TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

An tAcht um Thithe an Oireachtais
(Fiosrúcháin, Pribhléidí agus Nósanna Imeachta), 2013

REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
(Inquiries, Privileges and Procedures) Act, 2013

Volume 1: Report
Volume 2: Inquiry Framework
Volume 3: Evidence

KPMG: Core Book 42

January 2016

Table of contents – by line of inquiry

B1: Effectiveness of banks' board governance, client relationships and business models

B1b: Integrity of financial reporting.

B2: Effectiveness of banks' credit strategies and risk management

B2b: Appropriateness of credit policies, delegated authorities and exception management.

B3: Effectiveness of banks' funding, liquidity strategies and risk management

B3e: Capital structure and loss absorption capacity.

B7: Impact of banks' external audit processes in supporting effective risk management

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

Description	Bates Number [Relevant Pages]	Page
European Commission Green Paper Corporate governance in financial institutions and remuneration policies	KPMG00938 [001-020]	34-53

C2: Role and effectiveness of the Policy appraisal regime before and during the crisis

C2c: The liquidity versus solvency debate.

Description	Bates Number [Relevant Pages]	Page
Independent Auditor's Report 2008	KPMG00039 [001-002]	55-56
Independent Auditors Opinion 2008	KPMG00038 [001-002]	57-58

THEME: B1

Effectiveness of banks’ board governance, client relationships and business models

LINE OF INQUIRY: B1b

Integrity of financial reporting

MINUTE BOOK

MINUTES OF THE BOARD MEETING
of
ALLIED IRISH BANKS, p.l.c.

held on Wednesday, 5 December 2001 at Bankcentre,
Ballsbridge, Dublin 4 at 9.30 a.m.

PRESENT:	Lochlann Quinn	Chairman
	Michael Buckley	Group Chief Executive
	Adrian Burke	
	Padraic M. Fallon	
	Dermot Gleeson	
	Don Godson	
	Derek A. Higgs	
	Gary Kennedy	
	John B. McGuckian	
	Carol Moffett	
	Michael J. Sullivan	

IN ATTENDANCE:
W. M. Kinsella, Secretary
D. P. McSweeney, Chief Financial Officer - Items 3 and 4
C. A. O'Sullivan, Head of Group Finance & Corporate Services - Items 3 and 4
M. J. Lewis, Head of Strategic Human Resources – Item 5
S. C. Keating, President and Chief Executive Officer, Allfirst Financial Inc. – Item 6 (*via videolink*)
C. E. Doherty, Managing Director, AIB Capital Markets – Item 7
J. O'Donnell, Head of Investment Banking – Item 7

An apology for inability to attend was conveyed on behalf of Mr. Frank P. Bramble.

[redacted]

2780

2. Group Chief Executive's Report

The above Report, which outlined key business, banking industry and management and staff issues, had been circulated in advance of the meeting.

Mr. Buckley commented on the matters in the Report, including Group operating performance to October 2001, steps taken by the Revenue Commissioners to obtain information from AIB and AIB Finance Ltd. in respect of certain non-resident accounts, a loss incurred by Treasury, New York, on its Collateralised Mortgage Obligations trading account, and the level of Group exposures to Enron Corporation. He referred to the need to reshape support functions to eliminate duplication, measurably improve service, and reduce costs, and, in that regard, reported on proposals to combine the Risk and Finance functions at Divisional and Group levels, and on the need to make a significant capital investment in the development of a single information management architecture. He advised that the head of the new function would be appointed shortly, following consultation with the Chairman.

Mr. Buckley responded to questions and his Report was noted.

[redacted]

[redacted]

7. **Strategic Responses**

A paper entitled "Defence Planning" had been circulated in advance of the meeting.

Mr. Doherty commented on the importance of defence planning, and referred to the Defence Manual previously circulated to the Directors.

Mr. O'Donnell reported on the status of the key action plans outlined in the paper. These included the establishment of a Defence Committee of the Board to act on the Board's behalf immediately upon the receipt of an unsolicited bid for the Bank and in advance of a meeting of the Board. Following a discussion,

> IT WAS RESOLVED THAT, pursuant to Article 108 of the Articles of Association of the Bank, a Committee ("the Defence Committee") be and is hereby constituted, consisting of the following Directors, namely, Mr. Michael Buckley, Mr. Don Godson, Mr. Gary Kennedy, and Mr. Lochlann Quinn together with the following Officers, namely, Mr. Colm Doherty, Managing Director, AIB Capital Markets and Mr. Cornelius O'Sullivan, Head of Group Finance & Corporate Services, and that, in the event of any actual, proposed, threatened or otherwise possible unsolicited bid for the Bank, the authorities, discretions, functions and powers of the Board be and are hereby delegated to the Defence Committee insofar as concern the taking of such preliminary actions (including the making of announcements) as shall appear necessary or desirable to the Defence Committee in advance of a meeting of the full Board and, thereafter, with such powers, authorities and discretions as may then be delegated to it by the Board.

[redacted]

[redacted]

Chairman [signature]

Date 15/10/02

[redacted]

Credit Control – Credit Provisioning Grade 2

Observation

Credit provisioning policies act as a control to ensure that provisions raised are for legitimate non-performing loans where the probability of recovery of amounts in question is remote. These policies set threshold levels for approval of such provisions and specifically require Retail Credit Committee sign-off for provisions greater than €250,000. Provisions in excess of €1,000,000 are advised to Group Credit Risk and require the approval of the Group Credit Committee.

During the course of our audit, we noted 11 significant provisions raised in December 2004, nine of which were without the prior approval of the relevant credit committee. Approval for two of these provisions was not received as of 15 March 2005. All others were approved by either Group or Retail Credit Committee between 25 January and 22 February 2005.

Recommendation

Management should ensure that, going forward, credit provisioning policies are complied with and provisions are not recorded until the necessary approval has been received from the relevant credit committee.

Management response

All relevant decisions were considered by the General Manager Business & Personal Credit and by the Head of Credit Risk Management, and were advised to Group Credit Risk. In due course the mark-ups (1 outstanding) received full consideration at the divisional and group credit committees where appropriate. The primary objective is to ensure that all bad debt figures are included in the bad debt provision charge for the division on a timely basis for the relevant reporting period. Where provisions span a reporting period-end, it is not always possible to have the mark-ups considered by relevant credit committees before establishing the provisions. The main purpose of the mark-up is to analyse the cause of loss and learn from our loan loss experience in addition to confirming the appropriateness of the provision.

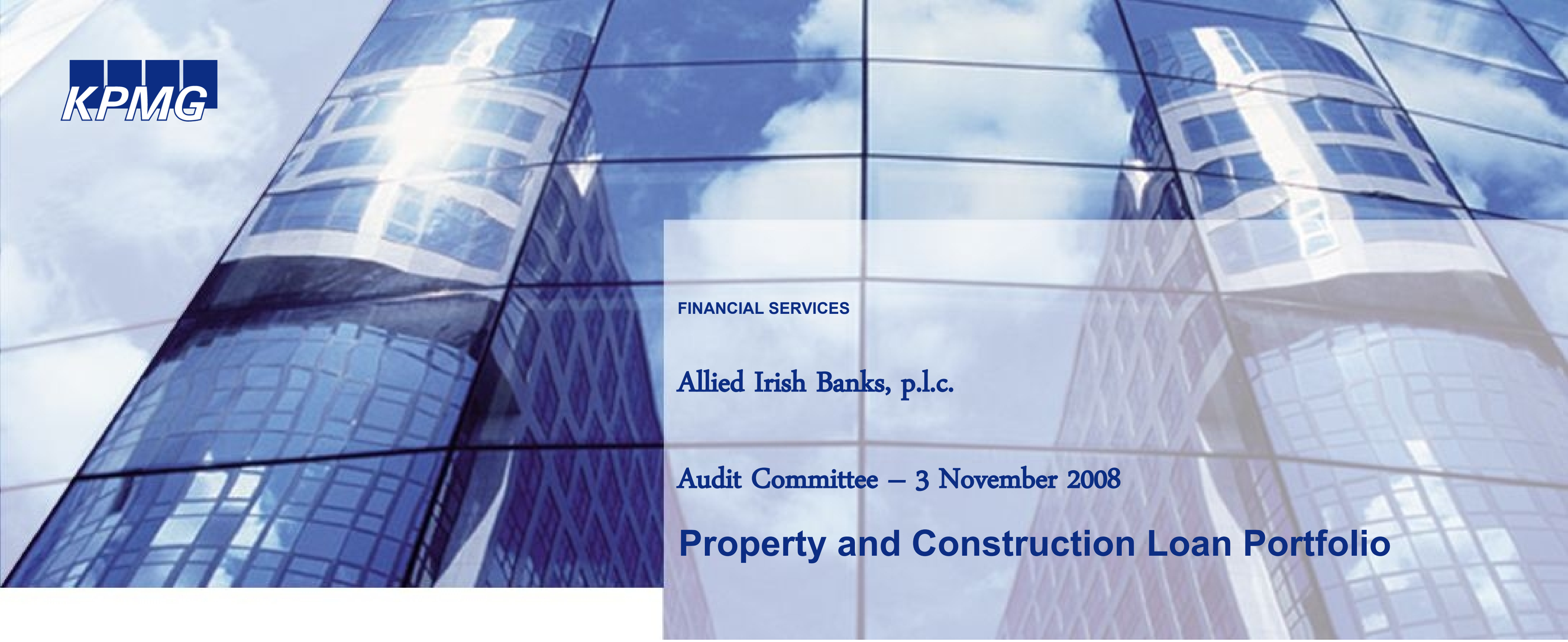
In the light of the audit comment, we will review the policy to ensure that there is consistency between practice and policy while also ensuring that the fundamental controls are not diluted.

Responsibility

Commercial Banking & Business Banking.

Timetable for Completion

The outstanding mark-up will be presented to Credit Committee by 30 June 2005.



FINANCIAL SERVICES

Allied Irish Banks, p.l.c.

Audit Committee – 3 November 2008

Property and Construction Loan Portfolio

AUDIT ▪ TAX ▪ ADVISORY

Review of the Property and Construction Loan Portfolio

- As a result of the economic environment there has been a significant deterioration in the quality of the Property and Construction loan portfolio, with:
  - Security values declining significantly;
  - Little demand for property related transactions;
  - No new funding or refinancing available for transactions; and
  - Ireland specific issues exacerbated by the global economic uncertainty.

- Given the concentration of advances to the Property and Construction sector in the ROI division, we are carrying out extensive loan review procedures on this portfolio.

- We have added a number of additional directors and managers to our team to assist with our loan review procedures. We are reviewing the individual files and discussing the key judgements with the AIB lending executives.

- From the total sector exposure of €30.4 billion we have selected the following **sample** of exposures to review:

	Exposure € billion	Exposure as % of total portfolio	Number of exposures
Top 30 exposures	€8.8 billion	29%	30
Grades 3, 4 and 5 (7 & 8)	€1.9 billion	6%	89
Total population sampled	**€10.7 billion**	**35%**	**119**

- There has been a significant deterioration across the portfolio and all grades. Loans graded at 3 and 4 are designated as "criticised" but are not specifically provided for.

- We have focused our testing on this segment as it should provide strong evidence as to whether appropriate judgements around provisioning have been taken across the portfolio.

KPMG01B06

KPMG00390-002

Review of the Property and Construction Loan Portfolio

- The key judgements relate to the expected quantum and timing of cashflows supporting the carrying value of the underlying loans.
- The purpose of this initial stage of our work is to gather all of the relevant facts about the individual loans selected and in particular about the quantum and timing of cashflows so that we can then discuss the critical judgements with AIB's senior credit personnel.
- Individual exposures are often complex and require extensive discussions with the lending executives to identify and analyse the key facts. Our work is however progressing well and we are receiving the full co-operation of AIB's lending teams.
- Based on our work to date it is apparent that AIB lending executives are very familiar with the current facts and circumstances of the more significant exposures. There is frequent contact with the borrowers and a good understanding of the underlying security and borrower's plans with respect to repayment. The customers typically have a range of assets both in Ireland and abroad which provides some flexibility in determining when outstanding loans will be paid down.
- For the other less significant exposures, in general and as expected there tends to be less frequent contact with the customers. In particular there tends to be less evidence on file regarding the expected timing and amount of cashflows related to these loans. We also note that a significant number of these exposures are outside Dublin, which increases the judgement related to the timing and recoverability of the cashflows.
- As the size and scale of the credit issues in this portfolio and the level of distress has become apparent in recent months, AIB (ROI) Division has significantly increased the resources allocated to the Credit Monitoring function. The current focus is on managing the increasing number of exposures which are migrating into the stressed/impaired categories (Grades 3, 4 and 5). The ongoing AIB reviews include:

  - Review of all exposures > €1m by the lending teams on a 6 weekly basis;

  - Special Credit Unit review of Grade 3 and 4 exposures > €5m; and

  - Monthly reporting to Group Credit Risk on all Grade 3 and 4 exposures > €25m.
- There has been a significant acceleration in specific provisions as credit management reviews have progressed over the last number of months.

Review of the Property and Construction Loan Portfolio

- Managing and reviewing the increasing number of exposures on a timely basis is a significant challenge in an ever changing environment. This combined with the underlying assessment of the timing and reliability of cashflows for individual exposures results in a significant amount of judgement in determining the specific and IBNR provisions for the year ended 31 December 2008.
- The forecasted increase in the level of specific provisions and the related significant increase in the IBNR is an appropriate response to the deterioration in the economic environment.
- The critical objective from our perspective is that management has identified and provided for its best estimate of the financial impact for the distress in this portfolio for the year ended 31 December 2008.
- AIB's management is forecasting significant additional provisions against the Property and Construction portfolio for 2009/2010. AIB's management is asserting that the conditions which may cause these losses to arise do not currently exist. These provisions are based on levels of future cash realisations that will result if economic conditions deteriorate further/persist for longer than expected. A critical issue for KPMG and the Audit Committee is to consider whether their view is appropriate.
- Our work is ongoing in respect of reviewing our selected sample of exposures and as a result it is not possible at this point in time to reach any definitive conclusions about the adequacy of the provision.
- The ultimate level of provision will be impacted by customer specific events and the assumptions made regarding more general economic events. The evaluation of the portfolio over the next 4 months is critical in this regard.

Acquired Loan Assets

NAMA was established in December 2009 following the enactment of the National Asset Management Agency Act, 2009 in November of that year. Five institutions (and their subsidiaries) were designated as participating institutions by the Minister for Finance in February 2010: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Nationwide Building Society and EBS Building Society[4].

LOAN ACQUISITION

The first loan transfers occurred in late March 2010. **Table 2** below summarises the major phases of the loan acquisition process:

TABLE 2: Phases of loan acquisition

	€bn	Date of transfer
Tranche 1	15.3	March – May 2010
Tranche 2	11.9	June – August 2010
Bulk transfer*	44.0	October – December 2010
Transfers in 2011	2.8	March and October 2011
TOTAL	**74.0**	

**At the request of the Minister for Finance, the transfer of the third and later loan tranches was accelerated as part of a bulk transfer in the last quarter of 2010.*

96% of the portfolio (€71.2 billion) was acquired within a nine-month period between March and December 2010.

Transfers in 2011 took place in two phases: a transfer of €1.1 billion in March (loans which were deemed eligible by AIB in late 2010) and a transfer of €1.7 billion in October. After the Supreme Court judgements in the **Dellway** case, NAMA instituted a process of consultation in June 2011 with debtors whose loans had not, at that stage, yet been acquired. Debtors were invited to make written representations to NAMA in respect of the possible acquisition of their loans and, in particular, as to any adverse effect such acquisition was likely to have on their interests. Debtors were also provided with an opportunity to make representations as to the eligibility of the loans by reference to the criteria for eligibility set out in the Act and in the Regulations.

Following a review of submissions received from debtors, the NAMA Board exercised its discretion, under Section 84 of the Act, to acquire loans totalling €1.7 billion and this acquisition was completed in October 2011. In the case of another €400m, the Board exercised its discretion not to acquire the loans concerned. Loans totalling €260m were deemed to be ineligible following a review of additional information received in debtor representations.

ACQUISITIONS BY INSTITUTION

Table 3 below summarises the transfers by institution:

TABLE 3: Loan acquisitions by institution (€ billion)

	AIB	ANGLO	BOI	EBS	INBS	TOTAL
Loan balances transferred	20.4	34.1	9.9	0.9	8.7	**74.0**
Consideration paid	9.0	13.4	5.6	0.4	3.4	**31.8**
Discount	56%	61%	43%	57%	61%	**57%**

Table 4 below provides a breakdown of debtor connections[5] by size of nominal debt acquired by NAMA (many of the debtors are also indebted to non-NAMA financial institutions).

TABLE 4: Distribution of NAMA debtor connections by size of nominal debt

Nominal Debt	Number of debtor connections	Average nominal debt per connection €m	Total nominal debt in this category €m
In excess of €2,000m	3	2,758	8,275
Between €1,000m and €2,000m	9	1,549	13,945
Between €500m and €999.9m	17	674	11,454
Between €250m and €499.9m	34	347	11,796
Between €100m and €249.9m	82	152	12,496
Between €50m and €99.9m	99	68	6,752
Between €20m and €49.9m	226	32	7,180
Less than €20m	302	7	2,117
TOTAL	**772**	**96**	**74,015**

4 The business of Irish Nationwide Building Society transferred to Anglo Irish Bank on 1 July 2011 and the merged entity now trades as Irish Bank Resolution Corporation Ltd. (IBRC). EBS Building Society was acquired by Allied Irish Banks plc. on 1 July 2011 and now operates as a subsidiary of AIB.

5 Debtor connections may consist of one debtor or a number of closely-connected debtors whose aggregate debt is considered by NAMA to be best managed as one cohesive connection rather than managed through separate debtor entities.

2. Matters arising from our review (cont'd)

Credit provisioning (continued)	

Credit provisioning (continued)

The IBNR adjustment factors in RoI and GB/NI were changed in the period leading to an increased provision of €5m in RoI and a net €5m reduction in GB/NI. The GB/NI IBNR reduction appears counter-intuitive given current economic conditions however the amount is not material and is in the context of historically prudent levels of IBNR reserves in GB/NI. The IBNR provision in Poland has reduced by €3m primarily due to the application of a new property grading tool which generates a lower default profile for this portfolio.

An argument could be made for reducing emergence periods in those books that management are more actively monitoring as any losses may now be identified earlier. Any reduction in emergence periods would have the effect of reducing the IBNR provision. No changes have been made to the emergence periods used which, in common with several peer banks, remain unchanged since conversion to IFRS. We concur with this approach to date.

Credit provisioning is a difficult area and particularly so in a downturn. IFRS requires provisions to be made on an incurred loss basis only and one of the key issues in deriving the IBNR is the determination of how long it will take for losses to emerge (i.e. the emergence period). AIB have carried out an extensive review of the loan book and it is their management judgement that all incurred losses have been provided for to date.

In our view the most significant risk around the half year results is the credit provisioning judgement. While a slowdown in the global economy and the particular issues in the Irish economy have been flagged for some time, most commentators have been surprised by the extent and speed of the slowdown and the impact of the increase in headline inflation and the very significant loss in consumer confidence.

In the context of the significance of the judgement around credit provisions on AIB's results we understand that management plans to set out some downside scenario analysis on the potential impact of current market conditions on the Group's credit portfolio, and the consequent impact on AIB's capital requirements.

We expect that increasing arrears across the Bank's books and sectors, downward grade migration and increased specific and IBNR provisions will continue to feature in the second half of 2008 and into 2009 as the worsening economic conditions in Ireland and UK take hold. The impact of the deterioration of the credit environment on AIB will be the most significant area of focus for management and for KPMG in the context of the Group's results for the full year.

MINUTE BOOK

MINUTES OF THE BOARD MEETING
of
ALLIED IRISH BANKS, p.l.c.

held on Thursday, 19 June 2008,
at Bankcentre, Ballsbridge, Dublin 4 at 8.00 a.m.

PRESENT: Dermot Gleeson Chairman
Kieran Crowley
Colm Doherty
Donal Forde
Stephen L. Kingon
Anne Maher
Dan O'Connor
John O'Donnell
Sean O'Driscoll
David Pritchard
Eugene Sheehy
Bernard Somers
Michael J. Sullivan
Robert G. Wilmers
Jennifer Winter

IN ATTENDANCE: W. M. Kinsella, Secretary
Michael O'Farrell, GM, Retail Banking, AIB Bank RoI – Item 5
Eamonn Hackett, MD, Global Treasury – Item 6
Brendan O'Connor, Head of Global Treasury Services – Item 6
Donal Murphy, Head of Wholesale Treasury – Item 6
Kevin Garvey, Head of Group Credit Review – Item 7
Paul Stanley, Head of ALM, Group Finance – Item 7

[redacted]

2. **Group Chief Executive's Report**
Mr. Sheehy presented his Report, which commented on the Group's financial performance to April 2008, Divisional business developments, loan growth, loan quality, operational risk, market risk and other issues, including a commentary on M&T's financial performance to April 2008. The list of exceptions to the Group Large Exposure Policy greater than €250m approved by Management during May 2008 was appended, together with the Board Dashboard dealing with the top Risk, Internal Audit, and Compliance issues, and the top Enterprise projects.

Mr. Sheehy reported on the recent successful Tier 2 capital issuance which had raised £700m, and he indicated that any opportunity that arose over the remainder of the year for a further issue would be availed of. He then reported on an initiative being developed to assist the housing market under which the banks and the Government would jointly contribute to a fund to increase the availability of Social and Affordable Housing. He then commented on the trading conditions being experienced by the UK and Poland Divisions.

Mr. Forde reported on the difficult conditions being experienced by AIB

CHAIRMAN'S INITIALS

2. **Group Chief Executive's Report** (Continued)
Bank RoI; access to, and cost of, funding were critical issues; there was no loan growth in Business Banking, and Wealth Management was stagnant; the mortgage market was slowing; and Divisional activity was heavily concentrated on managing the loan portfolio.

Mr. Doherty reported that the Bank's liquidity was strong, being €5bn surplus to internal policy and €12bn surplus to regulatory requirements, and that it was intended to maintain or strengthen that position. He advised that, in aggregate, Capital Markets Division was doing well; Corporate Banking was having considerable success in raising deposits, and the loan book was being grown in line with deposit growth; close attention was being paid to margins, and credit quality was robust. Global Treasury's recent performance had been strong, and a new asset valuation methodology for the Traded Credit portfolio had been approved by the Audit Committee and would be positive for the reported profit figures. Investment Banking was experiencing very difficult conditions. In general, the prognosis for the second half of the year was poor.

Mr. Wilmers reported that M&T's performance for May 2008 had been $16m adverse to plan. Charge-offs were adverse to plan and non-performing loans had increased. The major issues for M&T were the management of the Alt-A portfolio and the Construction/Real Estate portfolio. He advised that liquidity was being closely managed, and that Mr. Doherty had assisted M&T to strengthen its liquidity.

There was then an exchange of views on the state of the economy in Ireland and internationally and the outlook.

3. **Chairman's Report**
The Chairman reported that he had attended a number of international meetings of Bank Chairmen since the previous Board meeting. These had included private sessions with top US and European regulators, and the key messages emerging included the following:

- More regulation is to be expected, including higher capital and liquidity requirements.
- There are serious questions about the US economy.
- Inflation is the big risk worldwide.
- The shortcomings of stress testing have been exposed.
- The days of 20%+ RoEs are over.
- Oil and steel price increases do not reflect a bubble, but, rather, real demand.
- US Dollar weakness is expected to continue.
- Housing is the key issue; the fundamental proposition is that unless you know where the bottom of the housing market is you do not know the value of mortgage-backed securities; and until you know the value of mortgage-backed securities, you do not know the condition of many banks' balance sheets.

The Chairman then reported on a number of the issues discussed at the Non-Executive Directors' session held during the 15 May 2008 Board meeting. These included expressions of confidence in Management; concerns regarding Compliance and Audit costs (to include indirect costs, such as diversion of front-line energy, the danger of blunting competitive instincts, etc.) and a desire to continue to debate the appropriateness of those costs; reservations regarding the freeze on graduate recruitment; questions with respect to the value of incremental cost growth generally, and cost over-runs on projects.

CHAIRMAN'S INITIALS

MINUTE BOOK

4. **Group Management Accounts**

Mr. O'Donnell presented the Group Management Accounts to April 2008, noting that the profit figures therein were marginally lower than those reported in the Indicative April 2008 Accounts reviewed by the Board on 15 May 2008.

He then commented on the Indicative Accounts to May 2008, advising that year-to-date EPS growth was in line with the guidance given to the market for the half-year when the Traded Credit portfolio mark-to-market losses, other than the €30m loss included in that guidance, were excluded.

Mr. Sheehy reported that investors were expressing concerns with respect to capital adequacy and dividend policy. He considered the capital position to be satisfactory and he did not foresee a need to go the market for equity. With respect to the dividend, he advised that, in due course, Management was likely to recommend a 10% increase in the interim dividend. Some Directors expressed reservations in relation to such an increase.

The position was noted. The Chairman indicated that it would be premature to reach any conclusions with respect to the interim dividend, and that the matter would be considered on 24 July 2008 in the light of all relevant information.

5. **Retail Banking Business Review – AIB Bank RoI**

Mr. O'Farrell presented a paper under the above title. At the outset, he provided an update on the re-orientation of the Retail Banking Operating Model (Programme Alpha), which had been endorsed by the Board on 24 May 2007. This involved, inter alia:

- The establishment of specialist service centres, to enhance customer experience and create additional branch capacity for relationships, sales and service.
- A more focussed Credit Management approach.
- A refined Customer Management Model.
- Redesign of physical branch environment.
- Re-inforcing the Service Culture.
- Enhancing Branch Operational Excellence.
- Enabling staff to deliver to their full potential.

These changes had been implemented while delivering strong financial results, and, in that regard he reported that Branch Banking net profit had increased from €608m in 2004 to €940m in 2007. He commented on competitive performance in terms of market share changes in key product areas. He then discussed the new strategic challenges and how these were being addressed; he reported on the approaches being taken by the main competitors in the market; and he indicated that AIB was protecting and developing customer relationships and sustaining its commitment to staff. At the conclusion of the presentation, he advised that the new realities with respect to cost management, the difficult credit environment, and scarce funding were recognised, and that the work done in re-orienting the Retail Operating Model had been timely and would help to sustain and develop AIB's business through the cycle.

Mr. O'Farrell responded to questions and was thanked for his report.

CHAIRMAN'S INITIALS

6. **AIB Global Treasury Business Review**

Mr. Hackett, in a presentation, outlined the role of Global Treasury ("GT"), as follows:

6. **AIB Global Treasury Business Review** (Continued)

- To manage the funding and liquidity of AIB Group in all locations.
- To act as price maker for all market risk incurred across AIB Group.
- To deliver treasury risk solutions to institutional, corporate and commercial customers.
- To trade profitably and professionally in selected Wholesale Markets.

He commented on GT's strategic objectives, including maintaining its position as number one Treasury services provider in Ireland, its organisation structure, control framework, and financial performance over the 2004 – 2008 period.

Mr. O'Connor discussed the role of Global Treasury Services, which provided treasury products and services to a broad range of customers. He reported on its strong position in the domestic market, its business in the UK and North America, its financial performance, and the challenges and opportunities facing it.

Mr. Murphy reported on the responsibilities of Wholesale Treasury ("WT"), including the management of the funding and liquidity of the Group, and the generation of profit from taking discretionary positions in wholesale markets. He discussed the current strong focus on liquidity and funding, the markets for which had changed dramatically since Q3, 2007 and which remained distressed, and the need for active management of all aspects of AIB's positions. He commented on the services offered to internal customers, proprietary activity, and the material impact which the credit crises had had on the WT credit portfolios (in respect of which an alternative valuation approach had been developed in recognition of the inactive nature of current markets and the value and strength of the underlying assets), and on WT's income. He then discussed the challenges and opportunities facing WT.

Mr. Hackett reported on the operations and performance of BZWBK's Treasury, discussing its functions, profitability, customer business and services, and the challenges and opportunities it faced.

Messrs. Hackett, O'Connor and Murphy responded to questions, and were thanked for their report.

The Chairman thanked Mr. Hackett and his Team in Global Treasury for the critical role they had played, and were continuing to play, in prudently managing the Group's liquidity and funding and in capital raising, and he expressed the Board's appreciation of their work and professionalism in that regard.

[redacted]

CHAIRMAN'S INITIALS

[redacted]

Chairman ______________ Date 18th 11th 08

CHAIRMAN'S INITIALS

THEME: B2

Effectiveness of banks' credit strategies and risk management

LINE OF INQUIRY: B2b

Appropriateness of credit policies, delegated authorities and exception management

3186

MINUTES OF THE BOARD MEETING
of
ALLIED IRISH BANKS, p.l.c.

held on Thursday, 27 July 2006 at Bankcentre, Ballsbridge, Dublin 4, at 8.00 a.m.

PRESENT:

Dermot Gleeson — Chairman
Eugene Sheehy — Group Chief Executive
Adrian Burke
Kieran Crowley
Colm Doherty
Don Godson
John B. McGuckian
John O'Donnell
Jim O'Leary
Robert G. Wilmers
Jennifer Winter

IN ATTENDANCE:

W. M. Kinsella, Secretary
Kevin Garvey, Head of Group Credit Review – Item 4.2
Shom Bhattacharya, Group Chief Risk Officer – Item 4.3
Paul Quigley, Executive, Risk Integration & Measurement - Item 4.3
Joe Stanley, Group Head of Operational Risk Management - Item 4.3
David Meagher, Group Chief Credit Officer - Item 4.2, 4.3 and 5
Tony O'Mahony, Senior Manager, Credit, Legal and Bank Relations, AIB Capital Markets - Item 5
Philip Brennan, GM, Group Regulatory Compliance & Business Ethics - Item 6
Ray O'Connor, Head of Group Taxation - Item 7
Maeliosa O'hOgartaigh, Group Head of Accounting and Finance - Item 8

Apologies for inability to attend were conveyed on behalf of Mr. Padraic M. Fallon and Mr. Michael J Sullivan.

[redacted]

3187

MINUTE BOOK

2. Group Chief Executive's Report

The Group Chief Executive's Report had been circulated in advance of the meeting. It commented on the Group's financial performance to 30 June 2006, Divisional business developments, operational risk, market risk, and other issues, including M&T's financial performance to 30 June 2006. There was appended to the Report a "Board Dashboard" summarising the top 5 Internal Audit Issues, the top 5 Compliance Issues, and the top 5 Projects.

Mr. Sheehy commented on a number of matters in his Report, including an apparent change of sentiment at the top end of the property market, where developers were turning to intermediaries to take equity positions on property financing. While mortgage demand remained strong, AIB was 1% below its normal market share, a position that was not of concern in the short term. He then commented on a recently published EU Report on Retail Banking, which showed the Irish banks as achieving relatively high levels of profitability, and advised that the EU Commission had invited industry participants and customers to submit comments on the Report. AIB had retained expert advice and was reviewing the matter.

Mr. Doherty commented on the expected underperformance of Wholesale Treasury in the second-half of the year, and on the very low level of provisions in the first half. He reported that he had approved the sale of Ketchum Canada to its management for CAD$2.3m, and that its written-down book value was CAD$1.6m.

He advised that, following a review of the returns being earned on Corporate Banking's credit portfolio, certain relationships in the UK and the USA were being exited because of the inadequacy of returns. In addition, the Group Executive Committee had decided that, in order to protect the Bank's Irish franchise, AIB should continue to do business with certain major Irish corporate customers, despite margins being below target levels. Mr. Doherty then reported the resignation of [redacted] MD, AIBIM, to take up a position in the National Treasury Management Agency.

Mr. Wilmers reported that M&T had bid for 21 Citibank branches in Buffalo and Rochester, and that this would result in M&T becoming the largest bank in the related metropolitan areas. Some 16 of those branches overlapped with M&T branches, which would be closed. He commented on a Federal Reserve Board examination of M&T, the findings of which had been reported to the Board of M&T in June; he advised that, apart from criticisms in respect of compliance-type issues and a view that real estate concentrations were high, the Federal Reserve report had been positive.

[redacted]

4. **Financial Results: Half-year to 30 June 2006**

4.1 **Group Management Accounts**

A paper containing the Group Management Accounts for the half-year to 30 June 2006 had been circulated in advance of the meeting. The paper included Divisional Profit Summaries and comments thereon, Operating Profit Summary (before provisions), the Group's Summary Profit and Loss Account, Operating Expenses Analysis, the performance of the main Business Units, the Balance Sheet, Provision Analysis, Total Shareholder Return, and other key statistics.

Mr. O'Donnell commenced his presentation by commenting on Divisional variances in comparison with the May 2006 forecast; he then reviewing the key highlights for the half-year, including:

- EPS growth +29%.
- Strong Divisional profit growth.
- Operating profit before provisions +24% on a constant currency basis.
- Income/cost gap 6%.
- Cost growth 11% (9% excluding mandatory regulatory costs and higher performance-related costs).
- Cost/income ratio down by 2.7% to 52.4%.
- Exceptional credit provision writebacks. Bad debt provision rate of charge 3 bps, down from 13 bps at June 2005.
- ROE 30.4% compared with 20.1% for the same half-year in 2005.

He advised that, in the light of the results for the half-year, it was proposed to change the EPS market guidance for the year from "mid to high teens growth", to "in excess of 20%".

He commented on Divisional performance and variances against budget, and other aspects of the figures, including a comparison of AIB's TSR with peer banks. AIB's relatively low rating (along with the other Irish banks), which was determined largely in London and New York, was regarded as a concern, and it was noted that Management was addressing the matter to the extent practicable.

The financial results for the half-year were noted with approval, and Management was congratulated on the outstanding performance achieved.

RMAN'S
TIALS

4. **Financial Results: Half-year to 30 June 2006** (Continued)

(Ms. Winter left the meeting towards the commencement of Item 4.1 and returned during Item 8.)

4.2 Credit Review

The Credit Review had been circulated in advance of the meeting and was presented by Mr. Garvey. It contained the following highlights for the half-year:

- The provision charge was €12m, (0.03% of average advances). This was €67m favourable to Plan, and compared with €46m (0.13%) for the same period in 2005.
- Balance Sheet provision cover remained adequate; specific provision cover for identified impaired loans, at 59%, was unchanged. Provisions for unidentified impaired loans had reduced marginally to 0.18% of advances.
- Credit quality remained strong. Group Impaired Loans decreased by €81m (Fx neutralised: €66m), and had reduced to 0.8% of advances, from 1.0% in December 2005.
- Advances had increased by 12%; this was 1% ahead of Plan. The broad Property, Building and Construction sector continued to be a key driver of growth (+19%) and represented 31% of advances compared with 29% at December 2005. Residential Mortgages had grown by +11%, and represented 24.8% of advances, compared with 24.9% at December 2005.
- Provision experience to June 2006 continued to be exceptional and was assisted by strong recoveries, particularly in Capital Markets and GB&NI Divisions. Divisions were forecasting provisions of €117m (0.12%) for the year in comparison with a planned level of €158m (0.17%).

Mr. Garvey, commented on the above, and on the Home Mortgage report included in the paper, including Policy changes introduced in Q2, 2006.

Mr. Garvey then reported that, in respect to the broad Property, Building and Construction sector, AIB was in breach of the limit contained in the Central Bank's Licensing and Supervision Requirements and Standards for Credit Institutions ("the Standards"), which provided, inter alia, that a credit institution should not have risk assets amounting to more than 200% of 'Own Funds' concentrated in any one sector of business or economic activity which was subject to a common, predominant risk factor; where a common risk could be considered to apply to two or more separate sectors, the limit was 250% of 'Own Funds'. In that regard, he advised that AIB's exposures to the broad Property, Building and Construction sector amounted to 260% of 'Own Funds', while the limit was 250%.

He indicated that the matter had been discussed with IFSRA who did not regard it as a significant issue. IFSRA were informed that the breach was likely to continue, and had not requested that AIB change any of its existing practices . He suggested that other banks were also in breach. He then advised that the concept of sectoral concentration limits was under discussion at The Committee of European Banking Supervisors, as well as between the Irish Bankers' Federation and the Central Bank of Ireland. The Board requested that this issue be pursued with IFSRA, given that the Standards clearly required revision. It was noted that while a breach of the Standards might be fully understood at local regulatory level, it could potentially give rise to issues on foreign filings.

CHAIRMAN'S INITIALS

W

4. Financial Results: Half-year to 30 June 2006 (Continued)

4.2 Credit Review (Continued)

The reported breach of the Standards was noted, and the Chairman directed that Mr. Garvey investigate forthwith, with relevant areas in the Bank, whether the breach had implications for the sign-off of the Form 20F, or SOX certification, or the like.

Mr. Garvey was thanked for his report for the half-year.

4.3 Enterprise-Wide Risk Review

A paper containing the Risk Review for the half-year to 30 June 2006 had been circulated in advance of the meeting and was presented by Mr. Bhattacharya. The paper set out the objectives of the Risk Review and the methodology employed, and commented on the operating environment for risk management. The paper also contained the CRO's 'Statement on Internal Controls', affirming that all material risks had been identified and that no major control gaps were known to Management.

Mr. Bhattacharya commented on the top 10 risks as set out in the paper, and Messrs. Meagher, Quigley, and Stanley commented on the different aspects of risk.

Mr. Bhattacharya responded to questions, and was thanked for his report. He circulated the Risk Dashboard, for information.

[redacted]

[redacted]

Chairman: Dan McCarthy

Date: 4th Sept 06

BS
x 6767437

[redacted]

DRAFT — SUBJECT TO GCC [redacted]

REQUEST FOR APPROVAL OF EXCEPTION TO GROUP LARGE EXPOSURE POLICY LIMITS

[redacted]

1. **Background**

- [redacted]
- Peak underwrite facilities of €0.79m approved by AIB in September 2007.
- The breakdown of the current exposure of €789m is as follows:
  - €84m against self financing investment assets (73% LTV)
  - €149m against site hold facilities (70% LTV).
  - €190m against the [redacted] in respect of the purchase of ICG shares (€30m site refinance & €160m share purchase). LTV 61%.
  - €228m on the [redacted] (68% LTV). €100m of this exposure relates to the development of 270,000 sq ft (100,000 sq ft pre-let to [redacted]).
  - [redacted]
- Interest is funded as it falls due either from rental income or the cashflow of the group. Account performance is satisfactory.
- To date AIB has primarily banked the [redacted]. The current proposal is a good opportunity to bank the [redacted] side of his operation at an acceptable risk level. The Bank will have recourse to the [redacted] which has a net worth of €1.5bn.

2. **Sought - Total underwrite facilities of €991m -new facilities of €202m** [redacted].

- Increase in exposure of €202m is sought to participate in a syndicated facility of €605m with BoSI and NIB in respect of [redacted] site which is through his [redacted] **Group**.
- A summary of the facilities sought is as follows:

	Total Debt €'m	**AIB Debt (1/3) €'m**
Investment Facility	100	33.33
Development Facility	195	65
Land Facility	145	48.33
Equity Release Facility	165	55
Total	**605**	**201.6**

789
202
991

- The site comprises 417 acres with zoning spread across commercial, district centre, residential and amenity.
- Client has completed c.586k sq ft of office space at this point of which 449k sq ft has been successfully let. This is generating a rental income of €6.8m for client which is satisfactory to provide interest cover of 119% on the investment facility sought of €100m in total (€33.33m per bank).
- A development loan facility of €195m (€65m per bank) is sought towards the completion of an additional 657k sq ft of office space and associated infrastructure / roads. The drawdown of the development loan will be capped based on client achieving satisfactory lettings with no more than 300k sq ft of speculative / vacant space at any one time.
- The land loan and equity release facility amount to €310m (€103.33m per bank) with all facilities to be cross collateralized.
- Overall peak gearing amounts to 43% including interest rollup of €20m (€6.67m per bank) on the equity release facility.
- With the exception of this equity release facility, interest is to be funded as it falls due.
- The facility is for a two year term and is subject to refinance / review at that stage.

Only pages 1 to 3 were circulated to the Board. Chairman also received the full write-up

3. **Group Large Exposure Policy - Grade 4 (Weighted Borrower Grade)**

Proposed Underwrite Exposure	€991m	Large Exposure Policy Limit	€150m

The proposed exception to Group Large Exposure is recommended in view of the following key risk mitigants:

- Divisibility of asset and project risk involving a mix of residential, commercial and office projects as outlined below.
- Track record and experience of promoter with effective recourse to a corporate entity with an estimated net worth of €1.5bn [redacted]
- Repayment of €138m exposure scheduled over the next 12 months [redacted].
- Overall gearing (including non AIB debt) for [redacted] and his associated companies is below 40% (based on statement of affairs 30/06/07).
- The facilities now sought relate to the [redacted] on a standalone basis is very lowly geared at 43% when the facilities are fully drawn (including equity release).

[redacted]	Exposure €m's	Comment
	202	▪ Well spread site in terms of zoning and development. The banks exposure is spread across investment, land, development ▪ Max gearing 43% with letting risk capped at 300k sq ft
	228	▪ Significant pre-lets. ▪ Low initial site LTV at 48%.
	190	▪ LTV of 61% ▪ Planning Permission refused for 737 apartments and 270,000 sq.ft. commercial space (rejected by An Bord Pleanala on the basis of infrastructure/ transport networks and these issues are now being addressed.). ▪ ICG shares represent long term strategic investment.
	138	▪ To clear in c.12 months. ▪ Designated site, substantially complete. ▪ 45% LTV based on completed development value.
	90	▪ LTV of 68% ▪ Sites at [redacted]
	59	▪ 70% LTV ▪ 5 distinct sites with interest being funded.
	84	▪ 73% LTV ▪ Self financing.
	991	

4. [redacted]

The current proposal represents a gearing level of 43% with an LTV covenant to ensure that this position is maintained below 50%. The following table is a summary of the Banks position based on total hold facilities of €991m:

[redacted]	**Debt**	**LTV**
	202	43%
	228	68%
	190	61%
	138	63%
	149	70%
	84	73%
	991	

- Overall average gearing is 60% across the Banks total exposure to [redacted]. Average gearing excluding the [redacted]

5. Repayment Capacity

- Total annual interest payments amount to €27.28m based on peak drawdown of €605m. However, at peak drawdown clients will have additional leases in place which will generate additional rental income.
- On expiry of the facility in December 2009, it is anticipated that an additional 657k sq ft of office space will be fully completed and let with other blocks remaining under construction. Assuming client achieves an average rent of €22.7 psf (based on current average), this will generate additional rent of €10m for client.
- Worst case scenario is that the facility is fully drawn with 300k sq ft of the commercial space remaining unlet (as per condition of sanction). Based on this scenario, the additional rental income amounts to €5.4m (based on clients share).
- The table below summaries the position:

		Scenario 1	*Scenario 2*
	Current €'000	***Projected(657k sq ft let) €'000***	***Projected(357k sq ft let) €'000***
Rental Income	6,800	16,800*	12,200**
Interest (based on full drawdown excluding warchest facility)	27,280	27,280	27,280
Shortfall	(20,480)	(10,480)	(15,080)

*this assumes that the additional 657k sq ft of space is built and let during the life of the facility (2 years).
** this assumes that 300k sq ft of the completed space remains vacant.

- The projected shortfall can be met from the cashflow of the group.
- The bank will also have recourse to the overall [redacted]ch has an estimated net worth of €1.5bn.

6. Refinance Risk

- On expiry of the facility, client will have secured a minimum rent of €12.2m (assumes 300k sq ft remains vacant) which could service debt up to €177m at an all in rate of 6.2%.
- This would equate to an investment loan facility of €177m against a value of €256m, 69% gearing.
- The residual debt of €428m would be secured by vacant units / land with a value of €1.1bn, 39% gearing.
- Based on above we feel that refinancing should not pose a difficulty for the customer.

7. Oireachtas-P

Oireachtas-P

8. Income in 1st year

The projected EVA for the current proposal is €2.45m. This represents an EVA of 1.22% of exposure.

9. Recommendation

Divisional Credit Committee: Recommended.

Group Credit Committee: Recommended.

THEME: B3

Effectiveness of banks' funding, liquidity strategies and risk management

LINE OF INQUIRY: B3e

Capital structure and loss absorption capacity

Statutory duty confirm letter

A903
A901

ONY
29/4/09

KPMG
1 Harbourmaster Place
IFSC
Dublin 1
Ireland

Telephone +353 1 410 1000
Fax +353 1 412 1122
Internet www.kpmg.ie

Banking Supervision Department
Irish Financial Services Regulatory Authority
PO Box 559
Dame Street
Dublin 2

29 April 2009

Dear Sirs

Statutory Duty confirmation: Statement by the auditor of Allied Irish Banks, p.l.c. ('the Bank') to the Financial Regulator

This letter and appendix constitute a report as required by section 27B of the Central Bank Act 1997 in relation to our statutory duty to report certain matters to the Financial Regulator, as specified in section 47 of the Central Bank Act 1989 ("CBA 1989") and regulations 7, 8 and 9 of the Supervision of Credit Institutions, Stock Exchange Members Firms and Investment Business Firms Regulations 1996 ("the Post BCCI Regulations"). Appendix 1 to this letter lists the reporting periods in which we acted as auditor of Allied Irish Banks, p.l.c. ('the Bank") and are therefore subject to the statutory duty from 1 January 2008 to 31 December 2008.

Respective responsibilities of directors and auditor

It is the responsibility of the directors of the Bank:

- to take appropriate steps to provide reasonable assurance that the Bank complies with applicable legislation and the requirements of the Financial Regulator set out in Guidance Notes, Notices, Handbooks, Codes and other authoritative pronouncements (the Supervisory Requirements);

- to establish arrangements designed to detect non-compliance with the Guidance Notes, Notices, Handbooks, Codes and other authoritative pronouncements ("the Supervisory Requirements") and to report any breaches to you; and

- to report to the Financial Regulator any information, which they know or have reasonable, cause to believe is of material significance for the Financial Regulator's supervisory functions under the Supervisory Requirements.

HG 12/1/10

20/12/10

Our responsibilities are to report to you matters which come to our attention in the course of our work as auditors and are of regulatory concern to you, in accordance with section 47 of the CBA 1989 and the Post BCCI Regulations and to report on an annual basis to you in relation to whether circumstances indicating such matters have been identified in the course of our work.

Basis of statement

In discharging our statutory duties to report to you under section 47 of the CBA 1989 and the Post BCCI Regulations, we have had regard to Practice Note 19 (I) ("Banks in the Republic of Ireland"). In doing so, we are required to consider matters of which we have become aware in our capacity as auditor listed in the Appendix 1 to this letter.

The basis of the work done in respect of each capacity is referenced in Appendix 1 to this letter. We are not required to carry out any additional work to identify matters to be reported under the statutory duty.

Statement

In the context of the continued dislocation of financial markets and the significant levels of illiquidity in wholesale funding markets, KPMG met with Mr. Con Horan (Head of Banking Supervision) of the Financial Regulator on 23 February 2009 to discuss the impact of these market conditions on the Bank. In accordance with Practice Note 19 – The Audit of Banks in the Republic of Ireland, section 47 of the Central Bank Act 1989 and Regulations 7 of the Supervision of Credit Institutions, Stock Exchange Firms and Investment Business Firms Regulations 1996, KPMG informed the Financial Regulator at that meeting that we had an obligation to inform the Financial Regulator where there was reason to believe that:

- The continuous functioning of the Bank may have been affected; in particular, that there may have existed circumstances which were likely to affect materially the Bank's ability to fulfil its obligations to persons maintaining deposits with it or to meet any of its financial obligations under the Central Bank Acts, 1942 to 1989; and

- There were circumstances that led us to believe that a going concern basis of preparation for the Bank's financial statements for the 31 December 2008 year-end may not have been appropriate.

Subsequent to our meeting on 23 February 2009 with the Financial Regulator, KPMG also had discussions with the representatives from the Central Bank of Ireland and the Department of Finance. As a result of these discussions and on completion of our other audit procedures, including consideration of the expanded disclosures in the financial statements relating to the basis of preparation of the financial statements, KPMG concurred with the conclusions of the directors of the Bank that a going concern basis of preparation for the financial statements for the year-ended 31 December 2008 was appropriate.

Except for the matters noted above, no circumstances have come to our attention, in our capacity as described in Appendix 1, that have given rise to a statutory duty on us to report to you under; (i) section 47 of the Central Bank Act 1989, or (ii) Regulations 7, 8 and 9 of the Supervision of Credit Institutions, Stock Exchange Firms and Investment Business Firms Regulations 1996:

Our report is prepared solely for the confidential use of the Financial Regulator as required by section 27B of the Central Bank Act 1997. It may not be relied upon by Allied Irish Banks, p.l.c. or the Financial Regulator for any other purpose whatsoever. KPMG neither owes nor accepts any duty to any other party and shall not be liable for any loss, damage, or expense of whatsoever nature which is caused by reliance on our report.

Other matters

We have attached a copy of our reporting to the Audit Committee of Allied Irish Banks, p.l.c. on 18 February 2009.

Yours faithfully

KPMG

KPMG
Chartered Accountants and Registered Auditor

CC: Mr Philip Brennan, Allied Irish Banks, p.l.c.

Appendix 1 to Statutory Duty Confirmation

Capacity	Reporting period	Reference to basis of work
Auditor of consolidated financial statements of Allied Irish Banks, p.l.c.	Financial year ended 31 December 2008	Audit report dated 27 February 2009

THEME: B7

Impact of the banks' external audit processes in supporting effective risk management

LINE OF INQUIRY: B7b

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

EUROPEAN COMMISSION

Brussels, 2.6.2010
COM(2010) 284 final

GREEN PAPER

Corporate governance in financial institutions and remuneration policies

{COM(2010) 285 final}
{COM(2010) 286 final}
{SEC(2010) 669}

GREEN PAPER

Corporate governance in financial institutions and remuneration policies

(Text with EEA relevance)

1. INTRODUCTION

The scale of the financial crisis triggered by the bankruptcy of Lehman Brothers in autumn 2008 and linked to the inappropriate securitisation of US subprime mortgage debt led governments around the world to question the effective strength of financial institutions and the suitability of their regulatory and supervisory systems to deal with financial innovation in a globalised world. The massive injection of public funding in the US and Europe – up to 25% of GDP – was accompanied by a strong political will to learn the lessons of the financial crisis in all its dimensions to prevent such a situation happening again in the future.

In its Communication of 4 March 2009[1], effectively a programme for reforming the regulatory and supervisory framework for financial markets based on the conclusions of the Larosière report[2], the European Commission announced that it would (i) examine corporate governance rules and practice within financial institutions, particularly banks, in the light of the financial crisis, and (ii) where appropriate, make recommendations, or even propose regulatory measures, in order to remedy any weaknesses in the corporate governance system in this key sector of the economy. Strengthening corporate governance is at the heart of the Commission's programme of financial market reform and crisis prevention. Sustainable growth cannot exist without awareness and healthy management of risks within a company.

As highlighted by the Larosière report, it is clear that boards of directors, like supervisory authorities, rarely comprehended either the nature or scale of the risks they were facing. In many cases, the shareholders did not properly perform their role as owners of the companies. Although corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed significantly to excessive risk-taking on the part of financial institutions. This general observation is all the more worrying because corporate governance has been relied upon as one of the ways of regulating business life. Consequently, there is a need to address the fundamental question of whether the existing corporate governance regime is deficient as far as financial institutions are concerned or whether it has rather been poorly implemented.

In the financial services sector, corporate governance should take account of the interests of other stakeholders (depositors, savers, life insurance policy holders, etc), as well as the stability of the financial system, due to the systemic nature of many players. At the same time, it is important to avoid any moral hazard by not diminishing the responsibility of private stakeholders. It is therefore the responsibility of the board of directors, under the supervision

---

[1] COM (2009) 114 final.

[2] Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009. Mr Jacque de Larosière was chairman of the group.

of the shareholders, to set the tone and in particular to define the strategy, risk profile and appetite for risk of the institution it is governing.

The options outlined in this Green Paper are likely to accompany and supplement the legal provisions implemented or planned for the purpose of strengthening the financial system, in particular in the context of the reform of the European supervisory architecture[3], the Capital Requirements Directive (the 'CRD')[4], the Solvency II Directive[5] for insurance companies, reform of the UCITS system and the regulation of Alternative Investment Fund Managers.

Corporate governance requirements should also take account of a financial institution's type (retail bank, investment bank) and size. The principles of sound corporate governance referred to in this Green Paper focus primarily on large financial institutions. These principles should be adapted so as to be applied effectively to smaller financial institutions.

This Green Paper should be read in conjunction with the Commission Staff Working Paper (COM(2010) XYZ) '*Corporate governance in financial institutions: the lessons to be learnt from the current financial crisis and possible steps forward*'. This document takes stock of the situation.

It is also important to point out that, since its meeting in Washington on 15 November 2008, the G20 has endeavoured to improve, amongst other things, risk management and compensation practices within financial institutions[6].

Lastly, the Commission will soon launch a broader review on corporate governance within listed companies in general and, in particular, on the place and role of shareholders, the distribution of duties between shareholders and boards of directors with regard to supervising senior management teams, the composition of boards of directors, and corporate social responsibility.

2. THE CONCEPT OF CORPORATE GOVERNANCE AND FINANCIAL INSTITUTIONS

The traditional definition of corporate governance refers to relations between a company's senior management, its board of directors, its shareholders and other stakeholders, such as employees and their representatives. It also determines the structure used to define a company's objectives, as well as the means of achieving them and of monitoring the results obtained[7].

---

3 See the Commission proposals creating three European Supervisory Authorities and a European Systemic Risk Board.

4 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), *OJ L 177 of 30.6.2006* and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), *OJ L 177 of 30.6.2006*.

5 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) *OJ L 335 of 17.12.2009*.

6 It was confirmed at the Pittsburgh Summit of 24 and 25 September 2009 that compensation practices would have to be reformed in order to maintain financial stability.

7 See, for example, the OECD's Principles of Corporate Governance, 2004, p. 11. The Green Paper focuses on this limited definition of corporate governance and does not deal with some other important aspects, such as separation of functions within a financial institution, internal controls and accounting independence.

Due to the nature of their activities and interdependencies within the financial system, the bankruptcy of a financial institution, particularly a bank, can cause a domino effect, leading to the bankruptcy of other financial institutions. This can lead to an immediate contraction of credit and the start of an economic crisis due to lack of financing, as the recent financial crisis demonstrated. This systemic risk led governments to shore up the financial sector with public funding. As a result, taxpayers are inevitably stakeholders in the running of financial institutions, with the goal of financial stability and long-term economic growth.

Furthermore, the interests of financial institutions' creditors (depositors, life insurance policy holders or beneficiaries of pension schemes and, to a certain extent, employees) are potentially at odds with those of their shareholders. Shareholders benefit from a rise in the share price and maximisation of profits in the short term and are potentially less interested in too low a level of risk. For their part, depositors and other creditors are focused only on a financial institution's ability to repay their deposits and other mature debts, and thus on its long-term viability. As a result, depositors can be expected to favour a very low level of risk[8].

Largely as a result of the particularities relating to the nature of their activities, most financial institutions are strictly regulated and supervised. For the same reasons, financial institutions' internal governance cannot be reduced to a simple problem of conflicts of interest between shareholders and the management. Consequently, the rules of corporate governance within financial institutions must be adapted to take account of the specific nature of these companies. In particular, the supervisory authorities, whose mission to maintain financial stability coincides with the interests of depositors and other creditors to control risk-taking by the financial sector, have an important role to play in shaping best practices for governance in financial institutions.

Various legal instruments and recommendations at international and European level applicable to financial institutions and in particular banks, already take account of the particularities of financial institutions and the role of supervisory authorities[9].

However, the existing rules and recommendations are based first and foremost on supervisory considerations and focus on the existence of adequate internal control, risk management, audit and compliance structures within financial institutions. They did not prevent excessive risk-taking by financial institutions, as the recent financial crisis demonstrated.

---

[8] See Peter O. Mülbert, Corporate Governance of Banks, *European Business Organisation Law Review, 12 August 2008*, p.427.

[9] Basel Committee on Banking Supervision, Enhancing corporate governance for banking organisations, September 1999. Revised in February 2006; OECD, Guidelines for insurers' governance, 2005; OECD, Revised guidelines for pension fund governance, July 2002; Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, *OJ L 145 of 30.4.2004*; Solvency II Directive; Capital Requirements Directive; Committee of European Banking Supervisors, Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised), 25 January 2006, http://www.c-ebs.org/getdoc/00ec6db3-bb41-467c-acb9-8e271f617675/GL03.aspx; CEBS High Level Principles for Risk Management, 16 February 2010, http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-High-Level-Principles-for-Risk-Management.aspx

3. DEFICIENCIES AND WEAKNESSES IN CORPORATE GOVERNANCE WITHIN FINANCIAL INSTITUTIONS

The Commission considers that an effective corporate governance system, achieved through control mechanisms and checks, should lead to the main stakeholders in financial institutions (boards of directors, shareholders, senior management, etc.) assuming a higher degree of responsibility. Conversely, the financial crisis and its serious economic and social consequences have led to a significant loss of confidence in financial institutions, particularly with regard to the following.

3.1. The question of conflicts of interest

The questions raised by the issue of conflicts of interest and management of such conflicts are nothing new. Indeed, the issue arises in every organisation or company. Nonetheless, given the systemic risk, the volume of transactions, the diversity of financial services provided and the complex structure of large financial groups, the issue is particularly pressing in the case of financial institutions. Potential conflicts of interest can arise in a variety of situations (for example, exercising incompatible roles or activities, such as providing advice on investments while managing an investment fund or managing for one's own account, incompatibility of mandates held on behalf of different clients/financial institutions). This problem can also arise between a financial institution and its shareholders/investors, particularly where there is cross-shareholding or business links between an institutional investor (for example through the parent company) and a financial institution in which it is investing.

At Community level, the MiFID[10] is a step forward for transparency, devoting a specific section to certain aspects of this issue. However, the asymmetric information between investors and shareholders on the one hand, and the financial institution concerned on the other (an imbalance compounded by the ever-increasing complexity and diversity of the services provided by financial institutions), calls into question the effectiveness of market identification and supervision of various conflicts of interest involving financial institutions. Furthermore, as the CEBS, CEIOPS and CESR committees note in their joint report on internal governance[11], there is a lack of consistency in the content and detail of the conflict of interest rules to which the various financial institutions are subject, depending on whether they need to apply the provisions of MiFID, the CRD, the UCITS Directive[12] or Solvency 2.

3.2. The problem of effective implementation by financial institutions of corporate governance principles

The general consensus[13] is that the existing principles of corporate governance, namely the OECD principles, the recommendations of the Basel Committee, and Community legislation[14], already cover to a certain extent the problems highlighted by the financial crisis. In spite of this, the financial crisis revealed the lack of genuine effectiveness of corporate

---

10 Directive 2004/39/EC on markets in financial instruments, (OJ L 145 of 30.4.2004).

11 'Cross-sectoral stock-take and analysis of internal governance requirements' by CESR, CEBS, CEIOPS, October 2009.

12 Directive 2009/65/EC.

13 See the OECD's public consultation 'Corporate governance and the financial crisis' of 18 March 2009 and in particular the section entitled 'Implementation gap'.

14 Directive 2006/46/EC obliges financial institutions listed on regulated markets to draw up a corporate governance code to which they are subject, and to indicate any parts of the code from which they have departed and the reasons for doing so.

governance principles in the financial services sector, particularly with regard to banks. Several theories have been put forward to explain this situation:

– the existing principles are too broad in scope and are not sufficiently precise. As a result, they gave financial institutions too much scope for interpretation. Furthermore, they proved difficult to put into practice, in most cases leading to a purely formal application (i.e., a box-ticking exercise), with no real qualitative assessment.

– the lack of a clear allocation of roles and responsibilities with regard to implementing the principles, within both the financial institution and the supervisory authority.

– the non-binding nature of corporate enterprise principles: the fact that there was no legal obligation to comply with recommendations by international organisations or the provisions of a corporate governance code, the problem of the neglect of corporate governance by supervisory authorities, the weakness of relevant checks, and the absence of deterrent penalties all contributed to the lack of effective implementation by financial institutions of corporate governance principles.

3.3. Boards of directors[15]

The financial crisis clearly shows that financial institutions' boards of directors did not fulfil their key role as a principal decision-making body. Consequently, boards of directors were unable to exercise effective control over senior management and to challenge the measures and strategic guidelines that were submitted to them for approval.

The Commission considers that their failure to identify, understand and ultimately control the risks to which their financial institutions were exposed is at the heart of the origins of the crisis. Several reasons or factors contributed to this failure:

– members of boards of directors, in particular non-executive directors, devoted neither sufficient resources nor time to the fulfilment of their duties. Furthermore, several studies have clearly demonstrated that, faced with a chief executive officer who is omnipresent and in some cases authoritarian, non-executive directors felt unable to raise objections to, or even question, the proposed guidelines or conclusions due to a lack of technical expertise and/or confidence.

– members of boards of directors did not come from sufficiently diverse backgrounds. The Commission, like several national authorities, notes a lack of diversity and balance in terms of gender, social, cultural and educational background.

– boards of directors, in particular the chairman, did not carry out a serious performance appraisal either of their individual members or of the board of directors as a whole.

– boards of directors were unable or unwilling to ensure that the risk management framework and risk appetite of their financial institutions were appropriate.

15 The term 'board of directors' in this Green Paper essentially refers to the supervisory role of directors in a company which, in a dual structure, generally falls within the scope of the supervisory board. This Green Paper does not prejudice the roles attributed to different company bodies under national legal systems.

– boards of directors proved unable to recognise the systemic nature of certain risks and thus to provide sufficient information upstream to their supervisory authorities Furthermore, even where effective dialogue existed, corporate governance issues were rarely on the agenda.

The Commission considers that these serious deficiencies and acts of misconduct raise important questions about the quality of appointment procedures. The basis for quality in a board of directors lies in its composition.

3.4. Risk management

Risk management is one of the key aspects of corporate governance, particularly in the case of financial institutions. Several large financial institutions no longer exist precisely because they neglected the basic rules of risk management and control. Financial institutions have too often failed to take a holistic approach to risk management. The main failures and shortcomings can be summarised as follows:

– a lack of understanding of the risks on the part of those involved in the risk management chain and insufficient training for those employees responsible for distributing risk products[16];

– a lack of authority on the part of the risk management function. Financial institutions have not always granted their risk management function sufficient powers and authority to be able to curb the activities of risk-takers and traders;

– lack of expertise or insufficiently wide-ranging experience in risk management. Too often, the expertise considered necessary for the risk management function was limited to those categories of risk considered priorities and did not cover the entire range of risks to be monitored;

– a lack of real-time information on risks. To allow those involved to react quickly to changes in risk exposures, clear and correct information on risk should be available rapidly at all relevant levels of the financial institution. Unfortunately, the procedures for getting information to the appropriate level have not always functioned. Furthermore, it is crucial to upgrade IT tools for risk management, including in highly sophisticated financial institutions, as they are still too disparate to allow risks to be consolidated rapidly, while data are insufficiently consistent to allow the evolution of group exposures to be followed up effectively in real-time. This concerns not only the most complex financial products but all types of risk.

The Commission considers that the deficiencies and shortcomings highlighted above are very worrying. They appear to indicate the absence of a healthy risk management culture at all levels of certain financial institutions. On this last point, the directors of financial institutions in particular are responsible, because in order to establish a healthy risk management culture at all levels, it is essential that directors are themselves exemplary in this respect.

---

[16] See for example Renate Böhm and Hilla Lindhüber, *Verkaufen, Druck und Provisionen - Probleme von Beschäftigten im Finanzdienstleistungsbereich Versicherungen Ergebnisse einer Arbeitsklima-Index-Befragung*, Salzburg 2008.

3.5. The role of shareholders

The financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least. The growing importance of financial markets in the economy, due in particular to the multiplication of sources of financing/capital injections, has created new categories of shareholders. Such shareholders sometimes seem to show little interest in the long-term governance objectives of the businesses/financial institutions in which they invest and may be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons[17]. In this respect, the sought-after alignment of directors' interests with those of these new categories of shareholder has amplified risk-taking and, in many cases, contributed to excessive remuneration for directors, based on the short-term share value of the company/financial institution as the only performance criterion[18]. Several factors can help to explain the disinterest or passivity of shareholders with regard to their financial institutions:

- certain profitability models, based on possession of portfolios of different shares, lead to the abstraction, or even disappearance, of the concept of ownership normally associated with holding shares.

- the costs which institutional investors would face if they wanted to actively engage in governance of the financial institution can dissuade them, particularly if their participation is minimal.

- conflicts of interest (see above).

- the lack of effective rights allowing shareholders to exercise control (such as, for example, the lack of voting rights on director remuneration in certain jurisdictions), the maintenance of certain obstacles to the exercise of cross-border voting rights, uncertainty over certain legal concepts (for example that of 'acting in concert') and financial institutions' disclosure to shareholders of information which is too complicated and unreadable, in particular with regard to risk, could all play a part, to varying degrees, in dissuading investors from playing an active role in the financial institutions in which they have invested.

The Commission is aware that this problem does not affect only financial institutions. More generally, it raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders. As a result of this situation, the Commission will launch a broader review covering listed companies in general.

3.6. The role of supervisory authorities

Generally speaking, the recent financial crisis revealed the limits of the existing supervision system: in spite of the availability of certain tools enabling them to intervene in the internal governance of financial institutions[19], not all supervisory authorities, either at national or

---

17 See article by Rakesh Khurana and Andy Zelleke, Washington Post, 8 February 2009.

18 See Gaspar, Massa, Matos (2005), Shareholder Investment Horizon and the Market for Corporate Control, Journal of Financial Economics, vol. 76.

19 For example, Basel II.

European level, were able to carry out effective supervision in an environment of financial innovation and rapid change in the business model of financial institutions[20].

Furthermore, the supervisory authorities also failed to establish best practices for corporate governance in financial institutions. In many cases, supervisory authorities did not ensure that financial institutions' risk management systems and internal organisation were adapted to changes in their business model and financial innovation. Supervisory authorities also sometimes failed to adequately enforce strict eligibility criteria for members of boards of directors of financial institutions ('fit and proper test')[21].

Generally speaking, problems linked to the governance of supervisory authorities themselves, particularly the means of combating the risk of regulatory capture or the lack of resources, have never been sufficiently discussed. Moreover, it is becoming increasingly clear that the territorial and substantive competencies of supervisory authorities no longer correspond to the geographical and sectoral spread of financial institutions' activities. This complicates risk management for financial institutions and makes it more difficult for them to comply with regulatory standards, as well as presenting a major challenge for cooperation between supervisory authorities.

3.7. The role of auditors

Auditors play a key role in financial institutions' corporate governance systems, as they provide assurance to the market that the financial statements prepared by those financial institutions present a true and fair view. However, conflicts of interest could arise as audit firms are remunerated by the same companies who mandate them to audit their financial accounts.

At present, there is no information to confirm that the requirement, pursuant to Directive 2006/48/EC, for auditors of financial institutions to alert the competent authorities wherever they become aware of certain facts which are liable to have a serious effect on the financial situation of an institution, has been effectively enforced in practice.

4. INITIAL RESPONSES

In the context of its Communication of 4 March 2009 and measures taken to boost the European economy, the Commission has undertaken to address issues related to remuneration. The Commission has launched the international debate on abusive remuneration practices and was leading the implementation at European level of FSB and G-20 principles on sound compensation practices. Leaving aside the issue of whether or not certain levels of remuneration are appropriate, the Commission started from two premises:

– since the end of the 1980s, the substantial increase in the variable component of listed company directors' salaries raises questions about the methods and content of performance evaluations for company directors. In this respect, the Commission made an initial response at the end of 2004 by adopting a recommendation aimed at strengthening obligations to publish director remuneration policies and individual salaries, and calling on

[20] On the failings of supervisory authorities in general, see the 'de Larosière' Report, footnote 1.

[21] See, for example, OECD, Corporate Governance and the Financial Crisis, Recommendations, November 2009, p.27.

the Member States to establish a vote (mandatory or optional) on such director remuneration. For a variety of reasons linked, amongst other things, to the lack of shareholder activism, the explosion of the variable component and, in particular, the multiplication of profit-sharing plans granting shares or stock options, the Commission considered it necessary to adopt a new recommendation on 30 April 2009[22]. The aim of this recommendation is to strengthen governance of directors' remuneration, proposing several principles for director remuneration structures in order to better link remuneration to long-term performance.

– remuneration policies in the financial sector, based on short-term profits without taking into account the corresponding risks, contributed to the financial crisis. For this reason, the Commission adopted another recommendation on remuneration in the financial services sector on 30 April 2009[23]. The aim was to align remuneration policies in the financial services with healthy risk management and financial institutions' long-term viability.

Taking stock one year after the adoption of the two abovementioned recommendations, and in spite of a favourable climate for tough action on the part of the Member States, the Commission finds a mixed overall picture of the situation in the Member States[24].

Although there were strong legislative moves in several Member States to achieve greater transparency in remuneration for listed company directors and to empower shareholders in this respect, it was also noted that only 10 Member States have applied the majority of Commission recommendations. A large number of Member States have still not adopted the relevant measures. Furthermore, where the recommendation led to measures at national level, the Commission noted great diversity in the content and requirements of these rules, particularly on sensitive issues such as remuneration structure and severance packages. The Commission is also concerned about remuneration policies in the financial services. Only 16 Member States have applied the Commission Recommendation in full or in part while five are still in the process of doing so. Six Member States have at present taken no action on this front and do not intend to do so in the near future. Furthermore, the intensity (particularly requirements relating to remuneration structure) and scope of application of the measures taken vary depending on the Member State. Thus only seven Member States have extended implementation of the principles of the recommendation to the entire financial sector, as the Commission called on them to do.

5. OPTIONS FOR THE FUTURE

The Commission considers that, while taking into account the need to preserve the competitiveness of the European financial industry, the deficiencies listed in Chapter 3 call for concrete solutions to improve corporate governance practices in financial institutions. This chapter considers a variety of ways to respond to these deficiencies and tries to strike the right balance between the need for improved corporate governance of financial institutions and the necessity of allowing these institutions to contribute to economic recovery by providing credit to businesses and households. The Commission invites all interested parties to express their

[22] Recommendation 2009/385/EC.
[23] Recommendation 2009/384/EC.
[24] For a detailed examination of the measures taken by the Member States, see the two Commission reports on the application by the Member States of Recommendation 2009/384/EC and Recommendation 3009/385/EC.

views on the considerations set out below. Each of the options explored could lead to the development of measures on corporate governance in financial institutions. The added value of such measures should nevertheless be assessed in the context of impact analyses carried out in accordance with the Commission's guidelines on the subject[25].

More particularly, the Commission is currently exploring different ways of improving the functioning, composition and skills of boards of directors, strengthening risk management-related functions, expanding the role of external auditors and strengthening the role of supervisory authorities in the governance of financial institutions. The place and role of shareholders is also considered.

The main challenge in seeking to improve existing corporate governance practices will be to ensure real change in the behaviour of the relevant actors. This cannot be achieved through new regulatory and non-regulatory requirements alone. It must also be backed up by effective financial supervision.

The various solutions presented below provide a platform for general improvement of corporate governance in financial institutions. Their concrete application should be proportionate and could vary according to the legal form, size, nature and complexity of the financial institution concerned and the various existing legal and economic models.

5.1. Boards of directors

Based on the shortcomings highlighted by the recent crisis, it appears necessary for boards of directors to ensure the right balance between independence and skills is struck. Recruitment policies which precisely identify the skill needs of the board of directors and which aim to guarantee the objectivity and independence of members' judgment could help increase the board of directors' ability to effectively monitor management.

In order to safeguard the objectivity and independence of judgment of members of the board of directors, it seems necessary to strengthen measures intended to prevent conflicts of interest both within the board of directors but also within the financial institution in general, in particular by putting in place clear policies for managing conflicts of interest.

In view of the crucial role that the chairman plays in organising the work of the board, it would be useful to clearly define his/her skills, role and responsibilities.

It would also be useful to review the diversity of the composition of boards of directors. In addition to the need for specific individual qualities (independence, skill, experience, etc), greater diversity (women, directors with different cultural and educational backgrounds, etc) can contribute to the quality of the board's work.

In view of the increasing complexity of the structure and activities of financial institutions, ways to improve the efficiency of the board of directors' work should be investigated. In particular, limiting the number of boards on which a director may sit should be considered to enable them to devote sufficient time to performance of their duties.

It would also seem necessary to formalise the procedure for evaluating the board of directors' performance, in particular by defining the role of external evaluators and supplying

[25] SEC(2009) 92.

supervisory authorities and/or shareholders with the results of the evaluation so that they can judge the capabilities and effectiveness of the board of directors.

It seems that the duties and responsibilities of the board of directors, particularly with regard to the board's role in risk supervision, also need to be strengthened. It would be useful to consider creating a specialised risk supervision committee within the board of directors. Publishing the board of directors' approval of the risk strategy and profile in a public document (risk control declaration) could also contribute to good management and supervision of risks within financial institutions.

Generally speaking, it seems necessary for members of the board of directors to be familiar with the structure of their financial institution and ensure that organisational complexity does not prevent effective control of the institution's activity in its entirety.

It also seems necessary to clarify the respective roles and responsibilities of the various players in decision-making within the financial institution, particularly members of the board of directors and the senior management. In particular, the board of directors should ensure that clear responsibility structures are put in place covering the entire organisation, including subsidiaries, branches and other related entities.

Increased cooperation between the board of directors and the supervisory authorities would also seem desirable. In particular, a requirement that the board of directors alert the supervisory authorities to any substantial/systemic risks that they are aware of could be considered.

The Commission is also considering whether, in addition to shareholders' interests, which are essential in the traditional view of corporate governance, financial institutions also need to take better account of other stakeholders' interests. In particular, the creation of a specific duty for the board of directors to take account of the interests of depositors and other creditors in their decision-making ('duty of care') could help encourage the board of directors to adopt less risky strategies and improve the quality of the financial institution's long-term risk management. The creation of such a duty would nonetheless require careful examination of the existing legal regimes in the different Member States. Depending on the results of this examination, the Commission will then have to determine whether action at European level is needed to help strengthen financial stability across the European Union as a whole.

General question 1: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

1. Specific questions:

1.1. Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

1.2. Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

1.3. Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

1.4. Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

1.8. Should the chairman of the risk committee report to the general meeting?

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

1.10. Should a risk control declaration be put in place and published?

1.11. Should an approval procedure be established for the board of directors to approve new financial products?

1.12. Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

1.13. Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?

5.2. Risk-related functions

One of the main observations in the wake of the recent financial crisis was the failure of risk management functions, due in particular to the lack of authority of these functions and a poor system for risk-related communication and information.

It therefore seems necessary to strengthen the independence and authority of the risk management function, particularly by enhancing the status of the chief risk officer (CRO). In particular, it seems desirable that the chief risk officer should have at least equal status to the chief financial officer within the internal organisation of a financial institution, and that they should be able to directly report any risk-related problem to the board of directors. Establishing close relations between the chief risk officer and the board of directors (and its risk committee) could also help to strengthen the role of the chief risk officer.

It also seems desirable to improve the risk management function's communication system, in particular by introducing a procedure for referring any conflicts and problems encountered to the hierarchy for resolution. The board of directors should establish the frequency and content of the risk reports to be submitted to it regularly. Updating the IT infrastructure should also be a priority in order to substantially develop financial institutions' risk management capabilities and allow risk information to be circulated in good time.

Generally speaking, implementation of a policy to increase awareness of risk problems ('risk culture') for the benefit of all staff, including members of the board of directors, should be a requirement. In particular, it seems advisable to carry out an evaluation of the underlying risks before setting up any new financial products, market sectors or areas of activity.

Finally, it seems appropriate for senior management to approve an evaluation report on the adequacy and functioning of the internal control system, in order to ensure that internal control systems within a financial institution are effective, including with regard to risk.

General question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

Specific questions:

2.1. How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

2.2. How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

2.3. Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

2.4. Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

5.3. External auditors

In order to respond to the problems highlighted in Chapter 3, it seems necessary to examine ways of extending the reporting scheme by which external auditors alert the board of directors and supervisory authorities of any substantial risks they discover in the performance of their duties ('duty of alert').

Generally speaking, it seems desirable to strengthen cooperation between external auditors and the supervisory authorities in order to benefit from auditors' knowledge not only of individual financial institutions but also of the financial sector as a whole, while taking into account constraints relating to professional secrecy.

Finally, it is worth reviewing the role that external auditors should play more generally with regard to risk-related information in financial institutions. In particular, it could be envisaged for the external auditor to validate a greater range of information which is relevant to shareholders than it does at present in order to improve investor confidence in this type of information, thereby encouraging the proper functioning of the markets.

General question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

Specific questions:

3.1.	Should cooperation between external auditors and supervisory authorities be deepened? If so, how?
3.2.	Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?
3.3.	Should external auditors' control be extended to risk-related financial information?

5.4. Supervisory authorities

In order to respond to the shortcomings in financial institutions' corporate governance highlighted by the recent crisis, it seems necessary to redefine and strengthen the role of supervisory authorities in the internal governance of financial institutions. There is a need, however, to ensure a clear delimitation of roles and responsibilities between the supervisors and the governing bodies of financial institutions.

In particular, it might be possible to envisage creating a duty for supervisory authorities to check the correct functioning and effectiveness of the board of directors, and to regularly inspect the risk management function to ensure its effectiveness. It would be useful for the supervisory authorities to inform the board of directors of any shortcomings they discover so that the financial institution can correct them in good time.

It also seems necessary for the supervisory authorities to extend the eligibility criteria ('fit and proper test') for future directors to cover technical and professional skills, including those relating to risk, as well as candidates' individual qualities, in order to ensure better independence of judgment of future members of the board of directors.

Finally, cooperation between supervisory authorities on corporate governance of cross-border financial institutions should be strengthened, particularly within colleges of supervisors but also in the context of future European supervisory authorities.

General question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

Specific questions:

4.1	Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?
4.2.	Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?
4.3.	Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

5.5. Shareholders

The problems related to the particular role of shareholders in financial institutions have been partly discussed above. Shareholders' lack of interest in corporate governance raises questions in general about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders for all listed companies. Similarly, engaging shareholders presents a real challenge for financial institutions.

In order to motivate shareholders to engage in a dialogue with the financial institution and monitor senior management's decision-making, as well as to consider the long-term viability of the financial institution, the Commission intends to carry out a review centred around the following topics:

– strengthening shareholder cooperation through the creation of discussion platforms;

– disclosure by institutional investors of their voting practices at shareholders' meetings;

– institutional investors adherence to 'stewardship codes' of best practice;

– identification and disclosure of potential conflicts of interest by institutional investors;

– disclosure by institutional investors of the remuneration policy for intermediaries[26];

– providing shareholders with better information on risk.

General question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

Specific questions:

5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

5.2. Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires

signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

5.3. Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'[27]?

---

26 Particularly the managers of asset management companies.

27 Vote by a shareholder with no corresponding financial interest in the company for which they are voting, with potentially negative consequences for the integrity of the corporate governance of listed companies and the markets on which their shares are traded.

5.4.	Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

5.6. Effective implementation of corporate governance principles

In addition to the role of supervisory authorities in implementing good corporate governance practices within financial institutions as discussed above, it is worth considering senior management's legal accountability for the correct implementation of these principles. Effective and efficient sanctions may be needed in order to change the behaviour of the relevant actors. However, the Commission is of the view that any increase in managers' civil or criminal accountability should be examined carefully. An in-depth study on this subject should be carried out beforehand, recognising Member States' competence on matters of criminal law.

General question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

Specific questions:

6.1.	Is it necessary to increase the accountability of members of the board of directors?
6.2.	Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

5.7. Remuneration

The Commission has already adopted several recommendations on this subject[28]. Legislative proposals for credit institutions and investment firms are also currently being discussed in the context of the modification of the CRD[29] as well as for Alternative Investment Fund Managers. The Commission considers that, to prevent distortions of competition between financial institutions in different sectors, other similar legislative measures will have to follow for the other financial services sectors, in particular UCITS and insurance companies.

As regards the remuneration of directors of listed companies, the Commission report on the implementation by Member States of measures to promote the application of existing recommendations shows that this application is neither uniform nor satisfactory. Although a specific recommendation on remuneration exists for financial services, the recommendations on directors' remuneration also apply to directors of listed financial institutions and contain additional rules, particularly with regard to transparency of remuneration for directors. For this reason, the Commission gives consideration in this Green Paper to the need for and content of relevant legislative measures.

28 See Recommendation 2009/384/EC and Recommendation 2009/385/EC.

29 See the proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies – COM/2009/0362 final.

General question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

Specific questions:

7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

7.2. Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?

7.3. Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?

7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

7.5. What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

General question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

Specific questions:

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

5.8. Conflicts of interest

The weight and role of the financial sector in the economy and considerations relating to financial stability require that conflicts of interest should be at least partly regulated by very clear rules rooted in law and by attributing a clearly defined role to the supervisory authorities in monitoring their correct application.

General question 8: Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.

Specific questions:

8.1. What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?

8.2.	Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?

6. NEXT STEPS

Member States, the European Parliament, the European Economic and Social Committee and other interested parties are invited to submit their views on the suggestions set out in this Green Paper with a view to establishing a broad consensus on any measures that could be envisaged. Contributions should be sent to the following address to reach the Commission by 1st September 2010 at the latest: markt-cg-fin-inst@ec.europa.eu. In the follow-up to this Green Paper and on the basis of the responses received, the Commission will take a decision on the next steps. Any future legislative or non-legislative proposal will be accompanied by an extensive impact assessment.

Contributions will be published on the internet. It is important to read the specific privacy statement attached to this Green Paper for information on how your personal data and contribution will be dealt with.

THEME: C2

Role and effectiveness of the Policy appraisal regime before and during the crisis
Pre Crisis phase

LINE OF INQUIRY: C2c

The liquidity versus solvency debate

Independent Auditor's Report to the Members of Allied Irish Banks, p.l.c.

We have audited the group and parent company financial statements of Allied Irish Banks, p.l.c. for the year ended 31 December 2008 ('the financial statements') which comprise the Group Consolidated Income Statement, the Group Consolidated and Parent Company Balance Sheets, the Group and Parent Company Statement of cash flows, the Group and Parent Company Statements of recognised income and expense, Group Consolidated and Parent Company Reconciliation of movements in shareholders' equity and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with section 193 of the Companies Act 1990 and in respect of the separate opinion in relation to International Financial Reporting Standards ("IFRSs") as issued by the International Accounting Standard Board ("IASB"), on terms that have been agreed. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and, in respect of the separate opinion in relation to IFRSs, as issued by the IASB, those matters that we have agreed to state to them in our report, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and IFRSs both as issued by the IASB and subsequently adopted by the EU are set out in the Statement of Directors' Responsibilities on page 255.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with IFRSs both as issued by the IASB and subsequently adopted by the EU and, in the case of the parent company applied in accordance with the provisions of the Companies Acts 1963 to 2006, and have been properly prepared in accordance with the Companies Acts 1963 to 2006 and Article 4 of the IAS Regulation. We also report to you whether, in our opinion: proper books of account have been kept by the company; at the balance sheet date, there exists a financial situation requiring the convening of an extraordinary general meeting of the company; and the information given in the Report of the Directors is consistent with the financial statements.

In addition, we state whether we have obtained all the information and explanations necessary for the purposes of our audit, and whether the parent company's balance sheet is in agreement with the books of account.

We also report to you if, in our opinion, any information specified by law or the Listing Rules of the Irish Stock Exchange regarding directors' remuneration and directors' transactions is not disclosed and, where practicable, include such information in our report.

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Irish Stock Exchange, and we report if it does not.

We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended;
- the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Acts 1963 to 2006, of the state of the parent company's affairs as at 31 December 2008; and
- the financial statements have been properly prepared in accordance with the Companies Acts 1963 to 2006 and Article 4 of the IAS Regulation.

As explained in note 2 of the accounting policies to the financial statements, the Group in addition to complying with its legal obligation to comply with IFRSs as adopted by the EU, has also complied with IFRSs as issued by the IASB. In our opinion the Group financial statements give a true and fair view, in accordance with IFRSs as issued by the IASB, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended.

We have obtained all the information and explanations which 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.

In our opinion the information given in the Report of the Directors is consistent with the financial statements.

The net assets of the company, as stated in the company balance sheet, are more than half of the amount of its called-up share capital and, in our opinion, on that basis there did not exist at 31 December 2008 a financial situation which under Section 40 (1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the company.

KPMG

Chartered Accountants
Registered Auditor
1 Harbourmaster Place
International Financial Services Centre
Dublin 1
Ireland

27 February 2009

Independent Auditor's Report to the Members of Allied Irish Banks, p.l.c.

We have audited the group and parent company financial statements of Allied Irish Banks, p.l.c. for the year ended 31 December 2008 ('the financial statements') which comprise the Group Consolidated Income Statement, the Group Consolidated and Parent Company Balance Sheets, the Group and Parent Company Statement of cash flows, the Group and Parent Company Statements of recognised income and expense, Group Consolidated and Parent Company Reconciliation of movements in shareholders' equity and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with section 193 of the Companies Act 1990 and in respect of the separate opinion in relation to International Financial Reporting Standards ("IFRSs") as issued by the International Accounting Standard Board ("IASB"), on terms that have been agreed. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and, in respect of the separate opinion in relation to IFRSs, as issued by the IASB, those matters that we have agreed to state to them in our report, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and IFRSs both as issued by the IASB and subsequently adopted by the EU are set out in the Statement of Directors' Responsibilities on page 255.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with IFRSs both as issued by the IASB and subsequently adopted by the EU and, in the case of the parent company applied in accordance with the provisions of the Companies Acts 1963 to 2006, and have been properly prepared in accordance with the Companies Acts 1963 to 2006 and Article 4 of the IAS Regulation. We also report to you whether, in our opinion: proper books of account have been kept by the company; at the balance sheet date, there exists a financial situation requiring the convening of an extraordinary general meeting of the company; and the information given in the Report of the Directors is consistent with the financial statements.

In addition, we state whether we have obtained all the information and explanations necessary for the purposes of our audit, and whether the parent company's balance sheet is in agreement with the books of account.

We also report to you if, in our opinion, any information specified by law or the Listing Rules of the Irish Stock Exchange regarding directors' remuneration and directors' transactions is not disclosed and, where practicable, include such information in our report.

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Irish Stock Exchange, and we report if it does not.

We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended;
- the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Acts 1963 to 2006, of the state of the parent company's affairs as at 31 December 2008; and
- the financial statements have been properly prepared in accordance with the Companies Acts 1963 to 2006 and Article 4 of the IAS Regulation.

As explained in note 2 of the accounting policies to the financial statements, the Group in addition to complying with its legal obligation to comply with IFRSs as adopted by the EU, has also complied with IFRSs as issued by the IASB. In our opinion the Group financial statements give a true and fair view, in accordance with IFRSs as issued by the IASB, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended.

We have obtained all the information and explanations which 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.

In our opinion the information given in the Report of the Directors is consistent with the financial statements.

The net assets of the company, as stated in the company balance sheet, are more than half of the amount of its called-up share capital and, in our opinion, on that basis there did not exist at 31 December 2008 a financial situation which under Section 40 (1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the company.

KPMG

Chartered Accountants
Registered Auditor
1 Harbourmaster Place
International Financial Services Centre
Dublin 1
Ireland

27 February 2009