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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Michael Fingleton

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

Statement in writing by Michael Fingleton for the purposes of section 67(1)(d) of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013

I refer to the Direction dated 18th June 2015 requiring me to attend and make a statement in writing pursuant to Section 67 (1) of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013 as received by me on 24th March 2015 (the " Direction")

Biographical Information

I graduated from UCD in 1966 with a Bachelor of Commerce degree. I qualified in 1969 as a fellow of the Chartered Institutes of Secretaries, which was later renamed the Chartered Institute of Secretaries and Administrators. In December 1970, I qualified as a Certified Accountant. In 1975, I was called to the Bar at Kings Inns.

Prior to my 38 years at Irish Nationwide, I held positions in publishing, finance, the dairy industry and heavy engineering. I also spent some time in Nigeria in the late sixties with Concern.

Summary of my Involvement with INBS

I joined the Irish Industrial Building Society in 1971 in the position of Company Secretary, which effectively was the Chief Executive Officer. In 1971, the Society had one office in Camden Street and 5 staff. In my first full year in charge we made a profit of IR£ 20,000. In 1975, I became Managing Director of the Society. In the same year the Society changed its name to Irish Nationwide Building Society and appointed KPMG as auditors. The Society also acquired its first (flagship) Branch Office at 101 O'Connell Street, Dublin. By the end of the millennium Irish Nationwide had a network of 50 branches in Ireland, all but three of which were owned by the Society outright.

The Society also engaged in small-ticket commercial lending, including buy-to-let, farming loans, loans to shops and pubs, loans in respect of office units and residential units, as well as small development/construction lending. At least 10% of the Society's overall lending was in this area of the market.

The Building Societies Act 1989 gave Building Societies power to ***'hold and develop land, issue loans, invest in bodies corporate, carry out financial services, undertake auctioneering and conveyancing services and to operate abroad.'*** The Explanatory Memorandum issued with the Act encouraged building societies to get involved in residential development and provided specifically: "***that building societies should be a major source of funding for housing by investing directly in residential development".***

In the 1980's there was a relatively small number of houses being built and values were relatively stagnant for the decade. In the early 90's there was an anticipated increase in demand for houses but relatively little supply. In 1992 the Society acquired 70 acres of land in Lucan with planning for 650 houses for £1.4m. It then entered a joint venture with Ballymore Properties for the development of these lands, which was successfully and profitably completed. We continued to provide finance for such ventures right through the 90's and expanded into the UK London market with some of our own customers and later UK-based customers.

In 1994 the Society established a subsidiary bank in the Isle of Man to generate Sterling deposits for ongoing lending in the United Kingdom. The Society's philosophy was to prudently diversify its lending and to spread its risk. Again, until the global financial crisis, all these projects were completed successfully and profitably to the benefit of the Society and its Shareholders.

The Society gradually and incrementally developed its commercial lending in both the Irish and UK markets, funded by the continued expansion of our depositor base. In 2002/03, following the introduction of the Euro, the Society began to utilise the wholesale market for funding and expanded our lending programme in the UK and Ireland, and later in Continental Europe (principally France and Germany).

All other Irish financial institutions were already sourcing much of their funding from the wholesale markets. It is worth noting that even though the Society's credit rating was lower than most of its domestic competitors, because of the strength of the Society's balance sheet, we were able to raise funds at equivalent costs to our more highly-rated peers.

The EU FSAP (Financial Services Action Plan) provided for and encouraged the utilisation by banks of the EU wholesale market. This was considered to be positive in terms of cost of funds and lending. It was also commented on as a positive development by the IMF in its 2006 FSAP report.

Demutualisation

In 1996, following a full review of the Society's competitive position in the market place, the Board of the Society came to the conclusion that the Society did not have the "critical mass" necessary to go the plc route as envisaged by the 1989 Act. This was supported by the views in a number of broker reports commenting on the future of building societies. The banks had by then almost 50% of the home loan market. The choice was whether to merge with another building society or seek a change in legislation to affect a trade sale of the Society to realise value for its members. It was the unanimous view of the Board that the latter would be the best step to take to realise value for the Society's members.

In 1996, the Society sought an amendment to the Central Bank Act 1996 to facilitate trade sales of building societies, but this was turned down by the Government of the day despite strong support for our proposal from the Opposition. The issue was revisited in 1999/2000 and in 2002 the Society understood that the legislation had Government approval. However, this support seemed to disappear prior to the 2002 General Election. In 2003 it was resurrected once more, following correspondence with the Department of the Environment. It was suggested that the necessary changes be implemented through amendments to the Miscellaneous Housing Provisions Bill, 2003. However this also failed to materialise.

On 15th December 2004 the Minister for the Environment issued a statement confirming that the Government would amend section 102 of the Building Societies Act 1989. However, in June 2005 the Society received a copy of a letter written by the Minister of State for the Environment to a shareholder stating that it was ***"unlikely that the legislation would go ahead"***. The Society always held the view that there was continuing opposition to the change by elements within the Department of the Environment and by other interested parties, including the EBS.

However after appropriate representations were made, the proposed legislation was back on course. It took a further two years for the legislation to come through - delayed by the critics of the Society seeking amendments to the Bill, as well as continuing opposition within the Department. It is my strong belief that given the market conditions which prevailed from 2002-2007, that had the legislation been in place earlier, the Society would have been sold long before the night of the Guarantee.

Even with this delay, it should be noted that the Society had a number of parties interested in acquiring it after the legislation was passed. Two major international banks made indicative offers within acceptable parameters that the Society considered reasonable for further discussion. In March 2007 I had a telephone call from the European Head of GE Capital who informed me that they had prepared a detailed proposal for the main board in New York to acquire the Society. The Board meeting was scheduled for the end of the month but GE Capital instigated a review of their global operations and all acquisitions were suspended pending the outcome.

In early April 2007 the Society received a letter from Hypo Bank seeking to advance their interest in acquiring the Society. I flew to Germany and met with the CEO and Finance Director, and at that meeting it was agreed that Hypo would acquire the Society subject to due diligence and on condition that I would remain as Chairman for 2 years following the acquisition. Hypo Bank appointed HSBC as advisors to conduct the due diligence. However some weeks later HSBC advised the Society that Hypo was putting the INBS transaction on hold because they had been given the opportunity to purchase Depfa Bank (headquartered in the IFSC). The Society was told that once this acquisition was complete, the INBS purchase would be revisited. This of course never happened due to the difficulties encountered by Depfa Bank, which would go on to cost German taxpayers in excess of €100 billion.

The Gathering Storm

I reviewed the Society's position in September 2007 and concluded that in the short term a trade sale would not happen. I decided it was prudent to take measures to reduce the size of the Society's balance sheet and deleverage the Society's loan book. This policy was implemented in late-September 2007, and I informed the heads of commercial lending in Dublin and London of the change in the Society's policy. It was imperative that this policy was kept below the radar.

At this time we were fully aware of all the forecasts for a soft landing in general from the Central Bank, the Department of Finance, the OECD, the IMF, the ERSI, NESC, the EU Commission, as well as the banks' economists, stockbrokers and academia. Even forecasts provided by Professor Morgan Kelly said it would be over a period of eight years, and that all institutions were well capitalised. Also relevant was the OECD Report on Ireland, which was issued in April 2008 and included the following comment: ***"The Irish Banks are profitable and well capitalised to provide a buffer against a future downturn".***

In the UK there was more or less a similar consensus as evidenced by the following statements:

1. On 11th July 2007 **Gordon Brown** as Prime Minister in his first legislative programme pledged an additional 3m homes by 2020. (The Guardian 11/7/2007). (There was for the previous 20 years and there is still today a shortage of houses in the UK particularly in London and the South East).
2. **Bank of England** – ***"The UK housing market remains in good shape despite turmoil in the financial markets."*** Bank of England Monetary Policy Committee Member Kate Barker – 20th September 2007.
3. **Halifax Bank of Scotland** – The UK's largest mortgage lender said a crash was unlikely as fundamentals remain strong. Also that the credit crunch is likely to result in cuts in UK interest rates and thus supportive of house prices – Martin Ellis, Chief Economist – 18th September 2007.
4. **Royal Institution of Chartered Surveyors (RICS)** – Only 10% chance of a 1990's style housing market crash. Simon Rubinsohn – 18th September 2007. This is barely a month after Mr. Rubinsohn recommended buy to let investments – ***" people who were thinking of dipping their toe into the equity market may now be tempted to forget about stocks and buy to let instead"*** **-** (The London Independent).

The new strategy was formally adopted by the board in December 2007. No new lending was to be granted other than that which had been previously contracted or necessary to protect the security of the Society's loan assets. The purpose of this strategy was to build up liquidity and reduce our exposure to the wholesale market as well as reducing the Society's loan-to-deposit ratio and de-risk the balance sheet.

The Society planned for a reduction of at least €3 billion in the commercial loan book in 2008, which was based on the scheduled loan redemptions due to mature during 2008 of c. €5 billion (2007 Annual Account note 12). In 2007 the Society received loan redemptions of €2.5 billion on a projected €3 billion of scheduled loan redemptions for that year (2006 Annual Accounts note 11).

In addition, the Society planned to increase its deposit book by at least €1 billion. We launched a new savings account in January 2008 and by the end of February 2008 we had received almost €300 million in new deposits. Because of the embarrassment suffered by the ratings agencies in their evaluation of the sub-prime funds in the US, it was no surprise when they started to downgrade European, UK and Irish institutions. INBS was downgraded by Moody's and Fitch in Q1 2007, along with other Irish financial institutions. Even though the Society had almost €4bn in cash in January 2008, it had the same balance the day the false Reuters report was circulated at the beginning of September 2008. This represented over a 25% liquidity ratio and was a multiple of the liquidity requirements under the new regulations introduced by the Regulator in 2007.

B1

A. COMPOSITION, SKILLS AND EXPERIENCE OF THE BOARD AND BOARD SUBCOMMITTEES

The Building Societies Act 1989 required a board of a building society to be comprised of at least 3 directors. The Board of the Society had never less than five board members and not more than seven up to the date it was acquired by IBRC. This would include the two Government-appointed directors who joined the board in 2008.

The Board's responsibility was the oversight and governance of the Society. The executive directors, two of whom sat on the Board, were responsible for the day-to-day operation of the Society.

The Board met every week up until 2000 and from then bi-monthly to 2003, and monthly thereafter.

The board members of INBS during the relevant period were individually extremely well qualified both academically and professionally. They each were successful in their business careers and professions. Furthermore, because of their involvement in the lending processes of the Society, ranging in experience from 2 years to 12 years, their knowledge of the property market would have been at least comparable to that of the members of any other board in the financial sector in Ireland.

In addition, all the non-executive directors were members of the Audit Committee. This gave them ongoing insight into the detailed workings of the Society and its policies and procedures. They were also members of the Remuneration

Committee and the whole Board carried out the function of the Nomination Committee. The Assets and Liabilities Committee, the Provisioning and Credit Committee and the Assurers Provisions Committee reported directly to the Board.

The Minister for Finance, accompanied by his officials, at a meeting with the Chairman and myself at Farmleigh on the 21st November 2008 said: ***"the Board had done a great job".***

C. QUALITY OF BUSINESS MODEL SETTING PROCESS

Since 1992 the Society engaged in Commercial Lending (i.e. non-residential home loans), principally in land development, construction and income-producing investments. The Society also continued to promote and grow its residential loan book. The commercial loan book expanded incrementally, diversifying the Society's lending into the UK initially through some of our Irish borrowers and later UK-based borrowers. In the UK, the Society focused on London and the Home Counties' market, which had suffered and continued to suffer from an undersupply of residential units and a shortage of building land.

Once the Society decided to pursue a trade sale and to effect a change in legislation, the strategy, in the interim, was to build up balance sheet value profitably through its chosen markets. The Society didn't anticipate that it would take so long for the implementation of the legislative amendments necessary to enable the Society to effect a trade sale.

In November 1999, Bank of Scotland arrived in Ireland to shake up the home loans market by undercutting margins by up to 1.5%. It had a large effect on the INBS home loan book, particularly our longer-term performing loans. Every day the managers of the Society had to fight to defend the Society's book with mixed success. This started an intense price war among the larger institutions, with brokers becoming a major force - controlling, at the peak, some 40-50% of the home loans market - most of whom were allied to the larger financial institutions.

The Society sought to protect its book and expand it but was unable to do so successfully in the following years, even though the branch managers and agencies were incentivised to do so. It didn't help that the Society refused to adopt 100% home loans as a policy. Such loans were provided by the Society in exceptional circumstances only. We refused also - despite strong pressure form our branches and staff - to introduce tracker mortgages. I believe we were the only Irish institution not to do so. We also did not engage in self-certified income mortgages or expand into the sub-prime lending market, and for some time resisted the term extension of loans to 30/35 years. All this and the intensification of competition in the market prevented the Society from expanding its home loans book as it would have wished. The Society continued to fill the void by expanding its activity in the commercial lending market.

Up to 2002/2003 the Society depended on its deposit book both in ROI and IOM to fund its lending programme. It decided to follow all the other Irish institutions in sourcing funding from the wholesale markets to finance its expanding book. The Society had earlier decided to reduce its exposure to construction and adopted the policy in its joint venture and profit share programme to reduce the maximum terms of its loans to 5 years. From 2000-2007 the Society was turning over its total loan book almost every 3 years. Its average exposure on individual loans was 36 months to redemption.

The Society reduced the size of its loan book from €12,332m to €10,474m as at 31st December 2008. I believe we were one of the few, if not the only, Financial Institution to achieve a reduction of their book in 2008.

Loan Book Breakdown:

Commercial Property Loans (incl residential development)	€m	Residential loans €m	Total €m
UK	4,387	19	4,406
Ireland	2,727	2,242	4,969
Europe	1,069	30	1,099
Total	8,183	2,291	10,474

Source - 3 Irish Nationwide Annual Report & Accounts 2008

The Society's model was based on establishing a niche market based on repeat business with experienced borrowers who were well known to the Society and who had delivered successful projects since 1992.

The Society's policies and procedures evolved over the years to ensure compatibility with the manner in which its business was developing. Specifically, the Society's policies and procedures in relation to joint venture and profit share loans was to examine each proposal on its individual merits and condition it accordingly whether they were land development or income-generating properties.

Each year a draft budget was prepared and presented to the Board. Projected lending for the year would be discussed in the context of available capital and liquidity and share deposit ratios. Also, the economic climate both in Ireland and the UK would be an important factor in the considerations based on the reports from various external sources, which have been extensively referred to during this inquiry.

As referred to previously, the Society changed its policy as outlined in the last quarter of 2007 following its inability to effect a trade sale of the Society. This policy change was implemented against a backdrop of almost universal forecasts of a modest downturn in property prices (soft landing) in 2008/2009.

From 1992 until the end of 2007 the Society had no material losses on its loan book and, where any occurred, they were more than fully provided against. Indeed we recorded profits of almost €400m, including €109m of realised profit share income in that year (2007).

D.ADEQUACY OF BOARD OVERSIGHT OVER INTERNAL CONTROLS TO ENSURE RISK IS PROPERLY IDENTIFIED, MANAGED AND MONITORED

I believe the Board had adequate oversight of the internal controls to satisfy itself that all material risks were properly identified, managed and monitored. I also believe they had all the information necessary to satisfy themselves in this regard.

One of the functions of the Society reserved for the board was the determination of all risk management policies. The Board was fully involved in the lending process, as all loans in excess of €1 million were required to be considered and approved or otherwise by the board.

All non-executive directors were members of the Audit Committee, which excluded all executive directors. All meetings of the Audit Committee were fully attended. The Internal auditor of the Society (who was responsible for all operational and control procedures of the Society) was required to attend these meetings and provide regular written reports in relation to his findings in the course of the audit of the various functions and departments of the Society.

All other committees comprising the Society's senior executives reported directly to the Board, including the Credit Committee, the Provisions Committee, the Asset and Liabilities Committee and the Assurance Providers Committee.

In addition as members of the Board, the directors received, on a monthly basis, reports which included;

- Management Accounts with appropriate analysis
- Monthly printout of all commercial and residential mortgage accounts
- Details of all arrears and statement of Top 10 arrear accounts
- Details of all loan moratoria, extensions
- Asset and Liability Committee (ALCO) Reports
- Provisioning Committee Reports and Provision levels
- Details of any exceptions to Policies

In addition the board would receive a schedule of “the Watchlist”, which was a list of accounts which required close monitoring.

The Board and its members would also be appraised of the general economic environment in each of our geographic areas of activity. Within their own professional capacities they would be aware of the macroeconomic situation and the market economy and would be aware of all the economic reports and forecasts both from national and international sources, together with all similar reports emanating from banking and broker based economists and commentators.

Members of the Board also visited the UK and met a large number of the Society’s largest borrowers and visited many of the sites/properties being funded by the Society.

The Board also met with Group External Auditors without the Executive Directors present each year. The Audit Committee also had presentations from the External Auditors before and after the completion of the Annual Audit. Also, the external auditors reported to the Board as part of their statutory obligations and it is important to note that since their appointment (KPMG) always issued unqualified audited accounts

B5

A. ADEQUACY OF THE INCENTIVE AND RENUMERATION ARRANGEMENTS TO PROMOTE SOUND RISK GOVERNANCE

As CEO my remuneration was determined by the Remuneration Committee, which was comprised of all non-executive members of the board of the Society. There was never remuneration (including bonuses) linked directly to lending for commercial property. In addition, there was no commission paid to third parties for introductions of commercial lending.

Remuneration and bonuses paid to officers of the Society were determined by the terms and conditions of individual contracts of employment and were based on each individual’s performance and the Society’s overall performance on an annual basis. The only exception to this was in relation to residential loans where performance targets were set and incentivized for branch managers.

As a mutual Building Society, remuneration, or part thereof, could not be in the form of shares, deferred share options or any variation of same, unlike other quoted financial institutions.

B. IMPACT OF SHAREHOLDER OR LENDING RELATIONSHIPS IN PROMOTING INDEPENDENT CHALLENGE BY THE BOARD AND/OR EXECUTIVES

As a mutual Building Society, INBS did not have any institutional shareholders or holders of large blocks of shares. However, each investing member of the Society had one share irrespective of the amount invested.

The Society's strategy was to build up balance sheet value with secure and profitable lending in advance of a sale. This meant having a loan book with high-profile performing customers with records of successful development in key markets in Ireland, the UK and Europe. It was also to build strong long-term relationships with successful, professional and experienced borrowers, which it did successfully over many years.

These long-established relationships did not affect the judgment of the lenders, the credit committee or the board of the Society when evaluating each loan proposal. There was never a case of 'backing the jockey and not the horse'. There is a record of loan applications from many of the Society's long-term major borrowers which were turned down by the Society - and never accepted for consideration.

Every lending proposal was evaluated on an individual basis throughout the whole process and considered and conditioned on the proposal's merits.

C2

C. THE LIQUIDITY VERSUS SOLVENCY DEBATE

I understand the definition of Solvency to be the ability to discharge your financial obligations as they fall due for payment.

The question that has arisen is: '***Were the banks and building societies, and in particular Irish Nationwide, solvent on the night of 26th September 2008?'***

There was no evidence produced on the night to suggest that INBS was insolvent, nor has any evidence to date been produced to this committee or anywhere else as far as I am aware to suggest otherwise.

A report produced by Goldman Sachs for the Regulator on 19th September 2008 demonstrates we were not insolvent and in addition we had a liquidity ratio of 23%, which under the 2007 guidelines was well in excess of the minimum requirements of the Regulator.

Furthermore, all the Society's liquidity was held in cash, unlike other institutions, and it appears it came as some surprise to many of the officials on the night that the Society had this amount of cash available, which at the time was in excess of €3 billion.

The Regulator has clearly stated that on the night of the guarantee INBS was solvent. Furthermore the Society had in excess of €1.5bn in capital on its balance sheet.

It is also important to note that the deposit guarantee scheme increased the protected limits from €20,000 to €100,000 on 20th September. This covered 95% of the Society's deposit book and it was observed that from the date of the guarantee we had little or no difficulties with withdrawals. Furthermore, even if the Guarantee was not put in place, the Society when compared to the other institutions was well placed to maintain its then level of liquidity.

It is important to point out that PWC, before 26th September and subsequently (Project Atlas) did a detailed evaluation of the Society's loan book which was positive.

In preparation for the audit of the Society's accounts for the year ending 31st December 2008, KPMG carried out an extensive and in-depth analysis of the Society's total loan book. The review utilized the expertise of KPMG in London and independent experts in Ireland, and determined the level of Provisions to be applied against bad loans to be €436 million. After adjustments there was still €1.2 billion of capital on the balance sheet of the Society, which represented a Capital Adequacy Ratio of 10.2%. So at 1st March 2009, when the accounts were finalised, the Society was clearly solvent and a declaration of solvency was attached to the accounts.

C3

B. APPROPRIATENESS OF THE BANK GUARANTEE DECISION

There was no member of the Board or of the Executive Management of the Society involved in any discussions leading up to the Guarantee on the night of 26th September 2008.

There was no basis or evidence provided by the pillar banks in relation to the quality of the INBS loan book. AIB had no knowledge of our book whatsoever; equally BOI did not do any due diligence on the Society's loan book arising from their previous interest in purchasing the Society. I was surprised at the interest in INBS by Bank of Ireland. Mr. Goggins told me they were light in their Commercial Book as they were late into the market.

On the night of the Guarantee, I understood from the evidence that has been given to this Committee to date that AIB wanted INBS to be nationalized together with Anglo. There was no justification on the night for INBS to be nationalized as it had demonstrably adequate liquidity together with the benefit of the increase of the deposit protection scheme limit to €100,000 made on 20th September, which effectively covered 95% of the Society's deposits. It also had circa €1.5bn in capital on its balance sheet, equivalent to a capital adequacy ratio of 12%.

The motivation of the pillar banks in my view was competitive opportunism to eliminate a highly competitive deposit interest institution which would have allowed the pillar banks to pay much lower deposit rates as is in evidence today. To support my assertion I quote Eugene Sheehy's evidence to the committee (paragraph 41): ***"The Loss of deposits to Anglo and INBS were a regular feature of management meetings. The economic consequences of irrational deposit pricing are underestimated and contributed to the industry's problems"*** **he continues** ***"the cost of losing an individual account is trivial compared to the cost of re-pricing the entire deposit base. In the Republic of Ireland division with €35 billion in resources a 10 bps margin contraction cost €35m. The bank would have to lend €3.5bn on mortgages to earn this amount".***

C4

C. DECISION TO RECAPITALISE ANGLO, AIB, BOI, EBS PTSB AND THE ALTERNATIVES AVAILABLE AND/OR CONSIDERED.

I have no comment to make on the recapitalisation of the above institutions as I had no involvement or knowledge of the rationale of the process and how it involved or affected INBS - other than as referred to above. However I note that the other Building Society (EBS) was capitalised to the amount of almost €2.5bn.

R3

A. NATURE AND APPROPRIATENESS OF THE RELATIONSHIP BETWEEN THE CENTRAL BANK (INCLUDING THE FINANCIAL REGULATOR) DEPARTMENT OF FINANCE AND THE BANKING INSTITUTIONS

I have no knowledge of the relationship between the Central Bank, the Regulator and the Department of Finance except their legal relationships as set out in great detail in the Honohan Report. Therefore my response is confined to the relationship between the Society and those Institutions.

The legislative framework for the Building Society Sector are the Building Societies Acts 1989 and 1992, which regulate the range of activities that a Building Society can undertake.

Up to the end of the millennium the only matters that arose were principally consumer issues. The only significant prudential matter was in 1997 when the Regulators office reviewed the delegated functions of the Chief Executive and agreed with the Board to incorporate them as amended in a Board Resolution, which was recorded in the minutes of the Society dated 25th August 1997.

From 1989 there was only one occasion, in 2000, when the Regulator required a full review of the Society's commercial loan book. This review was undertaken by KPMG. Their principal concern was that in the course of their inspection they had been provided with a computer printout of loans in arrears which showed an exceptionally high figure. However, when KPMG reviewed the matter they found that the arrears figure was grossly overstated due to an incorrect figure generated by the computer system, which had been recently installed and was still being bedded down. The arrears figures generated were double what they should have been. In addition, the regulator was concerned that the level of provisioning may not be adequate. KPMG confirmed that the provisions on the outstanding arrears were covered three-fold and that 2% of the total loan book was provided for. This compared to less than 1% average for each of the other Irish financial institutions at the time.

In 2004 KPMG, following the establishment of the Independent Irish Financial Development Authority (IFSRA) in 2003 was asked to carry out a full review of the Society's Commercial Loan Book on behalf of the Financial Regulator. This covers the period from 01/01/2001 – 31/12/2003.

KPMG examined the composition of the loan book for the period under review and particularly the top 25 exposures (largest borrowers) in detail. They found that there were no losses on the commercial book and that the Society had only repossessed 2 properties in each of the 3 years under review. All repossessions were residential or buy-to-let properties. They also reported that total outstanding arrears were fully covered 3-fold and represented over 2.5% of the total loan book.

All issues raised by the Regulator were comprehensively dealt with by the Chairman of the Society in a letter dated 1st February 2005.

The Board of the Society commissioned a Vendors' Due Diligence report which was completed by KPMG in June 2007and sets out in great detail the position of the Society as at 31/12/2006. There were other reports commissioned by the

Financial Regulator which were dealt with by the Society in the normal course of business.

Basle II became a major issue in 2005 and 2006. Its implementation required a tremendous amount of work. In 2005 IFSRA imposed obligations on all Financial Institutions under the "Impairment Provisions for Credit Exposure". These requirements included Provisioning, Credit Risk, Management Policies and Procedures. They also required Internal Audit and Risk Management functions in the Society to reassess the credit policies and methodologies. In response, the Society established a Credit Risk Department in late 2005 recruiting the necessary staff including three qualified accountants. The Board initially approved an initial expenditure of €1m to acquire appropriate risk measurement software to facilitate the Credit Risk function.

In the interim period until the time of the guarantee the Society engaged in correspondence with the Regulators office on various day-to-day issues which were fully responded to and dealt with by the relevant executives within the Society. The Regulator increased the Society's capital requirements by 1% in 2005. In early 2006 this increase was also extended to all other financial institutions.

The Society's London/Belfast operations were regulated by the FSA (UK) and the Isle of Man subsidiary by the local Regulatory Authority.

Over the years I met the Financial Regulator and senior members of his staff together with members of the Society's Board and/or the Chairman on a number of occasions, at least once a year. The meetings were always civil, straightforward and many issues were discussed arising from the business of the Society. As I don't have the records of these meetings and I don't have access to these records of the Society I am unable to give any great detail at this time.

However I do recall that I did complain about the introduction of IAS39 at the time. Also at every meeting I ritually complained about the inability of INBS to compete on Income Generating Interest Properties due to many of our competitors offering rates of 1% or less, which the Society considered to be uneconomic.

Prior to the Guarantee, I don't recall any meetings with the Department of Finance other than a meeting with David Doyle on the evening of 18th September which I and the Chairman attended.

There was a meeting on 21st November 2008 in Farmleigh with the Minister, his officials, the Chairman of the Board and myself. There was a further meeting on 2 December 2008 in Merrion Street with the Minister, his officials and the Governor of the Central Bank and his officials, attended by the Chairman and myself. There were further meetings in 2009 up to the date I retired on 30th April 2009, but I was only at some of them. I also, for the record, attended the "round table" meetings in the Central Bank.

My involvement with members of the Oireachtas revolved principally around my campaign to have section 102 of the Building Societies Act change. These interactions occurred intermittently from 1995 to 2006 inclusive.

B2

A. APPROPRIATENESS OF PROPERTY RELATED LENDING STRATEGIES AND RISK STRATEGIES

I believe that the property related lending strategies and risk strategies of the Society were appropriate for the lending market in which the Society operated.

The Society did not engage in any other financial services other than property related lending. The Society had a very confined product line. The loan products, which can broadly be distinguished between residential mortgage and commercial lending can be characterised as follows:

1. Residential Mortgage products for principle private residences, holiday homes, residential investment property (buy to lets) and equity releases.

2. Within the commercial sector the Society would consider annuity or interest-only loans and repayment methods within the various sectors, including full capital and interest moratorium loans and bullet repayments which are advanced across a broad range of business sectors, predominantly Land Development and Investment properties. Business was generated principally through the Dublin and Belfast/London offices, with a small amount of business generated through regional branches. The lending process was centralised in Head Office, and all lending decisions irrespective of the source were made there. As referred to earlier, the Society's inability to expand its residential book for various reasons (e.g. no trackers, no 100% loans, no self-certification of income, no sub-prime loans and intense competition from larger institutions) led it, since 1992, to engage in joint venture and profit share commercial lending. The Society would lend up to 100% of the facility in return for up to 50% share of the eventual profit, together with its normal fees and interest. The lending policy and practice for such loans was that each loan would be assessed on a case-by-case basis and conditioned accordingly, and all loans greater than €1m would need to be approved by the Board. The Society was unique among financial institutions in that the entire Board fully engaged in the lending process and this enhanced the credit and risk evaluation structure of the organisation.

   The Society was not focused on increasing its market share but concentrated on lending to customers who were well known to the Society and who had been tried and tested and performed successfully in the past. The Society, at the end of 2007, had approximately 300 exposures, with the top 100 representing 80% of the commercial loan book. Over 80% of the

Society's business was repeat business. An important element of the business risk model was that all such loans were redeemed within an average of three years, thus mitigating the risk considerably. The shorter the term of the loan, the lower the risk. The lending risk strategy was very much influenced by past success and the ability of the Society to generate the necessary capital to sustain the lending programme on an ongoing basis. Within the individual customer base would be a number of individual loans covering a variety of sectors. The Society always priced its loans on the basis of risk.

The Society's policy was to confine its commercial exposure to centres of population. In Ireland this comprised Dublin, Wicklow, Kildare, Meath (dormitory counties) and Cork. In the UK, 60% of our lending was in London and the South East, with the balance spread over a number of other major UK cities. This policy was implemented on the basis that in the event of a downturn such locations would not be affected as much and would recover faster.

The Society obtained full professional valuations on all its loans, which is a key requirement in the lending process.

The concentrated size of the loan book facilitated the active monitoring of each transaction on a rolling basis. The Society had always up-to-date information on the performance and progress of each loan within each exposure. This enabled the Society to forecast the level of redemptions expected for each year.

When the crash came losses were incurred right across the spectrum of different types of lending, commercial and residential. In order to spread the Society's geographical risk we diversified in the 1990's; first to the UK in 1994 and then to Europe in 2004. However this did not insulate the Society from the effects of the crash as all locations were affected by it, some more than others.

Because of the competitive nature of the market I believe that no single bank could have prevented a property bubble. Only the Regulator, the Central Bank, the Department of Finance and ultimately the Government could realistically do so. And no action was taken to prevent this happening. In addition, property bubbles are contributed to by factors external to the Irish economy over which none of the market participants can exercise any control.

B. APPROPRIATENESS OF CREDIT POLICIES, DELEGATED AUTHORITIES AND EXCEPTION MANAGEMENT.

The Society had a full range of credit policies, practices, procedures and guidelines in place covering all the sectors both commercial and residential that it engaged in - including policies in relation to assessment, credit review, risk management, the monitoring of and control of large exposures, and product provisioning for loan losses.

All such policies, practices, procedures and guidelines were fully embedded in the lending culture of the organisation. The delegation of powers was reflected in the lending process which the Society implemented, the key features of which were:-

- All Commercial loan applications had to be prepared and all supporting documentation had to be in place prior to submission to the Credit Committee. The application must also include loan classification, details of fee arrangements, LTV and all other necessary information.

- The Credit Committee had the authority to approve all loan applications of up to €1m. Loan applications in excess of €1m required Board approval.

- In the exceptional event that a credit decision was required urgently and it was not possible to convene a meeting with the Credit Committee at least two members of the credit committee were required to support and approve the credit up to €1m. All amounts in excess of €1m were required to be approved by the CEO and two members of the credit committee. All loans so approved were required to be signed off by the credit committee and the Board at the earliest opportunity.

The Security of the asset was always a prime requirement of the Society's policy. A full valuation and a full legal charge were required. The Society utilised the services of the top external valuers in all jurisdictions and also employed highly qualified and experienced external legal firms to perfect the security. All exceptions to policy were reported to the Credit Committee and the Board as required. Because of the Board's ultimate involvement in the lending decisions many of the exceptions arising would be incorporated in the process and other specifically required reports would be furnished.

C. ANALYSIS OF RISK CONCENTRATION ON THE BASE, THE ADVERSE ECONOMIC SCENARIO AND THE IMPACT ON THE CREDIT STRUCTURE.

The Society's property book comprised 4 sectors: residential development, commercial investment, commercial development, residential mortgages. The Society's loan book, as already referred to, comprised 80% commercial and 20% residential. With each customer exposure there would be a number of loans from different sectors within the mix representing various levels of risk and realisability. However, when the crash came there was little or no difference in the level of losses incurred in real and relative terms. Residential mortgages did not fare much better than commercial loans.

Stress testing was required to be carried out by all financial institutions as part of the Central Bank's and Financial Regulator's biannual programme in 2004, 2006, and 2008. These stress tests analysed baseline versus shock scenarios on criteria furnished by the Central Bank and the Financial Regulator. The Society had more than adequate capital arising from all such tests. With the benefit of hindsight the "shocks" were clearly inadequate.

A different approach to stress tests commenced with the introduction of Basle II and Internal Capital Adequacy Assessment Policy (ICAAP) in 2007. These tests required by IFSRA were more stringent than the earlier stress scenarios. Again they proved to be inadequate.

The Capital requirements imposed by the regulator under Basle II were:

1. A risk weighting of 75% on all residential mortgages with an LTV in excess of 75%.
2. For residential investment mortgages a weighting of 75% applied to all mortgages.
3. On secured commercial real estate a risk weighting of 100%.
4. On secured speculative real estate a weighting of 150%.

The Capital Requirements Directive which implements Basle II Capital Requirements in the EU came into effect on 1st January 2008. The Society adopted the Basle II required approach to calculating capital. The Society's capital position is set out below as at 31st December 2008 as follows:

	Basel II 2008 €m	Basel I 2007 €m
Tier I Capital	1, 056	994
Tier II Capital	442	518
Total Capital	**1,498**	**1,512**
Capital Ratios		
Tier I	7.2%	8.1%
Own Funds Ratio (Total Capital)	**10.2%**	**12.2 %**

Source 4 Irish Nationwide Annual Report & Accounts 2008

Basel II Basel I
2008 2

R5

D. APPROPRIATENESS OF RELATIONSHIPS BETWEEN THE GOVERNMENT, THE OIREACHTAS, THE BANKING SECTOR AND THE PROPERTY SECTOR.

I have no knowledge of what the relationship was between the Government, the Oireachtas and the property sector. As regards the Government, my relationship was substantially concerned with the changing of section 102 of the Building Societies Act between 1996 and 2006. Equally my relationship with the Oireachtas, as already stated, related to the same subject. As regards the property sector the Society, because of its involvement as a lender in the property market, constantly, consistently and continuously monitored developments in that market. We kept ourselves fully informed. We never had any discussions with any representatives of property related bodies. The Society also was in close touch on an ongoing basis with estate agents, particularly those that carried out valuations for the Society.

We would of course utilise our internal and external network of contacts throughout the country, including within our Branch Offices. Equally, we informed ourselves through the media and the frequent reports commenting on the property market from the authorities such as the Central Bank, OECD, IMF, and ESRI etc. - as well as commentary from economists connected with banks and stockbrokers etc. Also, in the UK we would have access to reports and opinions from various sources, including publications from related Mortgage

Associations and of course from Estate Agents, and our network of customers and advisors and from regular economic reports. I had a full overview of all markets.

R1

B. EFFECTIVENESS AND APPROPRIATENESS OF THE SUPERVISORY POLICY AND POWERS

As far as the Society was concerned the Regulator was very diligent and robust in the pursuit of issues that he perceived from time to time needed to be addressed within the Society and clearly no issues were of sufficient significance such as to warrant any action to be taken by that office in respect of the Society other than to increase our Capital Adequacy Ratio by 1% in 2005, which he also applied to all other institutions some months later.

There was never any threat expressed or implied to take any other action in relation to any matter as far as I am aware. It is my view that the Regulator had all the powers necessary, both persuasive and legislative, should he so decide to have implemented any requirements he considered appropriate and necessary in relation to any issue.

As regards lending, the Financial Regulator also had the power to significantly curtail the growth in this area through the implementation of appropriate measures. By way of illustration:-

1. The Financial Regulator did have the power to increase the capital requirements in relation to all lending- (and did as mentioned utilise this power)
2. The Financial Regulator could have limited the LTV's for all or any category of lending as it deemed appropriate.
3. The Financial Regulator could have increased liquidity ratios.
4. The Financial Regulator could have put limits on the growth of lending engaged in by any institution.
5. The Financial Regulator could have put limits on the loan-to-deposit ratios.
6. The Financial Regulator could have ignored IAS39 and imposed the requirement on all institutions to increase the level of provisions, as was required in Spain.
7. The Financial Regulator could have introduced properly structured and conditioned sectoral limits for each segment of the lending spectrum based on risk and fully enforceable. I do not accept the view, as some commentators have expressed, that such requirements could be circumvented easily. I recall the Society seeking clarification from the Financial Regulator on a number of occasions in relation to sectoral limits and guidelines. We never got a response as far as I am aware.
8. The Financial Regulator could have increased the share to deposit ratios for Building Societies.

In 2005 the Financial Regulator also introduced the Administrative Sanctions Regulations together with the requirements of the "Impairment Provision for Credit Expansion" (covering provisioning, credit risk management, policies and procedures) as a condition on licences.

This gave the Financial Regulator all the powers necessary to regulate fully all financial institutions and bring any action it considered necessary to enforce compliance, together with all the other powers as to curtail lending.

R1

A. APPROPRIATENESS OF SUPERVISORY REGIME

During the material period 2000-2008 the consensus in Ireland and internationally was that 'light touch regulation' was preferable for financial markets. This approach favoured co-operation between financial institutions and their regulators as opposed to conflict. It was based on the philosophy that since financial markets were extremely complex, market distortions would occur if regulators interfered unnecessarily in their operation because regulators could never be in a position to fully understand all of the complexities of the financial markets. The international consensus seemed to be that competition in the financial markets would create an appropriate self-regulating environment which would avoid market distortions and create its own equilibrium. This philosophy was championed by former Federal Reserve Chairman Alan Greenspan, who often referred to the 'invisible hand' which governed behaviour in financial markets. This undoubtedly had a substantial impact on the regulatory regimes in Ireland, Europe and the UK.

At this time light touch regulation was credited internationally with ensuring stable interest rates, stable exchange rates and stable pricing. Harsh experience has taught us that light touch regulation can lead to enormous and disastrous market distortions, which is what happened in 2008. I believe that if the Financial Regulator had sought to adopt a more interventionist approach in the Irish lending market in this period it would have been out of step with the international regulatory consensus. That is not to say that it should not have been done.

Also, light touch regulation appeared to be a feature of the benefits presented to foreign institutions encouraging them to locate in the Irish Financial Services Centre. What effect this had on the regulatory regime, if any, I don't know.

As far as the Society was concerned all of its dealings and relationships with the Regulator and its staff were at all times conducted in a fully open, professional and transparent manner.