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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

John Stanley Purcell

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Joint Committee of Inquiry into the Banking Crisis

Witness Statement

John S. Purcell

Introduction

1. I want to begin by expressing my gratitude to the committee for inviting me to attend to give evidence at the inquiry. I also want to express my sincere regret to everyone who suffered as a result of the demise of INBS.
2. I joined INBS as Financial Controller in May 1986. I had qualified as a chartered accountant having trained at KPMG. INBS was my sole place of work until 31st March 2010. I was appointed Secretary of INBS in May 1993 and I was appointed to the board of INBS on 30 Dec 1994 as an executive director until March 2010. I was retained as a Director by the new Board of INBS at the behest of the State until March 2010 when all legacy Directors were required to resign from the Board's of the institutions which were the subject of the guarantee.

3. My role was very diverse and I was engaged in a wide variety of functions on a daily basis. Whilst I was heavily involved in reporting, treasury, retail deposits, IT systems and compliance, I was not involved in the lending function outside of my role on the Board.
4. It is important to appreciate the context in which the Society developed over time. Up to the crisis, INBS was successful. Profits increased year on year and the Society grew accordingly. The members of the Society, to whom we had to account, were on the whole happy with the performance of the Society over many years.
5. During the period leading up to the crash, much of the focus of the Society and a huge amount of my time was taken up with demutualisation. The members hoped to gain a windfall profit from the demutualisation and sale of the Society and the Board worked extremely hard to put the apparatus in place for demutualisation. This involved the production in 2007 by KPMG of a Vendors Due Diligence report which provided a detailed snapshot of INBS at that time. The report was widely circulated. I delivered it myself to the Central Bank. I don't recall anyone saying at that time that we were on the wrong course.
6. The strategy of the Society (including demutualisation) developed over a long period of time. In terms of lending, as time progressed it became apparent that the residential market was overly competitive and margins were diminishing. Tracker mortgages (which INBS did not market) were common place.

7. As everyone knows, during 2004, 2005, 2006 and 2007 INBS, AIB, Anglo Irish Bank, Bank of Ireland, Bank of Scotland, EBS, Permanent TSB and Ulster Bank lent heavily in the commercial/residential sectors. All of the institutions suffered extraordinary losses as a result of that lending. A combination of high liquidity, low interest rates, increased competition, government policy including tax incentives for development and rising property prices caused a surge in lending.
8. With regard to specific strategy, INBS moved to diversify lending and increased lending in the UK in particular. The UK property market did not collapse in the same way as the Irish market collapsed and in fact the London market improved in the aftermath of the economic crisis. Over 50% of loan book which transferred to NAMA related to assets outside Ireland. Consequently, I believe that the INBS assets transferred to NAMA were significantly undervalued.
9. INBS developed a strategy over time which involved lending to clients who had proven their success. Towards the end of 2007 it became clear to us that liquidity was tightening. The Board chose to arrest new lending in December 2007 when other institutions continued to lend anew. This was obviously the right strategy at that time.
10. By September 2008 INBS's liquidity was coming under pressure due to a credit rating downgrade and an inaccurate report on INBS by Reuters. The Regulator arranged at short notice a meeting on Sunday 7 September 2008 with AIB and BOI to discuss the possibility of the provision by AIB and BOI of a standby facility for INBS. INBS's liquidity on 7 September was about €3.5 billion and information was provided to the

meeting at short notice on liquidity, funding liabilities and the maturity of funding liabilities. The meeting concluded without any agreement to progress the provision of a standby facility. Had the matter progressed any additional information required not brought to the "at short notice meeting" would have been provided.

11. After the guarantee, I worked with the new directors appointed and I worked closely with the Department of Finance until my retirement on 31st March 2010.

12. Towards the end of 2009 Ernest & Young began an investigation into legacy issues at INBS. I gave E&Y every assistance required. The investigation ultimately led to the initiation of legal proceedings against the "old Board" (including me) for the losses of the society. IBRC and INBS formally accepted in the pleadings in the proceedings there was no dishonesty whatsoever on my part. I was not accused of any wrongdoing in that sense.

13. The proceedings represented an attempt by IBRC to make the directors personally liable for the losses of the society. A central plank of the claim was the allegation by the Plaintiffs that the delegation of powers by the Board of the Society to Michael Fingleton was excessive. On legal advice, I joined the Central Bank to the proceedings as a third party because they had approved the delegation of powers to Mr. Fingleton.

14. Given the extraordinary magnitude of the claim (for up to €6 Billion), I entered into a confidential settlement with the Special Liquidators after a mediation conducted by Mr. Justice Joseph Finnegan. The terms of the settlement are confidential. I can say that;

- (i) The settlement involved no admission of liability on my part;
- (ii) I did paid a sum personally to the Plaintiffs for the benefit of the State.

15. Separately, the E&Y investigation led to administrative sanctions proceedings being initiated against me by the Central Bank as far back as 2011. A Notice of Inquiry was issued on 9th July 2015 and I would ask the committee to be cognisant of the fact that I am the subject of that enquiry, pursuant to which punitive sanctions could be imposed on me by the Central Bank. I really can't understand how the Central Bank can purport to investigate me in relation to events for which they bear responsibility. That is the subject of legal proceedings.

16. I am not aware that any civil proceedings or any administrative sanctions having been initiated against the Management of any other Bank or Building Society as a result of the crash. I can't see how there is any benefit to the public in INBS being investigated and pursued on the double, when institutions which subsist have not been the subject of any serious investigation, inquiry or proceedings.

17. I will now address the specific issues which I have been asked to consider.

B1b. Integrity of financial reporting

18. The purpose of INBS's financial reporting system was to:

- Comply with statutory and regulatory reporting responsibilities;
- Provide information to the board, committees and management to enable them manage and control the business;
- Introduce as required International Financial Reporting Standards "IFRS" that applied to INBS's business.

19. The system was designed, monitored, reviewed, audited, amended, extended and upgraded to seek to ensure that financial reports were correct, consistent, complete and accurate. The financial reporting system provided records and information for both external and internal audits and reviews. The system involved regular reconciliations, internal checking and reviews, oversight and comparison with and analysis versus budgets.

20. Financial reporting calculated key ratios for regulatory and management purposes and provided information for funding and treasury management. New and improved reporting was introduced for fees accounting, treasury risks and controls as well as new accounting standards. The financial reporting was carried out by experienced qualified accountants assisted by trainee accountants and support staff.

B1c. Quality of the business model setting process

21. INBS operated a business model that was focussed on residential and commercial lending. INBS's business model was geared towards developing alliances with experienced property developers and home builders active in the Irish and UK markets. A large portion of commercial lending was repeat business.

22. The business model evolved over time from the introduction of the Building Societies Act, 1989. The Act allowed development lending by building societies which up to then, was only carried out by banks. The provision of current accounts and financial services such as life assurance broking and car finance was not viable for INBS due to economies of scale, the financial and management investment involved and INBS's size.

23. Over time, banks became more active and competitive in the residential lending market. The entry of foreign banks brought more competition and lower margins. INBS first engaged in residential property development in 1992. The development was successful. From then on in the 1990's INBS built up experience and gradually successfully expanded into residential development and commercial lending in Ireland and the UK based on repeat business with experienced people.

B2a. Appropriateness of property-related lending strategies and risk appetite

24. INBS's strategy was to avail of the provisions of the Building Societies Amendment Act 2006 to demutualise and engage in a trade sale.

25. As a building society INBS's lending had always been property related. The competitive environment in the 1990's and 2000's made it difficult, if not impossible, for INBS to diversify away from property lending. INBS continued residential lending and gradually from 1992 expanded residential investment and residential development and commercial property lending. Over the years INBS's lending function built up experience, skill and a customer base to be able to take advantage of lending opportunities in its chosen markets. In the 2000's INBS's lending increased with the expansion in the property market and the availability of funding.

B2c. Analysis of risk concentrations in the base, the adverse economic scenarios and the impact on capital structure

26. INBS's Top 30 loan exposures amounted to over 40% of total loans.

27. INBS's capital consisted of Reserves (Retained earnings and revaluation reserves) and £250m. subordinated debt raised in October 2006.

28. INBS's capital base and solvency ratios at year end were:

Year	Total Capital €m.	Solvency Ratio
2006	1,603	13.70%
2007	1,856	12.30%
2008	1,558	10.20%

29. The minimum requirement was 10% in 2006 and 2007 and 11% from, 7 August 2008. The high level of loan loss provisions in the 2008 accounts caused the solvency ratio to fall below the new 11% minimum. In the period to September 2008 INBS's calculation of provisions for impairment, credit reviews, grading of commercial lending and estimates of future income from success related fees did not indicate any serious impact on INBS's capital.

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

30. INBS's funding mix was determined by the share/deposit ratio requirements of the Building Societies Act 1989 and the Central Bank/Financial Regulator. The Act required a 50:50 ratio, but permission to operate a 30:70 ratio was granted by the Central Bank/Financial Regulator in 1999.

31. INBS had to maintain a ratio of share accounts (retail savings accounts held predominately by individuals based in Ireland) to deposit accounts which included retail deposit accounts, loans from banks and borrowings

under the EMTN programme. This was the “Euro Medium Term Note programme” which related to unsubordinated debt securities listed on the Luxembourg exchange. The ratio at 30:70 meant at least 30% of funding had to be in the form of share accounts while up to 70% could be in the form of non- share deposits, bank and EMTN loans.

Funding Costs

32. The interest paid on retail share and deposits accounts (Customer Accounts) was a function of the competition for retail funds and the maturity of the deposit. The longer the term of the deposit, the higher the rate. The cost of EMTN funds was based on a margin above EURIBOR/LIBOR and was less expensive than retail funds.

Funding Sources

33. INBS’s funding sources were determined by the share deposit ratio and the availability of funding by EMTN debt securities. EMTN funding also helped to extend the maturity profile as EMTN borrowings were generally for periods of three to five years. EMTN funding also reduced INBS’s use and dependence on the short term interbank market. The funding of the sterling loan book was from the customer accounts of Irish Nationwide (IOM) Ltd and sterling EMTN funding.

34. Half of INBS’s total funding came from customer accounts and half from deposits from banks, EMTN and subordinated debt.

Maturity Profile of Funding

35. The maturity profile of funding involved a little over half of funding maturing in periods of up to one year and the rest in periods out to five

years. INBS sought to raise funding through its EMTN programme so as to avoid the risk of dependence on the short term interbank market.

B3b. Analysis of liquidity risks under adverse scenarios

36. The adverse scenarios considered by INBS on an ongoing basis which would give rise to liquidity risk were a sudden outflow from customer accounts, repayment of maturing EMTN loans, a large reduction in loan repayments while new funds were not available from the EMTN programme.

37. Liquidity risk, (ie; the inability to raise funds to meet commitments in the form of cash outflows in the short term without the loss of income or capital) was managed historically by INBS by placing five to ten percent of liquid assets on overnight deposit. The remaining liquidity was placed on deposit for periods up to three months with well- established European banks.

38. INBS sought to raise sufficient funds through its EMTN programme so as to avoid dependence on the short term interbank market in the event of adverse scenarios for liquidity. INBS also arranged standby facilities to be available to deal with liquidity risk.

39. When liquidity tightened significantly in 2007, INBS sought to increase liquid assets by attracting retail funding. In December 2007 INBS decided to cease new lending except for commitments already made. In the first half of 2008 INBS increased its liquid assets through inflows from retail deposits and loan repayments. INBS's liquid assets ratio at 31 December 2007 was 23% and it was also 23% at the end of September

2008 when the State Guarantee was introduced notwithstanding the considerable outflows during September 2008.

Liquidity ratio and Liquidity guidelines from July 2007

40. Up to July 2007, INBS was required to maintain a liquidity ratio of 25%. Assets held for liquidity purposes (mainly interbank placements with established European banks) were required to comprise at least 25% of funding liabilities which consisted of Deposits by banks, Customer Accounts and EMTN debt securities. INBS's liquidity ratio at the end of 2006 was 28.9%.
41. From July 2007 new liquidity guidelines were introduced by the Regulator to replace the previously required ratio of 25%. The guidelines required that a stock of liquid assets must be held to meet outflows in two time bands, sight to 8 days (minimum requirement 100%) and over 8 days to one month (minimum requirement 90%). In 2007 INBS significantly exceeded the minimum requirements.

B3c. Interest rate risk appetite setting and monitoring

42. Interest rate risk exposure arises where there is an imbalance between fixed rate and floating rate assets and liabilities. INBS was adverse to interest rate risk and sought to have all assets and liabilities on a floating interest rate basis by swapping fixed interest rates for floating interest rates through swap agreements. Interest rate risk was monitored by regular reports on the effectiveness of hedging transactions entered into.

B3e. Capital structure and loss absorption capacity

43. INBS's capital consisted of Reserves (Retained earnings and revaluation reserves) and £250m of subordinated debt raised in October 2006.

Year	General Reserve	Revaluation Reserve	Tier 2 Capital (Subordinated Debt)	Total Capital €m (a)	Provisions for loan Impairment (b)	Absorption capacity (a)+(b)	Total loans	Absorption capacity as a percent of loans
2006	1,056	181	366	1,603	82	1,685	10,492	16%
2007	1,364	146	356	1,856	99	1,955	12,431	16%
2008	1,189	71	298	1,558	545	2,103	11,019	19%

44. INBS's capacity to absorb losses increased from 2007 to 2008 as its commercial loan book was reduced. If residential lending was excluded from total loans the absorption capacity to absorb commercial loan losses at the end of 2008 would be 24%.

B4a. Adequacy of the valuation policies and assumptions to accurately assess loan security

45. An assessment of security for loans was required under the Building Societies Act. INBS's policy was that all facilities be secured. The security would be valued by a professional valuer and the valuations be completed and addressed to INBS. All loans in excess of one million were to be valued by an external professional valuer. Valuers were provided with instructions in INBS's standard format.

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

46. INBS had sought to enhance the effectiveness of internal audit by recruiting more staff, training and improvements to internal audit systems. KPMG carried out a report on internal audit in 2005 and produced a strategic performance review of internal audit in 2008. INBS engaged Deloitte to carry out internal audits on the IT function, Treasury and Commercial lending.

B6b. Effectiveness of the oversight of the prevailing risk culture

47. Internal Audit had a direct reporting line to the Chair of the audit committee. The Internal Auditor met non-executive directors without executives being present. Internal audit had a documented internal audit charter which set out the purpose of internal audit, the scope of internal audit work, reporting lines, responsibilities, standards and authority. Internal audit had a documented internal audit policies and procedures manual.

B7a. Impact of prevailing accounting standards in recognising risks

48. The impact of IFRS accounting rules reduced INBS's loan loss provisions in 2005 and resulted in lower loan loss provisions while the property market remained strong. The incurred loss rules prevented and then delayed loan loss provisions.

49. In addition IFRS rules resulted in the unrealised surplus on revaluations of property and other assets increasing Reserves in economic upswings and having the opposite effect in a downturn. So the solvency ratio was

boosted by unrealised amounts in good economic times and then reduced sharply in the downturn.

50. IFRS also resulted in loan fees being brought into income before they were received. Any amount not received would later be removed from income if they were unlikely to be paid to INBS.

B7b. Effectiveness of the external audit process to identify and report to the board and management any concerns related to significant risk exposures, including property, funding and liquidity.

51. KPMG's management letter for 2004 reported to the board on concentration risk. In the 2005 management letter KPMG reported on the growth of the Belfast branch as a business risk. KPMG's management letter for 2007 regarded as positive plans to enhance the board and strengthen the executive team.

C2c. The liquidity versus Solvency debate

52. I am not an economics graduate and I have never worked in the economics area. So my opinion expressed on this topic is made in that context.

53. The credit crunch began in 2007 with the deterioration in the credit quality of sub-prime mortgages. Uncertainty as to where losses might arise in banks resulted in liquidity being withdrawn and the onset of the credit crunch. The property market was slowing in Ireland but there were general predictions that there would be a soft landing. However the credit crunch persisted into 2008 and uncertainty about the property

market and the economic outlook remained and this uncertainty and loss of confidence together with the Lehmans collapse resulted in the banking crisis in 2008.

54. Asset values in the continuing turbulence began to reflect the absence of liquidity more than the assets intrinsic payoff. The greater the uncertainty, the more protracted the adjustment process and the higher the risk of overshoot with significant damage to the system. In this situation liquidity shortage worsened solvency and vice versa - both spiralled downwards.

C3b. Appropriateness of the bank guarantee decision

55. Given the circumstances at the time and what is known now, it was probably the best option available.

C4c. Decision to recapitalise Anglo, AIB, BOI, EBS and PTSB and the alternatives available and/or considered

56. I don't have any particular knowledge about the alternatives available or considered in relation to the recapitalisation but it seems to have been done to enable them support the needs of the economy and to restore confidence in these institutions by increasing their capital ratios.

R1a. Appropriateness of the regulatory regime

57. The regulatory regime would have been more appropriate if ratios limiting loans made to deposits, commercial lending to residential lending and loan to value ratios had been introduced as property lending began to expand.

R1b. Effectiveness and appropriateness of the supervision policy and powers

58. A rules based approach to supervision would have been more effective to deal with the rising property prices and lending from the early 2000s.

R3b. Nature and appropriateness of the relationship between the Central Bank (Including the Financial Regulator), Department of Finance and the banking institutions.

59. INBS was in regular communication with the Central Bank/Financial Regulator and to a lesser extent with the Department of Finance - our relationship was always conducted in a respectful, businesslike and proper manner at all times.

60. As far as the relationship between the Central Bank and the Department of Finance is concerned, there is a necessary distance between the two, so that the Central Bank is independent and free from political influence. This does create an unusual vacuum in oversight insofar as the Central Bank/regulatory function is concerned. The question arises as to who regulates the regulator? It is noteworthy also that the Central Bank/Regulatory function is subject to far less stringent requirements of public disclosure than other public bodies. Given these factors, there is an argument for the introduction of a transparent system of external oversight and review of the Central Bank and its regulatory function.

Documentation

- 61.a. I confirm that the documents provided with this statement are true and correct.
- b. The documents provided are in the public domain.

John S. Purcell

5th August 2015