Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Niamh Brennan

Strictly Private & Confidential

As indicated on its cover page, the document(s) contained within are confidential unless and until the Joint Committee decides otherwise including where the Joint Committee publishes such document(s). For the avoidance of doubt, "documents" include witness statements in this context. Further to section 37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013 ("the Act"), while the documents remain confidential, you must not disclose the document(s) or divulge in any way that you have been given the document(s), other than:

> "(a) with the prior consent in writing of the committee,
>
> (b) to the extent necessary for the purposes of an application to the Court, or in any proceedings of the Part 2 inquiry, or
>
> (c) to his or her legal practitioner."[1]

Serious sanctions apply for breach of this section. In particular, your attention is drawn to section 41(4) of the Act, which makes breach of section 37(1) a criminal offence.

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

Oireachtas Joint Committee of Inquiry into the Banking Crisis

Witness Statement

Professor Niamh Brennan

6 August 2015

1. Context

1.01 This witness statement is provided following correspondence dated 18 June 2015 and 3 July 2015 from Deputy Ciarán Lynch, Chairman of the Oireachtas Joint Committee of Inquiry into the Banking Crisis. I have been asked to address 27 questions. My responses to the questions are constrained by the Banking Inquiry limit of 9,000 words (excluding Banking Inquiry questions and my confirmation, which I have included in my witness statement for ease of reference).

1.02 I was a non-executive director of Ulster Bank (2001–2009).

1.03 The Banking Inquiry has furnished me with Core Documents. I have seen these documents during my time as a non-executive director of Ulster Bank, except for the following:

- Hospitality [UBI02150-001]
- Group Asset and Liability Committee Minutes 29/4/2004 [UBI00489-001]
- Group Risk Credit Policy and Strategy Committee Minutes 28/7/2005 [UBI1730-001]
- Financial Regulator Letter 24/7/2008 [UBI00729-001]
- Group Asset and Liability Committee Minutes 10/9/2008 [UBI00437-001]
- Group Asset and Liability Committee Minutes 25/10/2006 [UBI00451-001]
- Bonus Details for Top Role Holders [UBI01981-001]
- Ulster Bank Note on Remuneration for the Banking Inquiry [UBI02078-001]
- Financial Regulator Letter 19/6/2006 [UBI02153-001]
- Ulster Bank Group Sector Review – Property Portfolio [DEL00660-001]
- Commercial and Residential Real Estate Sector Review 2007 [CMC00005-001]
- Group Internal Audit: Dublin Mortgage Centre, December 2006 [UBI02152-001]

1.04 My witness statement is structured as follows:

- In Section 2 – my approach to preparing the witness statement
- In Section 3 – my expertise and experience
- In Section 4 – the Ulster Bank context
- In Section 5 – the unique governance features of subsidiaries
- In Section 6 – responses to the 27 questions asked of me by the Banking Inquiry
- In Section 7 – conclusions on lessons to be learned.

1.05 A number of documents are attached to my witness statement that are not included in the Core Documents furnished to me by the Banking Inquiry, as follows:

- Document 1 – Ulster Bank's governance, called "High Level Controls", June 2006
- Document 2 – Selection of extracts of minutes of Niamh Brennan's recorded contributions at board and audit committee meetings
- Document 3 – Extracts of minutes of board and audit committee meetings re the Dublin Mortgage Centre
- Document 4 – Extracts of minutes of board and audit committee meetings re management information systems
- Document 5 – Extracts of minutes of board and audit committee meetings re sectoral concentration
- Document 6 – Extracts of minutes of board and audit committee meetings re mortgages over limits.

2. Preparation of this witness statement

2.01 In preparing this statement, I have been supported by an independent legal team, the procurement of which has been supported by Ulster Bank, for which I am grateful. I have also relied on information provided by Ulster Bank through its legal advisors, Arthur Cox. This witness statement concerning my non-executive directorship of Ulster Bank is based as far as possible on factual evidence. I have also opined on events from my perspective. Inevitably, the passage of time and events have influenced my opinion. During its preparation, I provided a draft of my statement to Ulster Bank solely for fact-checking purposes.

3. Expertise and experience

3.01 I hold a first class honours BSc (Microbiology and Biochemistry) degree from University College Dublin (1976) and a PhD in Accounting from the University of Warwick (1995). I trained and qualified (1979) as a chartered accountant with Stokes Kennedy Crowley & Co. (now KPMG). In 2007, I qualified as a chartered director with the Institute of Directors (London).

3.02 Following four years as an auditor with Stokes Kennedy Crowley & Co., I joined the Accountancy Department at UCD as a junior academic in 1980. In 1999 I was appointed Michael MacCormac Professor of Management at UCD. In 2002, I founded the UCD Centre for Corporate Governance which provides training to company directors.

3.03 During my career as an academic, I have been privileged to hold a number of business appointments outside UCD. I have gained considerable hands-on corporate governance experience as a non-executive director and audit committee member of a number of companies and State entities (see reply to Q2).

4. Ulster Bank context

4.01 Ulster Bank is a high street, clearing bank in the Republic of Ireland (and in Northern Ireland), similar to AIB and Bank of Ireland. Until the year 2000, Ulster Bank's owner/shareholder was NatWest Bank in the UK. In 2000, Royal Bank of Scotland (RBS) acquired NatWest Bank which included Ulster Bank. In 2004, RBS acquired First Active plc, which had a significant mortgage business. RBS decided to house this acquisition in Ulster Bank.

4.02 The parent company, Ulster Bank Limited, is headquartered in Belfast. Thus, it is regulated by the UK Financial Services Authority/Financial Conduct Authority for both the business of Ulster Bank and the consolidated Ulster Bank Group. Ulster Bank Limited has a number of subsidiaries, two of which, Ulster Bank Ireland Limited and First Active, have banking licences in the Republic of Ireland and are therefore regulated by the Irish Financial Regulator. The board took comfort from Ulster Bank having a dual regulatory oversight.

4.03 Appointment to the board of Ulster Bank

RBS acquired Ulster Bank's then parent, NatWest Bank, in 2000. The then chairman of Ulster Bank, Sir George Quigley, was charged by RBS to refresh the Ulster Bank board. Sir George was a board member/chairman (1994–1996) of Co-operation Ireland, a North-South not-for-profit peace building organisation. We were fellow board members of Co-operation Ireland. Sir George's knowledge of my experience as a non-executive director led him to invite me to join the Ulster Bank board in 2001.

4.04 My initial appointment to the Ulster Bank board was for a three-year term (2001–2004), which term was renewed (2004–2007). I was then invited to remain on the board for a further year (2007–2008), which invitation was repeated (2008–2009). It is best practice under the UK Combined Code for non-executive directors to serve two three-year terms, with any additional periods of service subject to review. Thus, it was appropriate that I complete my service as non-executive director in 2009.

4.05 I served on the Ulster Bank Group Audit Committee during my tenure as a non-executive director.

4.06 During my term on the Ulster Bank board, I was also appointed to the boards of Ulster Bank subsidiary companies: Ulster Bank Ireland Limited from May 2003 to June 2009 and First Active from June 2005 to June 2009. Following the death of Mr William Burgess, I was appointed chairman of Ulster Bank Ireland Limited from June 2006 to October 2008, when Ulster Bank Limited board chairman, Mr Sean Dorgan, was appointed chairman of Ulster Bank Ireland Limited. Following the retirement of Mr Martin Wilson, I was appointed chairman of First Active from June 2006 to October 2008.

5. Governance of subsidiary companies

5.01 The governance of subsidiary companies is uniquely different to that of stand-alone autonomous companies. Subsidiary boards do not carry out the full range of governance responsibilities compared with, say, publicly listed autonomous company boards. Some responsibilities relating to subsidiaries are reserved to their shareholders/owners, i.e., their parent companies. For example, the CEO of the parent company (not the board of the subsidiary) generally appoints the CEO of the subsidiary. Remuneration of the CEO of a subsidiary is generally a matter for his/her line manager, who is usually the group CEO. Subsidiary company remuneration may be overseen by the parent company board, through its remuneration committee.

5.02 Functions not reserved to the parent company are delegated to the local subsidiary board. The parent company decides the extent to which it is willing to delegate functions to a local board. In all cases, subsidiary boards have a more limited range of functions compared with an autonomous board, as decided by the parent company.

5.05 My belief is that RBS were motivated by three factors in putting in place the Ulster Bank board:

- to have local knowledge represented on the board (thus, a large number of the non-executive directors were Irish with significant local business experience and expertise)
- to facilitate the exercise of RBS Group-level oversight over Ulster Bank local management (thus, a number of non-executive directors were senior managers of RBS (CEO, company secretary)
- to facilitate the exercise of independent oversight over Ulster Bank management (thus, the presence of independent non-executive directors on the board).

5.06 RBS made the decision to acquire First Active in 2003, effective 2004, and directed its subsidiary, Ulster Bank, to house the acquisition on behalf of RBS. This is an example of a decision reserved by the parent company to itself yet with consequences for the local subsidiary, Ulster Bank. As a non-executive director of Ulster Bank, the acquisition of First Active in 2004 concerned me from a governance point of view. I was concerned that the Ulster Bank board would be held responsible for this acquisition, notwithstanding that the board had no role in the acquisition. My concerns at the Ulster Bank board meeting of October 2003 are recorded in the minutes as follows:

5.07 **Ulster Bank board meeting minutes 23 October 2003**
"106/03 Group Profits Report
Professor Brennan enquired as to the extent of the due diligence work undertaken by RBSG on behalf of the Company, and on which the Board of Directors were placing reliance for the purposes of approving the Acquisition. The Chairman outlined the process but agreed to revert to Mr F Watt, RBSG Group Finance Director, requesting that he circulate a paper to the Board setting out the due diligence work undertaken."

6. Questions/Lines of inquiry

The Banking Inquiry has directed me to address 27 questions dealing with 16 lines of inquiry.

Q1 B1a Composition, skills and experience of board and board subcommittees

Director Fitness

Could you please briefly outline the Banking skill set and Financial Services qualifications you hold?

6.01 Qualifications
- BSc (Microbiology and Biochemistry), University College Dublin, first class honours (1976)
- Associate/Fellow (FCA), Chartered Accountants Ireland (1979)
- PhD (Accounting), University of Warwick (1995)
- Chartered Director (CDir), Institute of Directors (London) (2007)

Q2 B1a Composition, skills and experience of board and board subcommittees

Director Fitness

What experience and qualifications did you bring to the Board as a director?

6.02 Employments
- External auditor, Stokes Kennedy Crowley & Co. (now KPMG) (1976-1980)
- Lecturer in Accounting & Corporate Governance/Michael MacCormac Professor of Management, University College Dublin (1980–)
- Academic Director, UCD Centre for Corporate Governance (2002–)

6.03 I have taught and published extensively on Financial Reporting and Corporate Governance.

6.04 During my tenure with Ulster Bank, I had hands-on, board-of-director corporate governance experience as a non-executive director and/or board chairman as follows:

- Non-executive director, Lifetime Assurance Company Limited (Bank of Ireland's life assurance company) (1990–1999)
- Non-executive director, Co-operation Ireland (1991–2002)
- Board member, Coillte (the State forestry company) (1992–1997)
- Non-executive director, Ulster Bank (2001–2009)

- Non-executive director, Ulster Bank Ireland Limited (2003–2009)(chairman 2006–2008)
- Non-executive director, First Active (2005–2009) (chairman 2006–2008)
- Board member, The Health Service Executive (2003–2011)
- Non-executive chairman, Brennan Holdings Group (formerly an insurance broker; now an investment holding company) (2008–)
- Non-executive chairman, Dublin Docklands Development Authority (State planning and property organisation)(2009–2012)

6.05 During my tenure with Ulster Bank, I also had hands-on audit-committee corporate-governance experience as audit committee member/chairman as follows:

- Audit committee member, Lifetime Assurance Company Limited (1991–1999)
- Audit committee chairman, Co-operation Ireland (1991–2002)
- Audit committee member, Ulster Bank (2001–2009)
- Audit committee member, Department of Agriculture and Food (2000–2007)
- Audit committee chairman, The Health Service Executive (2004–2011)

6.06 My knowledge of the technicalities of banking was more limited. However, there was considerable banking expertise on the Ulster Bank boards at executive director level, RBS non-executive director level and independent non-executive director level, to complement my external auditing, financial reporting, corporate governance and audit committee expertise.

6.07 For example, chairman of the board (2001–2008), Dr Alan Gillespie, had worked at Citibank/Citigroup and at Goldman Sachs.

6.08 The RBS non-executive directors on the board also had extensive banking experience. RBS Group CEO, Mr Fred Goodwin, was a non-executive director of the Ulster Bank Group (2000–2007). Mr Millar McLean, RBS Group Company Secretary, was a non-executive director of the Ulster Bank Group (2001–2010).

6.09 The Ulster Bank executive directors also had considerable banking experience. Ulster Bank CEO and Ulster Bank finance director were ex-officio members of the Ulster Bank Group board. These were Martin Wilson (CEO 1998–2004; executive director 1991-2004; non-executive director 2004-2006), Cormac McCarthy (CEO 2004–2011), Ivan Laird (Finance Director 1995–2002), Richard Houghton (Finance Director 2002–2004), Michael Torpey (Finance Director 2004–2008) and Senan Murphy (Finance Director 2008–2011).

6.10 Another non-executive director who joined the board following the First Active acquisition, Mr Trevor Bowen, is a former partner of KPMG. During his time with KPMG he was the audit engagement partner for Ulster Bank. From that previous role as external auditor, his knowledge of the inner workings of Ulster Bank and of banking was considerable. Mr Bowen was chairman of the Ulster Bank audit committee.

6.11 There were a number of Ulster Bank non-executive directors who had considerable business experience in other sectors of the economy at the highest levels in their organisations. These include (together with their terms on the board):

- Mr Sean Dorgan, former CEO, Industrial Development Authority (chairman 2008–2013)
- Mr William Burgess, former CEO, IBM (2001–2006)
- Sir Nigel Hamilton, former head of the Northern Ireland Civil Service (2009–to date)

- Ms Lucy Gaffney, chief operations officer, Esat Telecom (2004–2007)
- Ms Eileen Gleeson, former advisor to the President of Ireland (2004–to date)
- Mr Peter Malone, former CEO, Jurys Hotels plc (2001–2005)
- Prof Peter McKie, CBE, former CEO, Du Pont, Northern Ireland (1997–2005)
- Lady Brenda McLaughlin, Chancellor, Queens University Belfast (2001–2009),
- Mr Mike Mills, former CEO, Ulster Carpet Mills (2006–to date),
- Mr Phil Nolan, former CEO, Eircom (2006–to date)
- Mr William P. O'Kane, founder of O'Kane Poultry Limited (19909–2002)
- Mr Martin Rafferty, former chairman, United Drug plc (1984–2003)
- Mr Ian Webb, chairman/former CEO, John Hogg and Company (2006–2013).

Q3 B1a Composition, skills and experience of board and board subcommittees

Director Training

As an Independent Non-executive Director (INED), did you think that you received sufficient induction and on-going development training to enable you to fulfil your role and responsibilities as a Director?

6.12 On joining the Ulster Bank board in June 2001, a half-day induction programme was scheduled for new board members after our second board meeting in September 2001. As our induction session commenced, news came to us of the events of 9/11. Given the seismic nature of those events, the formal induction session was interrupted.

6.13 Extensive one-on-one support was provided by management to assist the Ulster Bank Board in understanding the operations of the Bank, in particular, by the then CEO, Mr Martin Wilson and by the then Finance Director, Mr Ivan Laird.

6.14 RBS provided considerable support to the Ulster Bank boards, especially when new regulations were introduced. We received comprehensive briefing papers from RBS, for example, when changes were introduced into company law or to corporate governance regulations.

Q4 B1b Integrity of financial reporting

Management Information (MIS)

Were you satisfied that you were getting all the relevant information you needed to understand the risks and exposures incurred by your institution?

6.15 During my time on the Ulster Bank boards, I believed the boards were receiving all relevant information necessary for them to function effectively. As far as I was aware, Ulster Bank executives provided the Ulster Bank boards with all information they needed and were generally responsive in providing any additional information requested. The Banking Inquiry has furnished me with Core Documents that I have not seen before.

Q5 B1b Integrity of financial reporting

Management Information (MIS)

Were you satisfied you were able to discern the full financial position of the Group at all times?

6.16 As is usual on boards, the Ulster Bank boards only received data from management information systems (MIS) at a very high level. The financial-MIS data at board level was primarily accounting data, in the form of budgets, monthly management accounts and quarterly/half-yearly/annual financial statements. Significant management effort was expended in assuring the integrity of financial MIS. During my time on Ulster Bank boards, the financial MIS relating to the integrity of financial reporting was, in my opinion, effective.

6.17 Confirming my opinion of the quality of Ulster Bank's accounting systems, every year, Ulster Bank's external auditors, Deloitte, included the following statement in its external audit report:

> "We have obtained all the information and explanations we consider necessary for the purposes of our audit. In our opinion proper books of account have been kept by the Company. The Company Balance Sheet is in agreement with the books of account."

6.18 <u>Financial-MIS operational issue influencing accounting data</u>

The core documents reveal an Ulster Bank temporary financial-MIS operational issue. The Finance Director comments in his report to the Ulster Bank Board dated 27 April 2007 [UBI01906-37] that there were operational difficulties in producing month-end financial reports. As a result, while he was able to provide the Ulster Bank Limited board with the total numbers, he was unable to include the analysis of those total numbers into divisional results.

6.19 The problem was caused by the migration in October 2006 of Ulster Bank's financial MIS to RBS's IT systems in Edinburgh. This centralisation project was a highly complex IT project entailing significant risk. Management made a number of presentations to the Ulster Bank boards and Audit Committee providing assurance that project risks were well managed. Back-up plans were in place in the event of issues arising with the migration. As is clear from a number of Core Documents [see, for example, UBI00104-001], for a short time, the project experienced some operational issues. During this period, the Ulster Bank boards continued to receive accounting information at a high level. The 2006 Ulster Bank audited financial statements were successfully approved on 27 February 2007, with a clean audit opinion, only two weeks behind the normal annual financial reporting timeframe.

6.20 <u>Accounting error /misstatement Ulster Bank & Ulster Bank Ireland Limited 2007 Financial Statements</u>

In his evidence, former CEO Mr Cormac McCarthy referred to an error in the 2007 financial statements. This issue is relevant to the question of the integrity of financial reporting. The error was technical in nature relating to a highly complex area of accounting – consolidation – and was subsequently corrected. Details of the error and its correction are included in the Ulster Bank Limited 2008 financial statements, as follows:

6.21 **8. Financial instruments**

Restatement of the 2007 balance sheet

2007 balance sheet numbers have been restated to correct the misclassification of intercompany balances with related parties being members of the Ulster Bank Group and its ultimate parent, RBS. Some related party balances were classified as banking counterparties and subsequently have been moved to customer balances.

The impact of the restatement is shown below:

	Group			Bank		
	Previously Reported 2007 €m	Restated 2007 €m	Impact €m	Previously Reported 2007 €m	Restated 2007 €m	Impact €m
Loans and Advances to banks	**24,315**	**17,281**	**(7,034)**	**18,460**	**16,732**	**(1,728)**
- Comprised of						
- Loans to third party banks	4,211	4,211	-	4,146	4,146	-
- Loans to Related party banks	12,555	13,070	515	12,586	12,586	-
- Loans to Related party non banks	7,549	-	(7,549)	1,728	-	(1,728)
Loans and Advances to Customers	**36,476**	**36,760**	**284**	**35,082**	**36,810**	**1,728**
- Comprised of						
- Loans to third party customers	36,476	36,476	-	35,082	35,082	-
- Loans to Related party non banks	-	284	284	-	1,728	1,728
Deposits by banks	**34,022**	**18,476**	**(15,546)**	**32,529**	**17,835**	**(14,694)**
- Comprised of						
- Deposits by third party banks	2,729	2,729	-	2,679	2,679	-
- Deposits by Related party banks	15,232	15,747	515	15,156	15,156	-
- Deposits by Related party non banks	16,061	-	(16,061)	14,694	-	(14,694)
Customer accounts	**17,492**	**26,288**	**8,796**	**17,283**	**31,977**	**14,694**
- Comprised of						
- Deposits by third party customers	17,294	17,294	-	17,085	17,085	-
- Deposits by Related party non banks	198	8,994	8,796	198	14,892	14,694

Q6 B1b Integrity of financial reporting

Management Information (MIS)

As an Independent Non-Executive Director, did you think that the information (both financial information and other information) provided to the board was of sufficient quality to enable you to effectively challenge Management on their stewardship of the business?

6.22 As I responded in Q5, during my time with Ulster Bank, I was satisfied with the quality of the information coming to the Ulster Bank boards. That information was used to challenge management on its stewardship of the business. The Banking Inquiry has furnished me with Core Documents that I have not seen before.

If not, did you ever voice your concerns to other Directors or Senior Management and what action, if any, was taken?

6.23 During my time on the Ulster Bank boards, any concerns I had were expressed at formal board or committee meetings [see Document 2]. The concerns I expressed did not relate to the integrity of financial reporting. (See response to Q9 for further commentary on board interaction).

Q7 B1c Quality of business model setting process

Strategy

How much time was allocated in the agenda of the Board to discussing, monitoring and reviewing strategy and the development of the Bank's business model?

6.24 As is normal in large multi-national companies, the strategy for the group is first set by the parent company. Subsidiaries operate within group strategy. Thus, the strategy for Ulster Bank was set by RBS at a high level. Certain strategic issues were reserved to our RBS parent company and were not delegated (nor could they be delegated) to the local Ulster Bank board. An example of a strategy reserved to RBS is allocation of capital across the RBS Group. It is always a matter for a parent company as to how it wishes to resource the group/allocate capital.

6.25 The delegated authority from RBS to Ulster Bank is called the "High Level Controls" document [Document 1]. This document contains the board responsibilities for Ulster Bank. These specify the Ulster Bank board's strategic involvement as:

> **"3.3 Board Involvement**
> The Chairman will facilitate a Bank Board Strategy "Away Day". The purpose of this meeting is to:
> - Review performance against the previous years Operational Plan;
> - Review market conditions and prospects; and
> - Consider strategic initiatives and proposals from the business and support units.
>
> **3.4 Promulgation of Strategy**
> The implications of the Bank Board Strategy meeting will inform the context and preparation of the Operational Plan and Financial Budget for the coming year. The outcomes will also be taken into account by the Group Chief Executive to amend the list of initiatives involving the business and support units.
>
> **3.5 Board Approval**
> The Operational Plan will be considered by the Executive Management Board and recommended to the Bank Board and RBSG for approval."

6.26 Within the context of RBS setting group strategy, the Ulster Bank board spent considerable time on strategy at formal board meetings and an annual away day. The board and management attended an annual away day out of Dublin (generally in Dundalk or Monaghan). We discussed strategic issues such as the positioning of Ulster Bank in the Irish market, particularly by reference to other comparable high street retail banks, for example, AIB and Bank of Ireland; opportunities to grow Ulster Bank; branding and image of Ulster Bank. However, ultimately, Ulster Bank operates within high level strategic decisions of its shareholder, RBS.

Q8 B1c Quality of business model setting process

Peer Group Pressure

Can you give your views on the extent to which the business model of the bank was influenced by the activities of competitors and how important this was as a factor compared to other factors such as the quality of lending?

6.27 As an independent non-executive director, I personally did not experience peer pressure of any kind from any source during my time on the Ulster Bank boards.

6.28 Ulster Bank executives told the Banking Inquiry that they experienced peer pressure arising from the activities of their competitors. I was not so aware. While competitor analyses were tabled and discussed at board meetings, I considered competitor analysis to be a normal practice of any business.

6.29 I now believe pressure was being exerted on Ulster Bank executives by RBS, specifically the then CEO, Mr Fred Goodwin. As is normal in large multi-national groups, staff were very loyal to Mr Goodwin. I never heard an executive criticise Mr Goodwin, until after he left RBS in October 2008. This has been well covered by the journalist Iain Martin in his book on RBS [Martin, Iain (2013) *Making it Happen: Fred Goodwin, RBS and the Men who Blew up the British Economy*. Simon & Schuster, London].

6.30 To conclude, it is my opinion that any pressure in Ulster Bank came primarily from the CEO of the parent company, not from Ulster Bank's peers.

Q9 B1c Quality of business model setting process

Board Interaction

ln the documentation obtained by the Banking Inquiry there is limited evidence of comments from the Directors. Can you please outline your experience of challenging business models or proposals during Board meetings?

6.31 The minutes of Ulster Bank board meetings, as far as I am aware, are generally an accurate but highly summarised account of what took place at meetings. The extensive debate and discussion at meetings, many lasting four hours or more, inevitably cannot be recorded in the minutes word for word.

6.32 Minutes often do not identify what is being said by individual board members. Thus, the extent to which board members contribute to board meetings is hard to capture just from looking at minutes. You have to be in the boardroom to really understand the board dynamics.

6.33 Ulster Bank executives recognised and embraced the need for debate, questioning and challenge by the non-executive directors. Such behaviour was the norm, was expected. If non-executive directors asked a question or requested additional information, management went to considerable efforts to ensure that their concerns were addressed. Generally, issues raised at meetings were recorded in the minutes and also in the matters arising from the minutes at the following meeting. Matters arising from the minutes of meetings were almost always addressed promptly in advance of the next meeting. In general, items not resolved stayed on matters arising until resolution.

6.34 In a selection of extracts from minutes, I include contributions I am identified as having made at board and audit committee meetings [Document 2]. There are many other contributions in minutes ascribed to the board where, although I am not separately identified in the minutes, I was an active participant.

6.35 In my opinion, every Ulster Bank board member contributed substantively and positively to board meetings, expressing opinions, sharing knowledge, asking questions, challenging executives, etc. That was our job.

Q10 B1c Quality of business model setting process

External Advisors

Did the Board and the Executive Management take external advice on the business model for the bank, from whom and did you feel that their input was considered fully?

6.36 As a wholly owned subsidiary of RBS, Ulster Bank's business model was and is directed by the parent company. Adopting group strategy is the norm for wholly owned subsidiaries. From time to time, RBS executives (not external advisors) presented to the Ulster Bank board.

6.37 The board of Ulster Bank did not separately receive external advice on the business model for the Bank. However, management may have obtained the input of advisors.

Q11 B1c Quality of business model setting process

Growth targets

The levels of Earnings per Share and Profit before Tax (PBT) targets at 15%+ per annum seen, across the banks, might appear ambitious in a relatively mature market. What was your view on this?

6.38 Q11 is not a question about Ulster Bank *per se*; rather, it is a question about market conditions more generally.

6.39 The statement associated with this question, relating to profit-before-tax targets and general market conditions, is quite sweeping such that I do not feel competent to answer the question.

Q12 B1c Quality of business model setting process

Culture

Prior to and within the period of time examined by the Banking lnquiry there were a number of prominent episodes suggesting problems with the internal culture of individual credit institutions in lreland (DlRT, 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?

6.40 This is a broad industry-wide question which I can only answer by reference to my experiences with Ulster Bank. Ulster Bank has a process whereby all serious incidents (called Group Notifiable Events ("GNEPs")) are reported to its parent company, RBS. I have reviewed the GNEPs' register during my time on the Ulster Bank board. There were no GNEPs/episodes of the type referred to in this question.

6.41 In relation to the question of internal culture, in my opinion, there were three distinct cultures evident in Ulster Bank:

- When I joined the Ulster Bank board, a strong and distinctive conservative and prudent culture, as described by Sir George Quigley when he invited me to join the Ulster Bank board (see Section 4), was evident. In Ulster Bank, there was a strong emphasis on processes and procedures, which made sense to me.
- As RBS's acquisition of Ulster Bank began to bed down, greater ambition and performance demands became apparent, together with a command-and-control management style.
- In 2004, RBS acquired First Active which introduced another culture, referred to in the May 2004 Group Audit Committee meeting minutes as:

> **Group Audit Committee minutes 22 May 2004**
> **"5. Group JnternaJ Audit Report**
> Mr McCarthy advised that the increase in issues raised was not unexpected in an acquisition scenario, being indicative of the merging of two different cultures…".

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?

6.42 RBS had in place the full range of written governance policies reflecting the emphasis it placed on governance. Reflecting the command-and-control management style, there was a strong imperative from RBS that all group companies adopt RBS policies and that RBS policies operate consistently across the group. The Ulster Bank board reviewed and adopted all RBS governance-related policies, customising them where necessary to the Ulster Bank context. Examples of policies particularly relevant to defining ethics and values are RBS's Code of Behaviour for Employees and RBS's whistleblowing policy. Oversight of management's implementation of these policies is exercised by the Ulster Bank board with assistance from the internal and external auditors. To the Ulster Bank boards' knowledge, the policies were practiced across Ulster Bank.

Directors and senior management?
- were they included in personal objectives for all personnel to adhere to?

6.43 As a non-executive director, I would not have seen personal objectives for individual personnel. Setting personal objectives for personnel is a day-to-day HR management task/administrative matter, not a governance issue for the Ulster Bank board. Setting personal objectives for top role holders was not delegated to the Ulster Bank board by RBS. Rather, governance of Ulster Bank top-role-holder remuneration was reserved to the RBS board Remuneration Committee.

Q13 B1d Adequacy of board oversight over internal controls to ensure risk is properly identified, managed and monitored

Oversight and Control

Were there active discussions, challenges and remedial actions taken by the Board regarding risk management and internal controls?

6.44 The Ulster Bank boards actively discussed and, where appropriate, challenged management in relation to all issues brought to the boards' attention. Generally, management took any remedial actions necessary to address problem areas.

6.45 An example of this is the operational risk associated with the Dublin Mortgage Centre which was one of the most problematic internal control areas during my time on the Ulster Bank board. Problems in the Dublin Mortgage Centre first came to the Ulster Bank board's attention following an internal audit report in December 2006 [UBI02152-001]. Attached are extracts from Ulster Bank board and audit committee meeting minutes recording the active discussions and challenges by the non-executive directors concerning this issue and the focussed remediation actions taken by management [Document 3].

Q14 B1d Adequacy of board oversight over internal controls to ensure risk is properly identified, managed and monitored

Oversight and Control

Many of the risk related committees were composed largely of Senior Executives without Non-Executive Directors. Would this have affected the board's capacity to maintain an effective awareness of - and carry out appropriate assessment - of risks to the bank?

6.46 Ultimately, the risk appetite for Ulster Bank is set by its parent, RBS. Because of its command-and-control management style, RBS retained to itself many of the risk management functions that would otherwise be carried out by a stand-alone autonomous board. This is reflected in the Ulster Bank board terms of reference (see the "High Level Controls" document [Document 1]) which specified that the Ulster Bank board:

> "12. Receive and consider high level reports on matters material to the Group, in particular:
> (a) Relations with Regulatory Authorities;
> (b) Group Risk Management (including compliance matters);
> (c) Human Resources matters (including pension scheme arrangements);
> (d) Information Systems and Technology;
> (e) Health & Safety;
> (f) Disaster recovery;
> (g) Material litigation and claims;

(h) Premises;
(i) Audit matters;
(j) Signing authorities;
…
18. Consider and approve delegated authorities for expenditure and for lending, and for other risk exposures, subject to delegated authority from RBSG."

6.47 In obtaining assurance on risk-related internal controls, the Ulster Bank boards received reports, and approved delegated authorities (from RBS), for risk exposures, including:

- Annual Internal Audit Plan
- Annual Risk Management Plan
- Quarterly Internal Audit Opinion
- Quarterly Certification from the Ulster Bank CEO, required under the US Sarbanes-Oxley legislation of (i) compliance with minimum standards, (ii) no material unresolved breaches of policy, (iii) no significant control weakness [e.g., UBI02036-110]
- Quarterly Risk and Controls Assessment Report
- Quarterly Risk Management Report
- Minutes of Group Risk Policy & Controls Committee.

6.48 Referring back to the question, Ulster Bank's risk committee was an executive-level committee, i.e., an executive committee composed of senior executives comprising:
(i) RBS senior executives (representing RBS Group interests)
(ii) Ulster Bank executive directors (board representatives)
(iii) Ulster Bank senior executives (operational management)
No non-executive director sat on the Ulster Bank risk committee.

6.49 I do not know whether a risk committee, composed of senior executives only without non-executive directors, affected the Ulster Bank board's capacity to maintain an effective awareness of, and carry out appropriate assessment of, risks to Ulster Bank. Neither do I know whether a board-level risk committee including or composed entirely of non-executive directors would have resulted in a different outcome. The problem was not the risk committee (no matter how composed). The problem, in my opinion, was the risk-related functions reserved by the shareholder, RBS, to itself and not delegated to Ulster Bank.

6.50 In my opinion, the increasing demands of the shareholder, RBS, referred to earlier in relation to Q11, over time adversely affected Ulster Bank's risk appetite and RBS's oversight of risk in Ulster Bank.

Q15 B1d Adequacy of board oversight over internal controls to ensure risk is properly identified, managed and monitored

Management Information (MIS)

The documentation made available to the Banking Inquiry suggests that the Management Information reports and data available to Board Members contained deficiencies. Were the directors aware of this and how did they address such deficiencies?

6.51 Financial MIS and its impact on financial reporting integrity is addressed in my response to Q5. This question, Q15, relates to day-to-day operational-MIS available to staff on the ground to assist them in doing their jobs.

6.52 Such operational-MIS did not come to the Ulster Bank board. However, the quality of operational-MIS was:

(i) reviewed by executives in charge of day-to-day operations
(ii) audited by the internal auditors
(iii) reported to the Ulster Bank board when there were weaknesses.

6.53 A summary is included of references to management information weaknesses extracted from the minutes of board/audit committee meetings of which I was a member [Document 4]. The Ulster Bank board oversaw remedial action plans to rectify issues raised leading to improved management information systems.

Q16 B1d Adequacy of board oversight over internal controls to ensure risk is properly identified, managed and monitored

Concentration Risk

Did you have concerns over the increasing concentration of the loan portfolio in the property and construction sectors and if so, did you discuss those concerns with any member of senior management or any other Directors?

6.54 A summary is included of references to sectoral concentrations extracted from the minutes of board/audit committee meetings of which I was a member [Document 5]. These show Ulster Bank non-executive directors expressing concern about concentration in the property and construction sectors as early as 2001. These extracts from the minutes also show management assuring the board that there were no sectoral concentration issues. Finally, to my knowledge, Ulster Bank operated within regulatory sectoral concentration limits. This was confirmed to the Banking Inquiry by Mr Cormac McCarthy:

> "We believed that [sectoral limits as set by the Regulator at the time] to be a limit and we adhered to it"

6.55 The Ulster Bank board received limited data on sectoral concentrations, as a result of which the board did not express more concern on the increasing concentration of the loan portfolio in property and construction. For example, the Ulster Bank board did not receive reports on sectoral reviews such as the July 2008 "Ulster Bank Group Sector Review – Property Portfolio" [DEL00660-001] included in the Banking Inquiry core documents. This sector review was prepared by an Ulster Bank executive for submission to the Group Risk Committee, an Ulster Bank executive committee (see discussion of executive risk committee in Q14).

6.56 The key ratio reported to the Ulster Bank boards, to assure the boards that the Bank was operating within its regulatory limits, is the capital ratio. Ulster Bank always comfortably operated within its capital ratio (with the exception of one breach in April 2009). Further, as RBS always made capital available to support the business, I had no concerns about concentration risk.

Q17 B2b Appropriateness of credit policies, delegated authorities and exception management

6.57 Under Ulster Bank's delegated authority (High Level Controls document [Document 1]), oversight of lending was not delegated by RBS to the Ulster Bank board. Credit decisions made by Ulster Bank executives were approved through the RBS credit approvals processes.

6.58 In return, RBS gave a commitment to always adequately capitalise Ulster Bank. As former CEO, Mr Cormac McCarthy, said in his witness statement:

> "I was assured by RBS that capital and funding support would be made available to support growth. In this regard capital and liquidity management were not considered to be a critical local UB priority".

6.59 RBS has stood by this commitment.

Lending Outside Lending Policy

a. Were you aware of the extent to which your bank issued loans that were outside the stated lending policy?

b. Did you have any concerns about the volume of loans that were issued outside the stated underwriting policy?

c. If you had concerns about the loans issued that were outside lending policy, how often were these concerns raised, in what format were they communicated, what details were communicated and to who?

d. If reports were issued or concerns raised, how were they received by management and what action was taken?

e. Did you feel that you were kept fully informed about these issues, the actions taken to address them and the final conclusion?

6.60 In addressing questions Q17a to Q17e, extracts of the minutes of board and audit committee meetings dealing with mortgage lending outside policy have been collated [Document 6]. These extracts show:

a. The Ulster Bank board was aware of mortgage lending outside policy
b. The phrase "underwriting policy" is used in banks to refer to lending limits. As is evidenced from extracts of the minutes of meetings, the Ulster Bank board expressed concerns at mortgage lending outside policy
c. Concerning mortgage lending outside policy, the frequency, format, details communicated and to whom are reflected in the extracts of the minutes of meetings
d. In my opinion, management responsiveness to mortgage lending outside policy was less, compared with responsiveness to other issues (e.g., Dublin Mortgage Centre [Document 3])
e. At the time, I believed I was kept fully informed about mortgage lending outside policy. As shown by the extracts of minutes, the Ulster Bank boards are on record as not being satisfied about the actions taken such that we kept asking the same questions. When I left the Ulster Bank board in June 2009, this issue was ongoing.

6.61 To conclude, as is clear from the extracts of minutes of meetings [Document 6], the Ulster Bank board was concerned over a lengthy period at the extent of mortgage lending outside policy. Board members regularly expressed concerns and constantly requested management to regularise the matter.

Q18 B2b Appropriateness of credit policies, delegated authorities and exception management

Lending Outside Lending Policy

ln your opinion was there sufficient evaluation of the credit risk and policy monitoring by the Credit Committee independent of the commercial bankers.

6.62 Segregation of duties between front-line, customer-facing commercial bankers and lenders and credit approval was regularly raised by the Ulster Bank board. The Ulster Bank board was given assurances that credit approval processes operated wholly independently of customer-facing commercial banking staff.

Were such evaluations, and issues such as risk register monitoring and exceptions to policy, passed up the line to both the Senior management and the Board?

6.63 The mortgage lending outside policy issue is addressed in my response to Q17.

Equity in the other projects appears to have been used as a form of additional security or collateral for loan portfolios. Were these non-tangible assets in accordance with policy and were they independently valued?

6.64 This question, dealing with lower level day-to-day transactions with customers, is more appropriately addressed to management than to a non-executive director.

Q19 B2c Analysis of risk concentrations in base and adverse economic scenarios and impact on capital structure

Internal Audit Reviewing Stress Tests

Did Internal Audit perform a review on the actual stress test performed and, in particular, did Internal Audit review the formulas and assumptions used?

6.65 I do not know whether internal audit conducted a review of stress tests. The audit committee receives quarterly internal audit reports. These reports only highlight problem areas. I have reviewed all audit committee minutes and can find no reference to internal audit of stress testing. This does not mean it was not done.

Q20 B2c Analysis of risk concentrations in base and adverse economic scenarios and impact on capital structure

Internal Audit Reviewing Stress Tests

a. Did the bank employ the services of a suitably qualified, independent expert, to carry out a review on the stress tests that were performed and the reporting of the results?

6.66 I am not aware whether Ulster Bank employed the services of a suitably qualified, independent expert, to carry out a review on the stress tests that were performed.

b. Did you feel that you were adequately informed about the results of the stress tests and their significance?

6.67 As explained previously, the Ulster Bank board monitored risk concentrations at a high level in the form of capital ratios.

Q21 B2c Analysis of risk concentrations in base and adverse economic scenarios and impact on capital structure

a. Was there a review of the adequacy of the reporting to the Board of key risks (e.g. the concentration risk being faced by the bank, LTV, 100% loans etc.)?

6.68 I am not aware of a review of the adequacy of reporting to the Ulster Bank board of key risks.

b. Did the Board receive adequate reports on the concentration levels of Sectorial and Customer exposures?

6.69 As explained previously, the Ulster Bank board monitored risk concentrations at a high level in the form of capital ratios.

c. Between the period 2004 and 2008, did you have any concerns about the growth in lending concentrated in property development and focused on a small number of customers?

6.70 In relation to the reference in the above question concerning "growth in lending concentrated in property development", I have addressed the question in my response to Q16.

6.71 In relation to the reference in the above question concerning "a small number of customers", this has to be considered from (i) the Ulster Bank perspective and (ii) the RBS perspective. The Ulster Bank board did not receive an analysis of loans per individual borrower. As required by EU Directive *Monitoring and Control of Large Exposures of Credit Institutions* (92/121/EEC of 21 December, 1992), RBS has responsibility for monitoring and controlling large exposures (i.e., size of large customer borrowings). The purpose of this EU directive is to ensure that groups have oversight at a group level of large exposures, regardless of which company within the group from which the customer borrows.

6.72 In my opinion, the Ulster Bank board did not have the concerns it should have had about the growth in lending concentrated in property development and focused on a small number of customers because data on these matters did not come to the Ulster Bank board.

d. Were the various risks associated with these concentration levels adequately reported and discussed bv the Board?

6.73 See response to Q16 earlier.

Q22 B4c Adequacy of valuation policies and assumptions to accurately assess loan security

Valuation of Assets

NAMA reported that when loans were transferred to them, they had problems with a large amount of assets taken as security. ln particular, a large number of assets taken as security, were not registered and that in a number of cases, an asset was presented as security for loans with multiple banks;

Although Ulster Bank did not participate in NAMA: -

a. Were you aware of similar problems within Ulster Bank?
b. What is your understanding of these issues?
c. Did you raise this as an issue and if so what action was taken?

6.74 Yes, I was aware of problems in Ulster Bank, with inadequate legal documentation perfecting Ulster Bank's title over assets on which lending was secured.

6.75 There were three levels of internal audit findings (from least to worst): important, significant, major. The internal audit Q4 2006 Quarterly Report referenced (p. 18) the following "significant" audit finding in relation to the Dublin Mortgage Centre:

> "Control of documentation required to obtain legal title over mortgaged properties is inadequate and ineffective."

In the internal audit Q3 2007 Quarterly Report (p. 5), the internal auditors report that they closed this recommendation in the quarter, meaning the issue was resolved by management.

6.76 Group Internal Audit raised "Security for Advances" as a "significant" internal audit issue in its Q4 2005 Quarterly Report. The finding was expressed as follows:

> "While Business Banking within the Republic of Ireland had already identified that security for advances is not always perfected, we highlighted that limited action had been taken to resolve this issue."

Subsequently, the Q1 2006 Internal Audit Quarterly Report reported that action plans to resolve this issue had been agreed with management. This significant audit issue remained an open item in the Q2 2006 and Q3 2006 internal audit reports. The item was not mentioned in quarterly internal audit reports thereafter. I am informed by Ulster Bank management that this issue was closed on 31 August 2007.

6.77 I raised the question of security at the February 2008 Ulster Bank Ireland Limited meeting as follows:

> **"Ulster Bank Ireland Limited minutes 14 February 2008**
> <u>04/08 – Chief Executive's Report</u>
> The Chairman [Niamh Brennan] introduced the Chief Executive's Report that had been circulated in advance of the meeting….Responding to a query raised by the Chairman [Niamh Brennan] as to whether the security issue in respect of the Wealth client investment is indicative of a larger problem with regard to security, Mr McDonnell confirmed to the Board that he was satisfied with the controls in place and that this was not a systematic issue."

Q23 B5a Adequacy of incentive and remuneration arrangements to promote sound risk governance

Remuneration

a. Can you outline the criteria for annual targets for senior management (i.e. were annual targets based on sales volumes, or percentage of market share etc.)?

b. How much weighting was given to risk modifiers when reviewing annual targets?

c. Were management offered non cash incentives?

d. Were non-performing loans considered when reviewing annual targets of the staff who sourced or underwrote them?

e. Up to 2008, had any staff member ever been removed or demoted as a result of sourcing or underwriting a non performing loan?

f. Can you comment on the decisions of the banks to offer severance packages to the senior executives after 2008, in light of the very significant losses the banks were booking at this time?

g. Can you outline the range of packages that were offered to senior executives who availed of early retirement or who resigned?

h. Please detail how many senior executives, to your knowledge, resigned (retired) from the bank without receiving a severance package?

6.78 As Ulster Bank is a wholly owned subsidiary of RBS, in a number of significant respects its governance differs from that of stand-alone organisations such as listed publicly quoted companies. One of those differences is that remuneration of a subsidiary CEO is negotiated with and determined by the Group CEO. Reflecting this difference, the Ulster Bank board did not have a remuneration committee. In his evidence, Mr McCarthy has referred to his remuneration being subject to governance oversight from the parent-company RBS board through the RBS-board Remuneration Committee.

6.79 The Ulster Bank board had no role in, or knowledge of, the remuneration of Ulster Bank's CEO or top role holders. Only once, in 2009 shortly before I left the board, at an audit committee meeting, was the CEO's remuneration mentioned. This was in the context of a discussion on the financial reporting requirements to disclose that remuneration publicly.

6.80 The Ulster Bank board was concerned at the effect of incentive remuneration on risk-taking within the Bank and queried how staff were incentivised. In response to our questions, management discussed incentive remuneration at branch level. No mention was made of top-role-holder remuneration. Bonuses to branches were based on a range of branch performance measures, using a balanced-scorecard methodology. Under this incentive scheme, branch performance (and not individual performance) was rewarded. The incentive remuneration pot awarded to the branch was then divided among individual branch staff. The minute below is an example of such a board discussion.

Ulster Bank Limited minutes 24 October 2001
"128/01 Project Horizon Update
Continuing, Mr Reid advised that the new sales points incentive scheme (Performance Plus), which was currently operating in 29 of the 34 branches already transformed under the Horizon model, had been well received by staff and was driving the appropriate behaviour in terms of customer service."

6.81 I questioned the influence of incentives on selling at the December 2003 Ulster Bank Limited board meeting as follows:

Ulster Bank Limited minutes 11 December 2003
"127/03 Chief Executive's Report
Mr Wilson advised that the Bank would be challenging the court decision in the case of [● redacted customer information], where the Bank was ordered to pay damages, the court having found that the Bank had missold a Farm Development Loan. Professor Brennan queried the extent to which the group has robust controls over selling techniques, in an environment where staff are incentivised on the basis of sales. Mr Bamber advised that the code of values within Retail is that good service is in the interest of the customer. He had introduced a new upward communications initiative "Speaking up in Retail" by which all Retail staff have his e-mail address and contact number, and can notify him of any concerns they may have. It was further noted that although it was impossible to confirm that all staff were adopting fair selling techniques, Mr Bamber was content that through the medium of the Retail Operational Management Meeting unusual sales patterns, that might indicate an issue, can be identified and investigated.

Q24 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?

6.82 As far as I am aware, no independent review by an external party/internal auditor of the risk culture and appetite of Ulster Bank was carried out.

Q25 B7a Impact of prevailing accounting standards in recognising risks

IAS 39

6.83 In my opinion, there are two accounting standards influencing bad debt provisioning: (i) International Accounting Standard (IAS) 37 *Provisions, Contingent Liabilities and Contingent Assets* and (2) IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 37 demoted the fundamental accounting principle of prudence. This was done to stop abuses at the time of over-provisioning by companies. IAS 37 (paragraph 14) introduced three conditions to be met before a provision can be made. Following the banking crisis, we now know that the IAS 37 change demonstrates the law of unintended consequences. While the over-provisioning problem may have been addressed, the accounting standard reduced flexibility in provisioning for future bad debts. IAS 39 (paragraph 59) repeats the three IAS 37 conditions before which a provision can be made and, further, specifies that companies must provide "objective evidence of impairment". Thus, IAS 37/IAS 39 tended to prevent companies from making robust bad debt provisions during what appeared to be strong economic conditions, when there was no evidence of stress in the loan book.

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

6.84 Yes, the adoption of IAS 39 was discussed at Ulster Bank meetings, as captured in the November 2005 group audit committee minutes, as follows:

> **Group audit committee minutes 17 November 2005**
> <u>"7. Group Risk Management Report</u>
> Mr McDonnell drew the Committee's attention to the provision charge which is now being presented under IAS39 rules, noting that he expected the charge for the year to be largely in line with plan. Responding to the Committee, Mr McDonnell confirmed that he was content that the [● redacted customer information] provision was a specific case which went wrong, where with hindsight the decision to build out was the wrong one to make, but was made at a time when subsequent title issues had not been identified, and was not reflective of a systemic problem within the sanctioning process."

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

6.85 The Ulster Bank board fully understood the implications of IAS 37/IAS 39, i.e, that bad debt provisions could not be made at the top of an economic cycle. The CEO, Cormac McCarthy, constantly correctly observed that the accounting standard was "pro-cyclical" when it should have been "anti-cyclical". Banking is well-known to be cyclical from an economic point of view. This means that in good times a counter-/anti-position should be taken such that provisions are set aside for future low points in the cycle.

c. Did the board seek an accounting specialist to advise on the implication 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 provided for the "Provision for Bad Debts" was adequate and in hindsight do you feel that the amount provided should have been different?

6.86 There was little the Ulster Bank board could do. Companies have no choice but to comply with accounting standards. IAS 1 *Presentation of Financial Statements* requires companies to include in their financial statements an explicit and unreserved statement of compliance with international accounting standards. Such a statement can only be made on compliance with <u>all the requirements</u> of international accounting standards.

Q26 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 your 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?

6.87 I was not aware of the existence of, nor did I attend, Financial Roundtable meetings.

Q27 Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the Banking Institutions

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

6.88 I had no interaction with the Central Bank or the Financial Regulator.

7. Lessons to be learned

7.01 ① We've been here before
In 2001, the seventh largest US corporation, Enron, collapsed in the biggest financial reporting fraud in commercial history. The Enron collapse was so seismic that it destroyed its auditors, Arthur Andersen. Following Enron, draconian legislation was introduced in the form of the Sarbanes Oxley Act, 2002. This legislation applies to RBS and to some Irish financial institutions by virtue of their stocks being listed on US stock exchanges. The Sarbanes Oxley Act, 2002 extends to all subsidiaries of US listed companies and applies to Ulster Bank (see, for example, the Sarbanes-Oxley Quarterly Certification from the Ulster Bank CEO [UBI02036-110]). The intention of the Sarbanes Oxley legislation was that such seismic corporate governance failure could not happen again. Clearly, the Sarbanes Oxley Act, 2002 was not effective in preventing the global financial crisis.

7.02 ② Is more regulation the answer?
Many worthwhile new regulations have been introduced following the banking crisis. However, will it turn out that these reforms will be just like the Sarbanes Oxley legislation and not protect us from the next crisis? Will more rules and regulations improve governance? Or is something more required in addition to more regulation?

7.03 Mr Eugene Ludwig, who investigated the AIB Rusnak Affair (one of Ireland's biggest frauds), is credited with dramatically improving supervision of the American banking industry when he was national banking regulator (27th Comptroller of the Currency). He said in an RTE interview that he did not look for more regulatory powers; rather he enforced his existing powers.

7.04 ③ The great dance of governance
Legislators, regulators, boards and directors need to stand back from the "*the great dance of governance*" (Bloomfield 2013, p. 392) and look at the bigger picture. Since the global financial crisis, the opposite has happened. The great dance of governance has become greater. There are significantly more rules and regulations, further obfuscating the need to stand back. [Bloomfield, Stephen (2013) *Theory and Practice of Corporate Governance. An Integrated Approach*. Cambridge University Press, Cambridge]

7.05 ④ Geology versus geography
As Stephen Bloomfield has observed, there is too much emphasis on the "geography" of governance and not enough on "geology" of governance. The "geography" of corporate landscapes manifests in governance structures, such as boards, board committees, risk management processes, etc. But to what extent is the "geology" – that which lies underneath – adequately taken into account?

7.06 ⑤ Risk management systems can create a false sense of security
In "*the great dance of governance*", a great deal of board, audit committee and management time is spent on risk management and risk management processes.

Boards are surrounded by processes, reporting up, reporting down. This can lull governors and managers into a false sense of security that risks are being well managed. Perversely, such a false sense of security can lead to the opposite – increased risk taking. Governors and managers need to stand back and asked basic common-sense risk-orientated questions such as: "What should keep us awake at night?"

7.07 ⑥ The insatiable appetite for growth
From 2001 to 2008, RBS and its CEO Fred Goodwin were fêted for their achievements. For example, Harvard Business School wrote case studies of RBS's success. The market, the media and commentators all signalled their approval of RBS's extreme growth. That positive feedback fuelled (I believe more so than any incentive remuneration) further growth. The market's insatiable appetite for growth has to be questioned. Is the market ready for more prudent lower sustainable growth levels?

7.08 ⑦ Understanding governance constraints: subsidiary companies
In relation to Ulster Bank, the major governance weakness was how governance was allocated between the parent company and its subsidiaries. Boards of regulated financial entities need to be able to govern on a stand-alone basis. This means that parent companies need to delegate more to subsidiary boards to give those boards the power and authority to meet their statutory and regulatory responsibilities in a holistic manner.

7.09 ⑧ Application of regulations to subsidiaries
Often regulators do not understand the nuances of governance of different types of organisation. Application of regulations to subsidiaries requires different considerations to stand-alone autonomous entities. For example, do regulators understand the difference between functions reserved to parent companies versus functions delegated by parent companies to their subsidiaries? Regulators need to scrutinise parent company governance in order to understand what functions they have retained to themselves and what has been delegated to their subsidiaries.

7.10 ⑨ The relationship between parent companies and their subsidiaries
I have referred in this statement to the RBS command-and-control management style. A command-and-control management style is necessary in multinational entities to ensure all parts of a group operate to the same standards regardless of location. The strong RBS command-and-control management style over time became subservient to the increasing ambition of the organisation.

7.11 ⑩ Power dynamics
Board effectiveness is a function of power dynamics. Power dynamics can be influenced by a variety of factors, such as competence of non-executive directors, effort levels of non-executive directors, executive directors "wearing their directors' hat" in the boardroom, the presence of dominant individuals. In the case of RBS, its dominant CEO adversely influenced the power dynamics within the organisation. None of these factors are capable of regulation. They go to the heart of governance – the "geology" of governance.

7.12 ⑪ Limitations on the role of non-executive directors
While non-executive directors are valuable corporate governance mechanisms, it can be difficult for them to have management follow through on board requests. In the case of subsidiaries, the power relations of subsidiary boards are more limited compared with the exercise of power by parent company boards which, for example, have the ultimate power to hire and fire senior executives.

7.13 ⑫ Accounting is highly judgemental
Many observers of the banking crisis will wonder how bank financial reporting turned out to be so wrong. The problem with almost all accounting information is that, while it has the appearance of precision and accuracy, it is the product of extensive subjective judgements. Most non-accountants do not understand the extent to which accounting is a matter of judgement. Bank financial statements were, with the benefit of hindsight, flawed. The judgements behind the accounting numbers were too optimistic. Specifically, receivables from customers were overstated because they did not reflect people's inability to repay their borrowings which subsequently came to light.

7.14 ⑬ Concluding comment
Taking into account the limited delegation of powers by RBS to the Ulster Bank boards, I am satisfied that Ulster Bank board members functioned at all times to a high standard of professionalism and integrity and that the non-executive directors, including myself, performed the functions expected of us to proper professional standards.

7.15 In retrospect, it is now clear that growth in lending and, in particular, lending to the property development and construction sectors made Ulster Bank, like other Irish banks, vulnerable to a collapse in property values. The local bubble in the property and construction sectors, coupled with the international disappearance of funding liquidity consequent on a global financial crisis, brought about the systemic failure of the Irish banking system.

7.16 Primary responsibility for avoidance of failures in the banking system lies with the individual banks which, regardless of competitive pressure, owe it to their customers and shareholders to follow sober, prudent, circumspect and sustainable policies in relation to their commercial lending, mortgage lending and growth model planning.

7.17 In the case of RBS and Ulster Bank, these policy issues were mainly decided at RBS Group level, rather than at the level of RBS subsidiaries, and were implemented by executives in accordance with RBS Group-level strategies.

7.18 The overall economic climate and zeitgeist was an optimistic one of semi-permanent growth. Executive performance was judged and remunerated across the banking industry in that context. Prudence and conservatism were not emphasised or valued or remunerated in the same way as pursuit of growth in lending and expansionary policies. There were few countervailing values or forces.

7.19 Irish banks were operating in a competitive environment in which the prudential role of the Central Bank at the time, viewed from outside, was muted and limited.

7.20 In retrospect, I am of the view that in the case of a regulated bank, which was in turn the subsidiary of a regulated bank, it was unlikely that its board or the non-executive directors could have acted differently from the way in which they did at the time, given the nature and levels of prevailing knowledge and expectations.

7.21 Like everyone else who participated in the banking sector during the Celtic Tiger years, I deeply regret the systemic failure that occurred and was allowed to occur, and the consequences for so many people who have suffered and continue to suffer so much hardship.

7.22 There are lessons to be learned – in relation to the governance, regulation and political and economic mind-sets which allowed systemic failure in the banking sector.

7.23 I wish the Banking Inquiry every success in drawing together the strands of what happened with a view to ensuring that these events do not recur.

Confirmation

I confirm that the documents provided by me, and exhibited in the metadata sheet accompanying this witness statement, are true and correct. Further, I believe that these documents are not in the public domain.

Niamh Brennan

____

Prof Niamh Brennan
6 August 2015