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Joint Committee of Inquiry into the Banking Crisis

Section 25 Statement of

Eamon Daly

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Joint Committee of Inquiry into the Banking Crisis

Statement of Evidence of Eamon Daly

former Internal Auditor, Irish Nationwide Building Society (INBS)

Pursuant to Section 25(i) and (ii) of the Houses of the Oireachtas (Inquiries,

Privileges and Procedures) Act 2013

Introduction

- My name is Eamon Daly and I was Internal Auditor with INBS from 29 May 2000 to 8 November 2004.
- My educational and career background is briefly summarised as follows:
 - I obtained a Bachelor of Commerce (Accounting) 2.1 degree from University College Dublin, graduating in 1993, and then trained and qualified as a chartered accountant with an accountancy practice in Dublin, qualifying in 1997.
 - Subsequently, I worked with PriceWaterhouseCoopers in Jersey, Channel Islands, in their financial services division, before returning to Ireland to take up a role as a client and fund accountant with JP Morgan Chase (then Chase Manhattan), taking up the role with INBS soon afterwards.

Internal Audit Department in INBS

Role and Responsibilities of the Department, Reporting Lines

- The Internal Audit Department (IAD) had responsibility to conduct internal audits of all operations of INBS, including overseas operations (which consisted of a UK operation with two branches in Belfast and London, which mainly focused on lending into the property investment sector in the UK, together with an Isle of Man subsidiary, which mainly operated as a retail sterling deposit raiser).
- IAD also had responsibility for fraud prevention and anti-money laundering, so internal audits of the anti-money laundering and fraud prevention functions were not conducted as to do so would have represented a conflict of interest.
- In my experience, IAD was never prohibited by the senior executive management from auditing a specific area of INBS's operations. However, the very limited resource allocated to the IAD function was a limiting factor in practice.
- As Internal Auditor, my reporting line was to Mr Michael Fingleton, the Managing Director, and periodically to the Audit Committee, which during all of my time with INBS had three members. On a day-to-day basis, I met frequently with both the Finance Director Mr Stan Purcell and the Managing Director and I had a constructive working relationship with both, while being careful to maintain and safeguard the independence of the internal audit function.
- During my time with INBS, Audit Committee meetings typically took place three or four times a year. There were also annual meetings between External Audit and the Audit Committee, part of which were held without either internal audit or the senior executive management being present.

IAD Resourcing

- During my tenure with INBS, the staff numbers in IAD ranged from three to five staff members (including the head of IAD). Some staff were recruited externally, others from the branch network or other departments. I can recall that staff turnover was relatively low compared to other sections within INBS, some of which had high rates of staff turnover.
- I would have regarded the department as very under-resourced even at the time and in hindsight even more so.
- In my experience/tenure, Internal Auditor did not have the authority to seek assistance from external consultants, even where to do so would have been desirable.
- I also note, from testimony to an Oireachtas Committee provided by the then Head of Internal Audit of Anglo Irish Bank in February 2009, that at that time there were 17 staff in the internal audit function of Anglo Irish Bank. While Anglo Irish Bank was a significantly larger bank than INBS, the auditable risks were in some ways similar to those experienced by INBS given the way in which INBS's loan book was developing from approximately the late 1990's onwards, with greater focus on expanding the commercial lending book and less focus on the traditional home loans operation.
- I also note from a written statement provided to the inquiry from the Group Head of Internal Audit with Bank of Ireland that that bank had approximately 90 staff in its Internal Audit function (an establishment number of 96 approved positions is quoted, with 14 vacant positions). While, Bank of Ireland was - and remains - a far larger institution than INBS, it is once again difficult to avoid the view that INBS's IAD function was significantly under-resourced by comparison.

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- During the 2000-2004 period, the Irish credit institution closest in balance sheet size to INBS was the Educational Building Society (EBS Total Assets as at 31/12/2004: circa €12 bn. INBS Total Assets as at 31/12/2002: circa €9 bn).
 - EBS was also the closest to INBS in terms of legal structure, in that both were mutual building societies - indeed, following the floating of the former First National Building Society on the stock market in 1998, they became the only two remaining mutual societies governed by the Building Societies Act 1989 (the former Irish Permanent Building Society had demutualised to form a public limited company four years previously, in 1994.)
 - My recollection is that as of circa 2001, EBS had approximately 5-7 staff in its IAD: however the anti-fraud/money laundering function was dealt with separately from the IAD in EBS, and also, significantly, there was a separate Risk Unit in EBS from 2002 onwards (I note from a statement furnished to the inquiry by a former Chief Risk Officer with EBS that this unit comprised three people initially).

IAD Reporting Framework, Planning, General Policies & Procedures

- IAD in INBS conducted approximately 25-30 audits per year, including audits of branches and the agent network.
- There was no specific IT auditor in INBS so internal audits of IT controls were limited at best.
- Each year an annual internal audit programme was prepared and reviewed and approved by the Managing Director and the Audit Committee. A copy was also made available to the External Auditors and to CBFR if required.
- In IAD we utilised audit programmes which were updated on an ongoing basis as needed and we maintained a register of IA follow-up issues to ensure recommendations made were tracked and followed-up with the relevant managers.
- At the conclusion of each audit, the audit report would be furnished to the relevant manager/supervisor/branch manager, discussed with that person, and management response comments invited and recorded.
- Each quarter an Internal Audit Quarterly Report would be prepared and furnished to the senior executive management which would include an executive summary summarising key findings, together with copies of all the IAD reports completed in the quarter.
- The quarterly Internal Audit Reports be included in the pack sent to the Audit Committee a week before each scheduled Audit Committee meeting.
- Planning of IAD's work in terms of what areas of INBS's operations were audited, and when, was relatively ad-hoc initially when I first commenced employment as the Internal Auditor.

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- Subsequently, in 2002, in response to Central Bank/Financial Regulator (CBFR) and External Auditor recommendations, I implemented, in conjunction with the department heads (middle management) and with the approval and oversight of senior management, a risk-based approach to internal audit, so that internal audits were scheduled and planned on a more systematic basis and in accordance with the results of the annual risk assessment.
 - During my time with INBS, and on the recommendation of the External Auditors, I implemented a scoring (rating) system in the internal audit reports issued and also implemented a criticality/importance scale for recommendations made.
 - I also, with assistance and input from the staff member responsible for branch and agent internal audits, and the Branch Development Manager, enhanced the branch audit programme so that it was developed in accordance with a risk assessment of the branch network rather than simply in line with a time-based periodic rota, as was previously the case.
 - It is important to note that IAD had no role in strategy and planning. There was no specific appointed Risk Officer or Risk Unit within INBS, so it was unclear where the responsibility for risk assessment and risk mitigation rested. A full time Compliance Manager position was not created until sometime in either 2002 or 2003. Prior to that, the role of Compliance Manager was allocated to another senior official who had significant other responsibilities. Even after the full time Compliance Manager position was created and an appointment made to that position, responsibility for the anti-money laundering & anti-fraud functions continued to rest within IAD. While there were good reasons for this given that the relevant expertise in those functions rested within IAD, it also meant that IAD continued to be burdened with significant

responsibilities (including onerous legal responsibilities under the anti-money laundering legislation) which inevitably lessened the quantum of human resource hours devoted to its core internal audit functions.

Commercial lending

- My recollection is that the commercial lending area was audited by IAD on three occasions between 2000 and 2004 and in each case numerous recommendations for improvement were made. The Belfast branch, which did a large amount of commercial lending, was audited in 2002 and was scheduled for audit again in 2005 (which was after my tenure, but to the best of my knowledge and belief it took place as scheduled). In addition, the procedures around INBS's property investment subsidiaries were audited in 2003/2004.
- Nevertheless, it is clear to me in hindsight that audits of commercial lending were not sufficiently frequent, and that the Belfast branch should have been audited more frequently also.
- However, also, it is important to bear in mind that staff resource numbers and expertise in IAD was limited, and even in the (impractical and hypothetical) case that IAD had done nothing other than continuously audit Commercial Lending, the practical reality is that both the Audit Committee and the CBRF would constantly have been asking why audits of other key areas were not being conducted.

Compliance - sectoral reporting/large exposures reporting

- I can recall that the CBFR had a particular concern with the area of Large Exposures Reporting. This related to the reporting and tracking of large commercial property loans. There was an issue that arose in 2002 and they requested that IAD review the area and investigate if there were control weaknesses, which we did. There was another issue in 2004 and they requested that IAD review the area again and make further recommendations for control improvements, which we did.

Treasury

- The Treasury function in INBS had a relatively straightforward 'vanilla' type operation compared to the larger institutions, with no proprietary trading. Its operations were mainly concerned with interbank funding and corporate, institutional and large retail deposit raising (and related customer care) with substantial EURO and GBP books and also a smaller US\$ deposit book.
- The manager was very experienced, as were a number of the key staff in the section, some of who had been recruited from other banks. As with other areas of INBS, internal audits of Treasury were conducted in accordance with the risk-based internal audit programme and various issues for improvement were identified.
- The Regulator was understandably concerned about controls in the Treasury areas in banks and anxious that there not be a repeat in any other Irish bank of the Allfirst (former AIB subsidiary) trading losses incident which was came to light in early 2002. Nevertheless, it seems to me that it was not the Treasury operations area which caused the difficulties INBS experienced in 2008 - 2010.

Anti-money laundering & fraud prevention

- Unlike in larger banks and even in many smaller ones, the anti-money laundering and fraud prevention functions were part of the remit of IAD.
- This required a significant time investment which I would estimate as being of the order of ½ day to 1 day per week for the head of function and another ½ day to 1 day per week for another employee with the function. In relation to fraud prevention, if a fraud arose the investigations would needed to be conducted on a prompt basis and could be time consuming, involving investigating the fraud, compiling a report for senior management, making any recommendations for control improvements which arose, and in some cases, assembling the necessary evidence for reporting to An Garda Siochana (AGS). As a result, inevitably, less time was devoted to the core function of IAD than would have been desirable.
- As both of these areas imposed significant responsibilities on IAD outside of its core internal audit function, I am dealing in more detail with both in separate paragraphs below.

Anti-money laundering

- Responsibilities in this area are summarised as follows:
 - Ensuring procedures to track suspicious transactions were in place and kept up-to-date in response to any legislative changes and best practice standards in the industry.
 - Assessing suspicious transaction reports (STR's) received on a prompt basis, and reporting onwards to AGS if necessary.
 - Dealing with queries/feedback from AGS in relation to STR's.
 - Dealing with Section 63 Orders from AGS. On average, there were about half a dozen of these per year. The work involved here constituted collecting account documentation in relation to specific account holders and the hand-over of such to an officer of AGS, typically within a tight deadline. I can recall that in many of the other institutions, and particularly the larger ones, such orders would be served on the relevant branch manager of the branch where the specific account or accounts were held, however the policy in INBS (which I essentially inherited) was that such orders were served on the MLRO at the INBS head office and the relevant account documentation would be assembled and handed over by the MLRO.
 - Liaising with the HR/Training department to ensure that their training manuals and other training materials were up-to-date and to ensure that all relevant staff and also tied agents received the necessary training and went on the required annual refresher course.
 - Dealing with Mutual Assistance Requests received from the Department of Justice (this relates to accounts which were the subject of requests from

other countries in relation to criminal investigations. Requests occurred relatively infrequently - perhaps one or two per year - but required a time investment in relation to the gathering of documentation and also attendance at court was required in order to hand over the documentation at court sessions, under the relevant legislation.)

- Providing summary reports to Audit Committee/Board of Directors as necessary in relation to the above matters.
- After the terrorist attacks of September 11 2001, all banks were required to implement enhanced monitoring functions.
- Also, in general during the time period 2000 to 2004 there was an increasing focus on the part of financial regulatory bodies globally on banks' compliance with the anti-money laundering guidelines.
- In INBS the numbers of STR's went from around one per month to close to one per week over three years. The work required to be done by the anti-money laundering function also encompassed ongoing monitoring of accounts which displayed suspicious activity and in some cases assembling and handing over of documentation for Section 63 orders in relation to accounts under investigation by the Money Laundering Investigation Unit or Criminal Assets Bureau. As from 2003, STR's were also required to be forwarded to the Revenue Commissioners. In addition we enhanced procedures for the tracking of accounts with large cash transaction volumes in 2003 or 2004. As a further and additional enhancement to anti-money laundering controls in INBS, a licence giving access to the "WorldCheck" database was purchased in 2004 which facilitated matching of customers' names against a

world-wide database of politically exposed persons and other heightened risk individuals and organisations.

Fraud Prevention

- Responsibilities here included investigating cases of fraud impacting on INBS and reporting onwards to AGS. During my tenure, cheque fraud and mortgage fraud were the main types of fraud encountered by INBS. I can recall that when I joined INBS in 2000, cheque fraud was the main issue but there was an increase in mortgage frauds in around 2003. Procedures for dealing with counterfeit notes were also part of the responsibilities in this area and I can recall that in either 2003 or 2004 the CBR introduced new procedures for the reporting of counterfeit banknotes. During my time in INBS, I wrote and implemented a procedures manual for the fraud and anti-money laundering functions.
- Though it occurred several years after my tenure, the case of the fraud for which the former solicitor Mr Thomas Byrne was convicted seems to indicate that fraud detection and reporting procedures were functioning well in INBS. This fraud affected many credit institutions but INBS was the one that reported the case to authorities. I can also recall that during my own tenure in (circa) 2003 a number of cases of mortgage fraud were discovered, investigated and reported to the relevant authorities and indeed in the wake of these reports the CBR arranged a meeting encouraging tightening-up of anti-mortgage fraud procedures in the regulated credit institutions.

Organisational Human Resources, Staffing, and Other Operational Issues

- In my view, there was an inappropriate strategic emphasis on the part of senior executive management of INBS on keeping the cost income ratio of INBS at a very competitive level compared to its peer group. In my view, this inappropriate focus fed directly into inappropriate under-resourcing in some key areas, and to many of the weaknesses in INBS identified by CBR, EA, and indeed IAD itself, in their respective reviews and reports.
- In this regard, it is worth noting that if we compare the situation of INBS to EBS, while the latter building society had a less favourable cost income ratio and a lower profitability ratio, it also had significantly higher staff numbers – and ultimately, as is well-known, although EBS also required government assistance during the banking crisis it comprised a much lower % of its loan assets than INBS (although I understand from statements provided to the inquiry that the NAMA loan discount % for INBS has been questioned by former directors of INBS).
- I recall that staff turnover in some areas, including at management grade, was quite high during 2000/2001. This in itself increases risk as key expertise/experience is lost. I can recall that by 2003/2004 staff and management turnover was lower, probably partially due to the fact that the staff and management would have expected to benefit in the event of demutualisation and a trade sale.
- Various reports into the banking crisis, in particular the Nyberg Report, did not look in detail at resourcing issues in the banks.

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- However, the publicly expressed view by the post-bailout senior executive management team of INBS was that INBS had previously operated as a significantly under-resourced credit institution in many key areas.

Risk Assessment & Monitoring

- Unlike in larger institutions, there was no separate risk unit within INBS. On the recommendation of the External Auditors, from 2002 IAD implemented a risk-based approach, preparing an annual risk assessment in conjunction with the section heads, and the annual internal audit plan was based on the results of this risk assessment.

Planning/Strategy

- To the best of my knowledge, there was no formal planning function within INBS and no individual or department was allocated the role and responsibility of planning and strategy. If there was a formal written strategic plan, I never had sight of it and it was not widely circulated within INBS. INBS did not employ an economist (though in this regard it is worth noting that other institutions which did employ economists also required government bailouts from Irish or UK taxpayers during the financial crash).
- In other organisations that I have had experience of, there is significant emphasis on planning, annual strategy board sessions are held as a matter of routine and in addition, middle managers have input into and involvement in the planning process.

Training

- During my tenure, efforts were made to improve training within the function and with the approval and at the direction of the Audit Committee, a formal training plan and training budget were put in place from 2003 onwards. Prior to that there was no formal training plan, although staff in the department who were members of professional institutes would have been required to fulfil Continuing Professional Development requirements.

Senior executive management succession/Board of Directors

- An experienced banking executive was recruited for the newly created position of Chief General Manager in late 2001 (and publicly identified as the successor for the Managing Director upon the latter's retirement) but only stayed in the role for a year and no replacement was appointed.
- My recollection is that during his relatively brief period with INBS, the chief general manager introduced tighter controls in the area of commercial lending and I had the impression that this slowed down the growth rate in new lending and that some of the other members of the board were not happy with this.
- While the board of directors had much expertise and experience, it was perhaps too small and insufficiently broad in terms of the range of that expertise and experience. For example, EBS had eleven directors as of 18/2/2005 (source: EBS Annual Report and Accounts for year ended 31st December 2004) compared to only five for INBS. Also, INBS had no public interest director as EBS had (and I note that the former EBS public interest director Ms Eithne Tinney has provided evidence to the inquiry).

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- However, I am also cognisant of Dr Michael Walsh's and Mr Michael Fingleton's evidence to the inquiry where both state that efforts were made to bring additional non-executive directors onto the board of INBS but that those efforts were not always successful due to the widespread market perception that INBS had no long term history as an independent organisation due to its plans to demutualise.

External assessments of IAD:

- I understand that a KPMG assessment review of IAD conducted in 2005 found areas for improvement in IAD but also identified nine areas where IAD was meeting Best Practice standards.
- The IAD function in INBS was seen by the CBFR as 'clearly under-resourced' (verbal comment from a Central Bank inspector made to me at the end of inspection in 2000).
- However, in my experience, there was little or no support from the CBFR to formally instruct/require senior executive management to significantly increase the resources allocated to IAD, as in general by policy the CBFR did not comment on resourcing in licensed institutions due to possible 'moral hazard' issues.

Summary:

- This statement is been furnished under **Section 25(i) and (ii) of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013.**
- Specifically, the statement seeks to provide necessary and relevant context into the role, remit, operations and resourcing of the internal audit function in INBS during part of the relevant period being examined by the Inquiry.
- IAD in INBS had responsibility for two key areas: internal audit and anti-money laundering/fraud prevention. In addition, in practical terms, as INBS had no risk unit, IAD had to perform its own risk assessment in order to generate the audit plan.
- During my tenure as INBS Internal Auditor, numerous improvements and enhancements were made to the IAD procedures/functioning/effectiveness and to INBS's control processes, with the guidance and direction of an Audit Committee featuring as it did the combined corporate finance, banking, governance, public sector, academia, accountancy and taxation expertise and experience of Dr Michael Walsh, Dr Con Power and Terry Cooney.
- The limited resources allocated to IAD, and the fact that the department had significant other responsibilities, were each factors that limited the quantum of staff resources allocated to core function.
- I have prepared this statement mainly from my own recollections, and to a lesser extent from information in the public domain, including witness statements provided to the Inquiry. I confirm that it is true to the best of my knowledge and belief.