Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Seamus McCarthy

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

Statement to Joint Committee of Inquiry into the Banking Crisis by Seamus McCarthy, Comptroller and Auditor General

Effectiveness of the Use of Supervisory Powers (Line of Inquiry R2a)

The Central Bank Act 1997 (as amended), provided for the Comptroller and Auditor General (C&AG) to carry out examinations of the efficiency of the Central Bank/Financial Regulator and of the systems, procedures and practices used by them to evaluate the effectiveness of their operations. Under that mandate, three special reports of the C&AG have dealt with the regulation of financial services providers.

- Special report 34 (December 1999) examined the prudential supervision undertaken by the Central Bank of credit institutions and investment firms. (This was completed when the PAC's DIRT inquiry — also banking related — was underway.)
- Special report 57 (May 2007) was a review of all the Financial Regulator's operations from its establishment in May 2003.
- Special report 72 (December 2009) was a review of the Financial Regulator's response to the crisis in the financial markets.

The primary focus of the examinations was on the efficiency of the Regulator's processes. An assessment of the Regulator's prudential judgments did not come within the scope of the examinations.

The following comments are based on themes in the findings of the reports relevant to this line of inquiry.

Approach to Prudential Regulation

Two contrasting approaches to the regulation of financial services have been referenced.

- **Principles-based regulation** — this involves the setting of a limited number of high-level principles to be adhered to by financial services providers, and which may be supplemented by guidelines to explain how the principles should work in practice. The statements of principles are intended to allow services providers a degree of discretion and freedom of action in how they conduct their business.
- **Rules-based regulation** — this involves setting detailed rules to be complied with by financial services providers, covering relevant aspects of how they do their business and how they manage relationships with their customers/investors and with the regulator. This approach may provide financial services providers with a high degree of certainty about what their regulators expect, but it may also result in high compliance costs.

In practice, in most jurisdictions, the approach to regulation of financial services providers falls between the pure models, based on a pragmatic combination of the two approaches.

Under either model, the extent to which services providers comply with the standards — whether principle or rules — has to be tested in some way, and enforcement actions should follow, if required.

The 1999 special report found that the Central Bank had adopted a 'light-touch' approach to prudential supervision, with limited on-site inspection activity combined with review meetings with the management of the institutions.

The 2007 report found that the Financial Regulator had inherited a varied and sizeable body of rules, regulations and guidelines. However, the Financial Regulator stated that, to the extent that it could do so, it intended to follow a more principles-based approach to regulation generally. This continued the previous Central Bank 'light touch' approach.

Risk assessment

The 1999 report found that the Central Bank did not base its prudential supervision effort on a formal risk-based approach, and recommended that such a system be developed. It also concluded that, if a formal risk assessment were instituted, the prudential risk profile of services providers in a financial services sector (e.g. credit institutions) could potentially be used to gauge the stability of the overall sector.

The 2007 report found that the Central Bank had commenced the process of developing a risk assessment model, and had carried out a review of models in use in other jurisdictions. On its establishment, the Financial Regulator had implemented a formal risk-rating model. The first iteration of the model was undertaken in 2004, albeit with many 'don't know' answers reflecting gaps in prudential supervision knowledge. A second round, with better information, was undertaken in 2005. This allowed the Financial Regulator to rank financial services providers based on their risk rating — a **relative risk model**. The risk ratings were then used to allocate the available resources.

The report concluded that while significant progress had been made in moving to risk-based supervision, the Financial Regulator could enhance the usefulness of the risk-rating model by formally defining risk categories and the appropriate supervisory stance for each category — an **absolute risk model**. This would provide the Financial Regulator with a risk-related basis for identifying the level of resources required for supervision work. It would also provide a measure of the stability of the overall sector, or at least an indication of a shift over time in sectoral risk.

Prudential returns

The Financial Regulator requires regulated bodies, at specified intervals, to submit formal reports and data about relevant aspects of their businesses — these are referred to as 'prudential returns'. The 2007 report found that quarterly returns from credit institutions were due within 15 working days of the end of quarter, and were generally submitted on time in electronic format.

Quarterly returns from credit institutions were received initially by the Statistics Unit of the Central Bank, where they were subjected to validation checks. (This arrangement ensured that the Central Bank had prompt access to all the standard prudential data for its own purposes, including financial stability assessments.) They were then sent to the Regulator's Banking Supervision Department, which analysed the data and produced a composite management report within 13 working days.

Using the prudential returns, the Financial Regulator prepared a quarterly report (the 'prudential pack') which provided detailed analysis of the solvency of financial services providers and the corrective action (if any) being taken to address concerns. This report was intended to provide assurance to the Authority and senior management on issues relating to the solvency and soundness of financial service providers.

Prudential Inspection

The 1999 special report on the examination concluded that the frequency of on-site prudential inspection appeared low, and that target levels of inspection set by the Bank were not being achieved. The 2007 report found a similar pattern — the frequency of inspection visits to financial services providers remained low, and the target levels of inspections were not being carried out.

The Regulator's inspection manual included the objective of carrying out a general inspection of every financial service provider at least once over a four-year cycle. In practice, the level of general inspection being achieved in most sectors was significantly less than the implied minimum 25% level. For example, only 8 (17%) of the credit institutions based in Ireland were subjected to on-site inspections in 2005, albeit those institutions accounted for approximately 56% of the gross assets of the banking sector.   In addition, the general focus of the inspections was on a high level review of the credit institution's systems — visits were generally confined to the financial services provider's head office, and branch visits were rarely included.

The Regulator was aware that its frequency of prudential inspections and their duration and scope were less than in most other equivalent national regulators, but justified this on the basis of its principles-based approach.

The 2007 special report recommended that the Regulator should arrange for an independent review of the adequacy of its prudential processes, including the target frequency and duration of inspections, the resource levels applied, the checks carried out on-site and the follow-up processes. We suggested that this be carried out by means of peer review i.e. by involving a number of experienced staff from other national financial regulators.

Instead of commissioning an international peer review, the Regulator commissioned consultants (Mazars) to carry out a review of the adequacy of its prudential inspection process as part of an overall operational review. By the time this was completed, the banking crisis was already unfolding. Mazars' report confirmed the low level of resources devoted to banking supervision, relative to other national regulators.

The 2009 special report found that the Regulator had significantly intensified its supervision of the credit institutions that had availed of the State guarantee for banking liabilities. However, it recommended that the Regulator consider incorporating a greater emphasis on testing of transactions and balances in its inspection work since risk-based systems can only function optimally when informed by 'on-the-ground' evidence based on actual transactions.

Enforcement

The 2007 report found that the Financial Regulator was using its enforcement powers in a limited way. While it had stated publicly that it would not hesitate to pursue sanctions where appropriate, its goal was to resolve issues to the benefit of consumers speedily and efficiently. It stated that its philosophy was guided by the principles of better regulation, particularly the principles of necessity, proportionality and effectiveness. It encouraged early settlement as a more cost-effective solution than a full inquiry.

Cost of Regulation

From its establishment in 2003, the Financial Regulator operated as a stand-alone entity within the (then) Central Bank and Financial Services Authority of Ireland (the CBFSAI), and under the direction of the ten-member Irish Financial Services Regulatory Authority. Many support services (ICT, HR, accounting) were shared with the Central Bank. By statute, six members of the Authority, including its Chairman and the Chief Executive of the Regulator, were also members of the Board of Directors of the CBFSAI, accounting for half of the latters' complement.

For financial reporting purposes, the Regulator's affairs were included in the financial statements of the CBFSAI. For the purposes of setting a budget for the Regulator, and setting regulatory levies, an (unaudited) account of the Regulator's income and expenditure — itemised by sector — was prepared.

The proposed annual levies were subject to approval in advance by the Minister for Finance, who directed that 50% of the costs of regulation were to be recovered through levies (with the balance to be covered by the Central Bank). The budget proposal was submitted to the Department together with separate commentaries by the statutory consumer and industry consultative panels. In effect, this consultation/approval process determined the level of resources available to the Regulator for its work. The Committee may wish to consider if this is consistent with the generally accepted principle that a prudential regulator should have operational independence and adequate resources.

The cost of regulation of the banking sector in 2005 was estimated at around €14 per €million of total banking assets. While international comparison of costs are difficult (because of differential salary levels and differing mandates), it was noted that the Irish cost level was similar to the cost level in France, and a little higher than the cost level in the UK and Germany. The cost of banking supervision in Singapore and Hong Kong was estimated at twice that level; in the US, the cost of banking supervision was over 10 times higher.

Overall

The 1999 and 2007 special reports pointed up weaknesses in the prudential regulation of credit institutions (and of other financial sectors). The Central Bank/Financial Regulator responded to some of the recommendations made to address those weaknesses slowly, and/or in a limited way. In general, these were recommendations which would have required significant additional resources if they were to be addressed properly, and which would probably have imposed a greater regulatory burden on regulated bodies. Lack of availability of resources appears to have dictated the strong adherence by the Financial Regulator to principles-based and 'light-touch' regulation.

Looking back, I see little evidence that there was any strong or consistent incentive or motivating force within the Financial Regulator, the consultative panels, the Central Bank or the Department of Finance (or in the wider administrative system) to ensure that the prudential regulation of financial service providers would be effective. In contrast, there was an evident strong motivation to increase consumer protection in response to a series of consumer-focused banking controversies.

Operation and Effectiveness of NAMA (Line of Inquiry C4b)

The functions of the National Asset Management Agency (NAMA) are to acquire property-related loans made by the credit institutions that participated in the NAMA scheme, to protect and enhance those loan assets and their underlying collateral, and to engage in workout arrangements designed to dispose of the loans or the underlying assets.

Under the National Asset Management Agency Act 2009, I have two non-discretionary functions

- to audit the annual financial statement of NAMA, and each of its group entities
- to carry out triennial reviews to assess the extent to which NAMA has made progress towards achieving its overall objectives.

The first triennial review was carried out for the period 2010 to 2012. The second is scheduled to cover the period 2013 to 2015, and planning work in relation to that examination is underway. Accordingly, I am not in a position to comment in this statement on what progress NAMA may have made since the beginning of 2013 in achieving its objectives.

In addition, two discretionary examinations were carried out (under section 9 of the C&AG (Amendment) Act 1993) into NAMA's economy and efficiency in the use of its resources and of the effectiveness of its management systems.

- Special report 76 (November 2010) reported on the structures, systems and procedures put in place by NAMA to implement its functions, and on the outturn of the first loan acquisitions
- Special report 79 (May 2012) reviewed the loan acquisition process and how NAMA was managing its relationships with its borrowers.

The comments that follow are based on the results of the reports referred to above, and those of the annual audits of NAMA financial statements from 2010 to 2014 inclusive.

Loan acquisition

Broadly speaking, NAMA was required to acquire loans to debtors related to property development and all other loans to those debtors, referred to as eligible bank assets. NAMA had discretion to decide whether or not to acquire an eligible asset, and considered a number of factors — including, for example, the scale of a debtor's exposure to land and development relative to their total exposure — when deciding whether to acquire a loan.

Ultimately, NAMA acquired almost 90% of the eligible assets it identified, acquiring over 15,000 loans at a cost of €31.8 billion from five credit institutions. The face value of the loans and associated financial derivatives acquired was €74.4 billion. This crystallised losses in the banks of €42.6 billion or 57% of the amount owed by borrowers. These losses contributed significantly to the level of financial support required by the banking sector from the State, but also removed a considerable element of the prevailing uncertainty about the credit institutions' financial position in the aftermath of the banking crisis.

The loan acquisition process was carried out expeditiously by NAMA. Almost all of the loans had transferred by the end of 2010. The acquisition price of all loans was finalised in 2012, following completion of a lengthy legal due diligence and loan valuation process.

Loan valuation

Audits and examinations carried out by my Office concluded that the property valuations, legal due diligence and loan valuation processes employed by NAMA were adequate and complied with regulations made by the Minister for Finance in March 2010.

The values at which eligible bank assets were acquired were determined using a methodology approved by the European Commission. The process valued loans by calculating the present value of the cash flows associated with the loans' underlying collateral using discount rates that were set down in regulations.

It is estimated that approximately 22% of the amount paid by the State to the banks represented State aid. This is partly related to an in-built uplift to the long-term economic value of the assets in the valuation model, but also reflects the higher discounts that would likely have occurred if the assets had been sold immediately to the market in an impaired loan situation.

Real estate accounted for almost 95% of the collateral provided by borrowers. The market values of those property as at November 2009 and the long-term uplift (8% on average) applied to those values were the key determinants of loan values.

In order to gain assurance about the property valuation, my Office used the services of the Valuation Office and of a former Commissioner of Valuation in Northern Ireland to review the process applied by NAMA. In regard to the valuations at November 2009, the advisors found that all of a sample of valuations examined had been carried out in accordance with the requirements of the Royal Institution of Chartered Surveyors 'Red Book', were in accordance with recognised national and international professional standards and that the valuers used by NAMA were qualified to carry out the valuations. This was consistent with the standard industry approach to valuation of property.

Dealing expeditiously with assets and protecting/enhancing their value

NAMA's predominant relationship with its borrowers is one of lender-borrower. Around 85% of the loans (by value) are managed directly by NAMA. The remainder are managed on NAMA's behalf by the participating credit institutions. The bulk of the property associated with the loans continued to be managed by debtors.

By mid-2012, NAMA had management strategies in place for all debtors. It had adopted five broad strategic approaches including full or partial restructuring of loans (€9.5 billion of acquired debt), support for debtors subject to the achievement of certain milestones (€7.4 billion) and consensual disposal strategy (€7.6 billion). The remaining debtors (€7.3 billion) were subject to enforcement.

At the end of 2014, insolvency practitioners (usually receivers) had been appointed to some or all of the assets of around a half of the original NAMA debtors.

Collateral management

A key challenge for NAMA was to develop an approach to property collateral that would enable it to achieve its objective of maximising the income potential of assets and their disposal value.

Property values in Ireland continued to decline after loan acquisition. During 2011, NAMA adopted various strategies to guide its management of different properties. In broad terms, it considered whether: to dispose of properties in the short-term; to hold them for later disposal; or to add value through further development. Different strategies were adopted for different property classes and locations e.g.

- **investment properties** — the approach was, in general, to sell properties in London, hold properties in Ireland and to assess other markets individually
- **completed residential assets** — the preferred approach was rental of properties generating rental yields of 5% or more
- **hotels** — the strategy was to progress the early sale of hotels in Great Britain and Europe and to protect the recoverable value of Irish hotels until conditions improved
- **land and development assets** — assets were generally held. NAMA concluded that demand would return at a different pace in individual markets, and expected weak demand to continue in Ireland in the medium-term.

Realised value of assets

At the end of 2012, NAMA had achieved almost €7 billion in proceeds from property and loan disposals. Over 80% of these had been in Great Britain, with the bulk of these in London. Just 9% of disposals were in Ireland. This was broadly in line with the disposal strategies set out by NAMA.

By the end of 2014, total property and loan disposals amounted to around €18 billion. Just under 60% were in Great Britain while 29% were in Ireland. During 2013 and 2014, the level of disposals in Great Britain and Ireland was broadly similar.

My Office examined the process used by NAMA in the period up to the end of 2012 to dispose of a sample of 144 properties with gross projected proceeds of about €1 billion. Overall, the examination found evidence that almost all property disposals reviewed had been sold through an open competitive process, or with testing of disposal prices against market valuation. This provides reasonable assurance that the prices obtained were in line with market prices at the time a property was sold.

Steps taken by NAMA to optimise income from debtors

In its 2012 strategic plan, one of the key objectives set by NAMA was to manage assets intensively and, where appropriate, to invest in them to optimise their income producing potential and disposal value. NAMA approached this in three main ways.

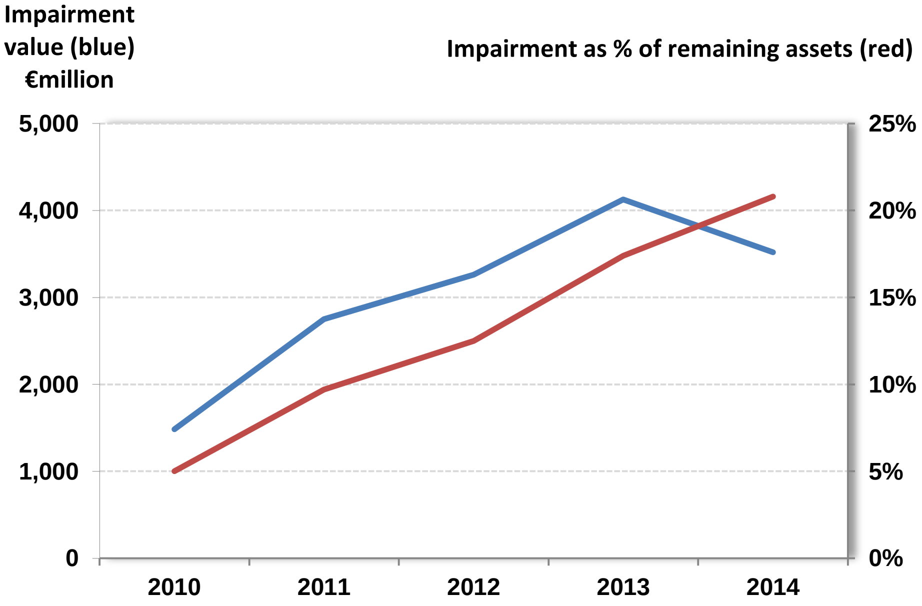
- **Maximise rental and operating income**. By the end of 2012, NAMA had realised around €4.8 billion in non-disposal receipts. Special report 79 found that for a sample of debtors, net non-disposal receipts were 25% lower than expected at valuation stage. NAMA found that there had been widespread leaking of funds when the loans were owned by the participating credit institutions — mainly rental income that should have been applied towards debt repayment — and took steps to address that problem.
- **Acquire previously unencumbered assets as additional collateral** for loans, expected by NAMA to ultimately yield assets to the value of around €800 million.
- **Advance funds to debtors for operational and capital expenditure**. By the end of 2014, NAMA had advanced around €2.3 billion directly to debtors for operational and development costs. The triennial review found that over half of the advances made to end-2012 and the planned advances at that date were for property in Great Britain and just over 40% in Ireland. The examination found that NAMA planned to make little or no capital investment in around 80% of its remaining land and development assets.

Quality of remaining portfolio

The extent to which NAMA has made provisions for impairment against its remaining assets and changes in the rate of impairment year-on-year may provide an indication of changes in the quality of the remaining assets held by NAMA.

The annual impairment provision in NAMA's financial statements fell in 2014, and the cumulative impairment reduced. However, the impairment provision as a proportion of the carrying value of the residual portfolio of loans increased, notwithstanding the improvement in property markets (see Figure). While there has been some increase in the impairment rate due to more detailed scrutiny of cashflows, the trend may also be an indication that the remaining assets are of lower quality than those already disposed of.

Trends in NAMA's impairment provision 2010 to 2014



Source: NAMA financial Statements 2010 to 2014

The profile of NAMA's remaining portfolio and disposal schedule at the end of 2014 shows a significant difference in the make-up of the portfolio when compared with the disposals to date. NAMA's annual report for 2014 indicates that

- 75% of remaining assets are located in Ireland (excluding Northern Ireland). Up to the end of 2014, 29% of total disposals had occurred in Ireland.
- 25% of the assets are in Britain and Northern Ireland, with around two-thirds of those in London. Up to the end of 2014, these locations had accounted for 62% of total disposals.

It is clear, therefore, that the key risk for NAMA in relation to its cashflows is the performance of the Irish property market.

NAMA has indicated that it may complete its work by around 2018. Because it is likely that not all assets will have been sold by then, it is important that consideration is given to how the residual assets will be managed thereafter.

Obtaining the best achievable financial return for the State.

A significant challenge facing NAMA is to achieve an appropriate balance between generating sufficient cash from disposals to meet its debt redemption targets, and making decisions on whether to hold properties for future disposal taking into account both the level of income being generated by a property and NAMA's view about the prospects for increases in value.

NAMA's primary commercial focus has been on cash generation in order to meet debt redemption targets and to meet costs. The Board sets an annual cash generation target, which is the key measure by which it monitors progress towards that overall objective.

The Act specifically requires NAMA to obtain "the best achievable financial return" for the State, but does not specify what that means. The objective of redeeming the debt is not an adequate or relevant performance measure in regard to this specific statutory requirement. While the Board has also set an objective of optimising the realised value of its assets, it has not set an expected or target rate of return.

In the absence of an expected or target rate of return, I was unable, in my first triennial review, to conclude on the extent to which NAMA's performance to date had contributed to obtaining the best achievable financial return. It was also difficult to assess the impact of accelerated or delayed cash receipts on NAMA's profitability.

In order to enable NAMA to better measure its performance, I recommended that the Board should set specific target financial return measures, which would be standard for a recovery unit of a financial institution or investment vehicle i.e.

- an overall expected or target rate of return against which to measure overall performance
- a target rate of return on disposals and on property held by debtors and insolvency practitioners.

The NAMA Board did not accept this recommendation. The Board took the view that such target rates of return would not be an appropriate metric for its business, on the basis that they would act as an unnecessary constraint on its flexibility, particularly given the stated objective of the Minister for Finance that NAMA should complete its work of deleveraging the portfolio as soon as possible.

In my view, setting target rates of return is not incompatible with flexible decision making. I expect to address this matter further in the 2013 to 2015 triennial review.

Risk management

NAMA is required, in common with all State bodies, to present a Statement on Internal Financial Control (SIFC) with its annual financial statements. The SIFC describes NAMA's control environment, its risk assessment process and the key risks identified, as well as setting out NAMA's key internal financial control processes and confirmation that the Board, with the assistance of the Audit Committee, had conducted an annual review of its controls.

The SIFC is reviewed in the course of the annual audit to identify any inconsistencies between what NAMA is reporting in the SIFC, and the audit's knowledge of NAMA's control systems. Where any such inconsistencies are identified, suggestions are made for amendments to the SIFC. It has not been necessary so far for the audit report to refer to any residual inconsistencies between the SIFC and the audit's knowledge of the control system. The Committee should note, however, that this process, while a standard part of the audit of financial statements, does not constitute a formal audit of the SIFC assertions.

Risk Management and Audit Committees

NAMA has four statutory sub-committees of the Board, including a Risk Management Committee and an Audit Committee.

- The **Audit Committee** has responsibility, inter alia, for the integrity of the financial reporting process, oversight of the internal audit function and the effectiveness of NAMA's internal control processes. The Audit Committee meets, on average, more than once a month.
- The **Risk Management Committee** has responsibility for reviewing and overseeing the executive team's plan for the identification, management, reporting and mitigation of the principal risks faced by NAMA and for satisfying itself that appropriate actions are taken in the event that significant concerns are identified. The Risk Management Committee meets around six times annually.

The audit reviews the minutes of all meetings of the Board and its sub-committees. Any issues of concern that are identified are addressed in the course of the audit, and are considered also in the audit's review of the SIFC.

Secondary objective – actions to stimulate the property market

In addition to its key objectives outlined above, NAMA has also set objectives which are secondary to its key commercial objectives. One of these was to generate transactions which will aim to contribute to a renewal of sustainable activity in the property market in Ireland. NAMA has undertaken two initiatives in relation to these secondary objectives.

- a **deferred payment initiative** (20% of purchase price deferred for 5 years) for residential property purchasers

- **provision of vendor finance** (up to 75% of sale price) for commercial property purchasers.

We found that there was limited use of these initiatives and, therefore, it was unlikely that they had affected the level of competition in the property market, in either way.

Use of Expert Advice (Line of Inquiry R4a)

Significant staff resources have been allocated by my Office to carry out the audit of the NAMA financial statements and to deliver the reports referred to above. The number of staff allocated varies over time, but averages around 9 wholetime equivalents per year. The staff assigned to the work are all experienced qualified accountants, or trainee accountants working under supervision.

Published guidance in relation to the application of International Financial Reporting Standards is very comprehensive, and has been used by the audit team in conjunction with international auditing standards to develop appropriate audit methodologies. Additional technical training has been provided to team members as required, either generally (e.g. training on International Financial Reporting Standards provided by a professor of accountancy contracted in) or in specific areas of relevance (e.g. training attendances re valuation of banking assets, or financial instruments).

A number of external experts were engaged by the Office in the period 2010 to 2014 for specific tasks as part of the financial audit of NAMA and/or for assistance in the preparation of reports on NAMA, where the Office did not have the in-house expertise or expert knowledge required for specific areas.

- The Valuation Office and a former Commissioner of Valuation in Northern Ireland were engaged to review the property valuation process undertaken by NAMA.
- The Valuation Office was contracted to review NAMA's valuations for a sample of properties.
- Legal advisors were contracted to review NAMA’s legal due diligence process.
- A professor of statistics advised on audit sampling methodology.

Matters which are taken into account in the decision to engage an expert include the competence, capability and objectivity of the expert; the significance of the accounting area or nature of the matter to which that expert’s work relates; and the significance of that expert’s work in the context of the audit or reporting work.

Attached Documents

For the convenience of the Committee, I attach the special reports of the CA&G referred to in the course of this statement — these contain (*inter alia*) more detail on the matters discussed. All the reports are exactly as presented originally to Dáil Éireann, and all are also publicly available on the website of my Office (*www.audgen.irlgov.ie*).

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17 July 2015

Mr Ciarán Lynch TD
Chairman
Joint Committee of Inquiry into the Banking Crisis
Leinster House
Dublin 2

Your ref: SMC01

Dear Chairman

I refer to my letter of 26 June and your response of 15 July.

As indicated previously, after I sent my statement to the Joint Committee of Inquiry into the Banking Crisis on 17 June 2015, staff of my Office identified a couple of minor corrections that require to be made to factual statements contained in the statement, as follows.

- Page 9, first bullet point, – first sentence should read "By the end of 2014, NAMA had realised around €4.4 billion in non-disposal receipts."

- Page 10, first bullet point, – first sentence should read "65% of remaining assets are located in Ireland (excluding Northern Ireland)."

No conclusion or opinion expressed in the statement is affected or altered as a consequence of these corrections.

I understand that the Joint Committee is agreeable to publishing this letter of correction alongside my original statement. Thank you for allowing me to correct the record in this way.

Yours sincerely

Seamus McCarthy.

Seamus McCarthy
Comptroller and Auditor General