and the Taoiseach's Office to seek a meeting later that night.

I did not participate in any meetings with the CB/DoF during the day or the night of the 29th September 2008 (other than my likely attendance with Brian Goggin at a meeting with the CB on the morning of the 29th September 2008).

I did not participate in any correspondence with the CB/DoF during the day or the night of the 29th September 2008.

QUESTION 20

Guarantee

(a) **In the period leading up to the night of 29th September 2008, was your bank in discussion with any other credit institution in relation to it's own liquidity or the liquidity of other credit institutions, the nationalisation of any credit institution or the proposed Guarantee and if so provide details?**

(b) **On the night of the Guarantee, please detail any knowledge you have of who remained at Head Office and in contact with your CEO between the hours of 9.30pm and 3am?**

(c) **In your opinion, was the Guarantee necessary for your bank and if not why not?**

(d) Did you feel that you were adequately informed about the above issue, did you have an opinion on this issue and were you listened to?

Q20 (a)

Bank of Ireland was not in discussions with any other credit institution, leading up to the 29th September 2008, in relation to its own liquidity or the liquidity of any other institution. Neither was Bank of Ireland, during this period, in discussion(s) with any other credit institution on the nationalisation of any credit institution. Neither was Bank of Ireland in discussions(s), during this period, on any proposed Guarantee.

The exceptions to the above were the meeting with INBS in early September 2008 as referred to below, (Q20(c)), and Bank of Ireland being made aware, in the early afternoon of the 29th September 2008, by Sean Fitzpatrick and David Drumm, that Anglo Irish Bank had a major liquidity issue looming on the morning of the 30th September 2008.

Q20 (b)

Those present in the Bank of Ireland Head Office in Baggot Street between 21.30 hrs and 03.00 hrs on the night of 29th September 2008 and who were in contact with Brian Goggin included myself, Denis Donovan (CEO Bank of Ireland Capital Markets Division) and Richie Boucher (CEO Bank of Ireland Retail Financial Services Ireland Division).

Q20 (c)

I believe this question should be considered in the context of a global financial crisis which was rapidly getting worse following the failure of Lehman's, AIG, Washington Mutual, amongst others and the rejection by the US Congress on the 29th September 2008 of TARP, thereby increasing the volatility and instability in the global financial system. In Ireland, we at Bank of Ireland were aware that the following entities were facing liquidity issues –

Anglo Irish Bank - we had been advised by Anglo executives, in the afternoon of the 29th September 2008, that Anglo was unable to roll over a significant liability maturing on the morning of 30th September 2008.

IL&P - we had been asked (in a scenario exercise) on the morning of 29th September 2008, in a meeting with the Central Bank whether Bank of Ireland would consider taking over IL&P.

INBS - Bank of Ireland and AIB were asked in early September 2008 (All Ireland Hurling weekend) to provide standby facilities to INBS. Meetings were held on the Sunday of that weekend in the offices of the CB/FR with some executives of INBS and it was clear to Bank of Ireland that the INBS liquidity position was serious. Bank of Ireland was asked by the Central Bank / Financial Regulator to assist INBS with their liquidity issues. Bank of Ireland declined on the basis of incomplete INBS information and the necessity for Bank of Ireland to maintain its available collateral for its' own liquidity needs.

In Bank of Ireland's own case we had over the previous months seen a significant decline in the availability of wholesale funding. In addition when wholesale funding was available it was on a secured basis and over a shorter term. Interbank lending had very much shortened in tenure and in some cases was overnight. We at Bank of Ireland felt that due to the imminent default issue faced by Anglo on the 30th September 2008 that urgent systemic action needed to be taken (hence our request for a meeting with the DOF and the political system on the 29th September 2008).

At 29th September 2008 Bank of Ireland had adequate funding/ECB eligible collateral to fund itself for a number of months, however if the systemic issue(s) outlined above were not dealt with, it was likely that our customer deposits (particularly international deposits) would be put under pressure.

I didn't have a considered view, on the night of the 29th September 2008, as to how the Irish banking system's systemic issues should be dealt with. It was clear that Anglo had very significant and imminent liquidity issues (we were asked that night of the 29th September 2008 to provide funding of €5 billion to Anglo - which we agreed to do on a short term basis by drawing down on available ECB facilities) and that a guarantee/nationalisation of Anglo was necessary. Nationalisation on the night of the 29th September 2008, in my view, was not feasible, due to market considerations and therefore, in my view the options were to guarantee its liabilities or to fund it until the following weekend and then take a more permanent decision.

In Government choosing the guarantee option on the 29th September 2008, Bank of Ireland, even though it didn't itself have imminent need of the guarantee, avoided any collateral damage associated with the solution of the "Anglo problem" and the guarantee provided liquidity and funding stability for all participants in the Guarantee Scheme.

Q20 (d)

I feel I was adequately informed/aware of the systemic issues facing Irish Banks/Building Societies on the night of the 29th September 2008. I had an opinion on the issue and I was listened to. The Government was in a very difficult/impossible position and decisive action had to be taken which it took.

QUESTION 21

Guarantee

In your view should Anglo and INBS have been Guaranteed or nationalised at the end of Sept 2008? Please describe any discussion of this issue between your financial institution and other financial institutions?

Did your institution seek to communicate its position on the Guarantee to the Government? Can you describe any such representations made by your institution to the Government?

Can you describe any discussions between your financial institution and others on the cost of the Guarantee? Can you give your own views on how the costs of the Guarantee were quantified?

Can you give your own views on the transfer of risk from the credit institutions to the sovereign entailed by the Guarantee? Were representations made by your institution to European parties on how to resolve the crisis? Can you describe such representations?

Q21

In my view, it is a moot point as to whether Anglo/INBS should have been nationalised or guaranteed on the night of 29th September 2008. My understanding is that the Government did not have the relevant legislation in place and even if it was in place, such action as nationalisation could not in my view be done mid-week due to market considerations. To my knowledge there were no discussions of this issue between Bank of Ireland and any other financial institution.

Other than what was said, at the late night meeting in Government Buildings on the 29th September 2008, I am not aware of Bank of Ireland seeking to communicate a position on the Guarantee to Government prior to it being announced.

I am not aware of any discussions with other financial institutions as to the cost of the guarantee other than the joint representation made by Bank of Ireland/Allied Irish Banks by letter to David Doyle, Department of Finance, dated 1 October 2008 which relates to the cost of the guarantee. I believe the cost of the guarantee (which was confidential and not shared with other financial institutions or indeed the financial markets at large) was particular to each participating institution and included the following considerations

(a) the credit rating of the particular institution

(b) the quantum of instruments guaranteed

(c) the imputed cost to the sovereign of providing the guarantee

To my knowledge no representations were made by Bank of Ireland to European parties on the resolution of the crisis.

Referring to the question on my views "on the transfer of risk from the credit institutions to the sovereign entailed by the Guarantee", I believe that risk contagion (crossover risks) between sovereigns and domestic financial institutions are difficult to avoid in a major crisis. Investors in a sovereign and in its financial institutions are often one and the same. A destabilisation of one has serious implications for the other and vice versa. To that extent, the transfer of risk brought about by the guarantee was giving concrete expression in the market's mind to an already pre-existing dependency.

<u>**QUESTION 22**</u>

R2b Nature and effectiveness of the operational implementation of the macro-economic and prudential policy

Financial Roundtable Discussions

The Financial Roundtable meetings were attended by senior management of you bank. Were you an attendee at any stage or were you informed of the roundtable discussions? Were discussions held with you or was any policy/strategy change considered as a response to these meetings?

Q22

I have no recollection of "Financial Roundtable" meetings.

To the best of my knowledge, I never attended any such meetings nor was I informed of any discussions that might have taken place at such meetings.

To the best of my knowledge, no discussions were held with me nor were any policy/strategy changes considered by me as a response to any such meetings.

QUESTION 23

Macro-Economics Inputs

Did you include macro-economic considerations in your credit strategy? Did you discuss Financial stability Reports or other macro-economic forecasts with the Banks economics unit or senior *management*?

Internal (to Bank of Ireland Group) economist views and other forecasts were taken into consideration when developing group strategy, including group credit strategy. These views and forecasts included medium term GDP, GNP, interest rates, foreign exchange rates, interest rates and unemployment. Shorter term, macro economic assumptions were also a fundamental part of the annual budget preparation process. Assumptions were complied based on the most recent forecasts from official sources such as CBI/DOF/IMF/ESRI/Reuters etc and views from the Bank of Ireland Economic Research Unit. The budget assumptions drawn from these economic forecasts influenced sectoral loan book growth and risk strategy in general.

Macro economic forecasts were regularly discussed with Bank of Ireland's Chief Economist and Davy Stockbroker's Chief Economist. Such forecasts were used in the preparation and review of group strategy by senior management and the Court of Bank of Ireland. The Bank's Chief Economist regularly presented to the Court. Financial Stability Reports formed some of the input into the Group Risk Policy Committee's (GRPC's) assessment of group risk.

QUESTION 24

Prudential Policy Implementation

In your opinion was the introduction of new liquidity requirements and reporting standards in 2007 a helpful measure to improve liquidity forecast and liquidity monitoring? If not, why not?

The Bank of Ireland Group responded to the Central Bank of Ireland in respect of the draft new liquidity requirements in January 2006, where the Group was supportive of the new requirements. The new requirements were beneficial as they introduced best international practice, in liquidity regulation, into the Irish Banking sector.

The Group implemented a range of measures in advance of the introduction of the new requirements including:

- Introduction of Liquidity Stress Testing;
- Updating of the Group's Contingency Liquidity Plan;
- Approval by the Court of Directors of the High Level Policy on Funding and Liquidity Risk;
- Introduced new liquidity metrics.

In summary the introduction of the new liquidity requirements and reporting standards in 2007 were a very helpful measure to improving liquidity forecasting and monitoring.

QUESTION 25

Prudential Policy Implementation

Please provide details of any discussions held with FR staff on the continuous relaxation of credit policies. Could you please describe the outcome of these discussions?

I have no recollection of any discussions(s) with Financial Regulator staff on the *"continuous relaxation of credit policies"*.

I recollect a discussion between the Bank of Ireland CEO and the Financial Regulator on the introduction into the market of 100% LTV Mortgages in 2005 in which the BOI CEO shared with the Regulator his discomfort with the introduction of this product.

QUESTION 26

R3b Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the Banking Institutions

Relationship with FR/CBI

Apart from the provision of reports to the Central Bank/Financial Regulator what other communication did you, or your reporting lines, have with staff at the Central Bank or Financial Regulator?

Prior to September 2008 I had relatively little contact with the Central Bank/Regulator. Some meetings were held in early/mid 2008 with myself and Brian Goggin present which discussed the general state of the financial services market and Bank of Ireland's liquidity position.

My most formal engagement with the Financial Regulator each year was a meeting the day before we issued our financial results (Interims and Finals) at which I shared with the Regulator the detail of the Results.

All regular reports which the Bank was required to provide to the Financial Regulator were prepared and submitted by Group Finance staff, who reported to me either directly or indirectly as CFO of the Bank and all queries were dealt with in the same manner.

QUESTION 27

Relationship with FR/CBI

(a) **Did the bank provide any "out of course" insight (i.e. informal) to the Financial Regulator on their credit risk and bond exposures during 2007 and 2008?**

(b) **If so how often would this have occurred?**

(c) **Who within the financial Regulator was your primary contact, for credit risk and bond exposures?**

Q27 (a)

To the best of my knowledge the Bank did not provide any "out of course" insights to the Financial Regulator on its credit risk and bond exposure during 2007 and 2008.

Q27 (b)

See answer to Q27 (a).

Q27 (c)

Neither I or Group Finance (for which I was responsible) had a primary contact within the Financial Regulator for credit risk and bond exposure.

QUESTION 28

Relationship with FR/CBI

How would you describe your relationship with the Central Bank/ Financial Regulator?

My relationship (as CFO of Bank of Ireland) with the Central Bank/Financial Regulator was professional and courteous. I understood that the Bank, as holder of a banking licence, had certain responsibilities and the bank always strove to deliver on those responsibilities in a thorough and professional manner.

<u>Question 29</u>

Relationship with FR/CBI

During reviews of your loan book, monitoring or governance structures, how would you describe the working relationship with the Banking Supervision teams of the CBI/FR? What was your view of the knowledge and expertise of the banking supervision teams?

The working relationship of Bank of Ireland with the Banking Supervision teams of the CBI/FR was professional and courteous.

In my view the banking supervision teams were knowledgeable but lacked expertise in some specialist areas.

The overriding issue was that the Banking Supervision teams were understaffed, too few being asked to do too much.

John O'Donovan