Note from the Department on Finance on the Report of the Commission of Investigation into the Banking Sector – April 20, 2011

The Minister for Finance, Mr. Michael Noonan, T.D., has today, (19, April,2011) following the agreement of the Government, laid before the Oireachtas and published the report of the Commission of Investigation into the Banking Sector, *Misjudging Risk: Causes of the Systemic Banking Crisis In Ireland.*

The Minister stated: "*I welcome the comprehensive report produced by the Commission of Investigation. It represents a thoughtful and multi-faceted analysis into the causes of the banking crisis in Ireland and bears careful and measured consideration by all concerned.*"

The Minister added that the Government will reflect on the most appropriate approach for further consideration of the report by the Oireachtas, following the statement the Minister will be making to the Dáil on Wednesday 20 April, He intends to discuss this further with the opposition parties.

The Minister said he wished to thank the Sole Member of the Commission, Mr Peter Nyberg, and his team for their work in producing the report and commended the Commission on producing the report within the demanding six month timeframe set down by the Oireachtas.

Notes

Establishment of Commission of Investigation

The establishment of a Commission of Investigation into the Banking Sector in Ireland was approved by Dáil Éireann and Seanad Éireann on 8 July 2010 and an Order formally establishing the Commission was made by the Government on 21 September 2010 (Commission of Investigation (Banking Sector) Order 2010 (S.I. No. 454 of 2010)). The Minister for Finance formally appointed Mr Peter Nyberg as sole member of the Commission of Investigation on 22 September 2010.

The Commission's terms of reference were to examine:

(a) the main causes of the serious failure, during the period 1 January 2003 to 15 January 2009, within each of the covered institutions, to implement and adhere to, appropriate standards and controls (including checks and balances) in the context of corporate governance and prudent risk management policy and procedures such as would have avoided the requirement for the provision of exceptional financial support from the State;

(b) the main causes for the adoption, during the period 1 January 2003 to 15 January 2009, by the Boards of Anglo Irish Bank Corporation and Irish Nationwide Building Society of business models and strategies, and the implementation by the senior managements of

those institutions of business and lending practices, which resulted in those institutions experiencing severe financial distress;

(c) whether in respect of the period 1 January 2003 to 15 January 2009 the external auditors of the covered institutions commented in their audit reports or other communications to the institutions concerned on the failures referred to in subparagraph (a) or the business models and strategies and business and lending practices referred to subparagraph (b);

(d) the main causes for the failures, during the period 1 January 2003 to 15 January 2009, in the performance of the statutory roles and responsibilities of the Central Bank and Financial Services Authority of Ireland in respect of the regulation and supervision of the covered institutions and the maintenance of financial stability, in particular in relation to the supervision and oversight of corporate governance and risk management policies and practices in the covered institutions, and the relevance in that regard of any advices or directions given by the Department of Finance to the Central Bank and Financial Services Authority of Ireland in relation to its supervisory role.

The Oireachtas stipulated that the Commission must complete its report within six months of its establishment.

The Report will also be available for sale in the Government Publications Sales Office, Molesworth Street, Dublin 2 from Wednesday 20 April 2011.

Appendix 1 - Summary of findings of the report of the Commission of Investigation into the Banking Sector

General

- The main reason for the crisis was the unhindered expansion of the property bubble financed by the banks using wholesale market funding. Attendant risks went undetected or seriously misjudged by the Authorities whose actions and warnings were modest and insufficient. [ES]
- The speed and severity of the crisis was made worse by world-wide economic events but notwithstanding these external factors, the problems causing the crisis as well as the scale of it were the result of domestic Irish decisions and actions. [5.3.1]
- Many of the problems and failings in Irish banks and public institutions were similar to those in other countries [5.1.1]
- The emergence of a systemic banking crisis requires that a number of important safeguards all become ineffective simultaneously [5.6.1]]

Findings in relation to the banks

- Banks set aggressive targets for profit growth. This drive for growth really implied a partial change in business model and strategy without the necessary corresponding strengthening of governance, procedures and practices. [5.2.1]
- Bank management in Ireland, like many banks elsewhere in the world, had forgotten the very nature of credit. Providing credit is not a sale of bank services; it is the acquisition of

a risky asset. The appropriate prudential focus of such a transaction is therefore limiting and mitigating risk (or, at the very least, understanding the real risk and pricing it accordingly) rather than expanding sales. This apparent inability, some might say unwillingness, of Irish banks to remember this basic principle of banking was a major cause of the banking crisis in Ireland. This problem was further exacerbated as many banks appear to have emphasised and valued loan sales skills above risk and credit analysis skills. [2.12.4]

- It seems to have been quite generally accepted that – traditionally volatile – market funding would continue to be available to enable the achievement of growth targets. [ES]
- The common issues identified with lending and credit policies in the covered institutions included: the relaxation of formal lending policies into only guidelines; a lack of operational limits on loan size or on total exposure to connected parties or sectors; the slow slide from lower-risk to higher-risk lending, from cash flow-lending to asset backed lending and from small to large to enormous loan amounts; an increasing amount of facilities provided on an interest roll-up or interest-only basis; higher loan-to-value ratios, equity releases and increased loan complexity (particularly involving investor syndicates later in the Period). [2.7.18]
- Boards and relevant observers appear to have had little appreciation of how the banks actually were run at grass-root level; at least they did not seem unduly concerned about the practices referred to above. The inadequate attention banks generally paid to credit risk management is, in the end, evidenced by the extent and nature of their subsequent problem loans. [2.7.27]
- In addition, in many institutions, governance, systems and processes were also inadequate, exposing the covered banks to significant but often unrecognised operational risks. [2.9.1]
- Management and boards in general appear not to have fully appreciated the two key risks to which their banks were exposed. These risks were increased exposures to funding-dependent development projects with future refinance risks and volatile wholesale funding [2.9.1]
- Bank management and boards seem to have been totally unprepared for both of their key risks (property loan impairment and funding problems) occurring simultaneously. This must be seen partly as a direct consequence of the insufficient attention paid to the assessment and management of risk over several years. [2.9.5]
- It appears now, with hindsight, to be almost unbelievable that intelligent professionals in the banking sector appear not to have been aware of the size of the risks they were taking. [2.11.7]

Findings in relation to Anglo and INBS

- In Anglo, credit risk management structures were, in practice, deficient and there was ineffective overview of Group credit decisions. Lending policies were treated as guidelines rather than strict rules; exceptions to policy were very common. In addition, the internal sector limits which did exist were not enforced. Loans were not clearly or appropriately classified by commonly used sector lending categories [2.7.4]
- INBS's credit management was unusual in many respects. Credit policies were applied very flexibly and, in addition, it had no effective, independent credit risk management

function. Consequently it operated without the "checks and balances" normally considered necessary in banks. [2.7.9]

- At INBS, a number of essential, independent functions either did not effectively exist or were seriously under-resourced. [ES]
- As a result of the extensive governance issues in INBS, the loan approval and administration process was not up to accepted banking standards, files were often badly maintained and loans were not subject to regular review or appropriately graded and classified. [2.7.11]
- Contrary to public perception at the time, lending at Anglo and INBS had proceeded with insufficient checks and balances during the Period. Traditional risk evaluation procedures and risk mitigants were not implemented in practice. [ES]
- The Risk function in Anglo was inadequately resourced and did not have the conviction necessary to ensure compliance with credit policy. The lack of adherence to good credit standards was manifest with exceptions to policy a frequent occurrence. These issues were particularly problematic because most Anglo Board members did not appear to have sufficient experience or specialist knowledge to fully recognise the specific risks attaching to a fast-growing monoline bank and the necessity for high quality management information systems. Also it is not clear whether all key letters from the FR, highlighting inter alia lending and risk management shortcomings, were disclosed to or considered by either the Risk and Compliance Committee, or the Board. The Board therefore lacked an internal, robust source of risk assessment and external feedback. [2.9.6 & 2.9.7]
- Neither Internal Audit nor the Audit Committee in Anglo was in a position to challenge credit decisions per se, where the main problems ultimately arose. The IA role in credit risk was limited mainly to carrying out inspections on processes such as adherence to terms and conditions of loan sanctions, which it duly did. [2.10.2]
- The Internal Audit function in INBS, while effective for its traditional residential mortgage type business, proved to be inadequate in the growth oriented commercial lending environment. It was lacking the requisite knowledge and skills in key areas such as IT, Treasury, and Commercial Lending and, as a result, responsibility for these areas was required to be outsourced to a large auditing firm. During the Period the FR identified a significant number of weaknesses, shortcomings and concerns in IA. [2.10.3]
- The Financial Regulator was clearly aware of many of these problems in the two banks: throughout the period, it raised significant concerns regarding governance at INBS. It also submitted a comprehensive list of procedural and portfolio problems to Anglo. It furthermore raised minimum capital ratios for both banks. Such remedies did not prove effective to ensure sufficiently greater prudence and accountability in either of the banks. [ES]
- Despite the fact that the FR detected numerous governance and process issues in INBS throughout and, indeed, prior to the Period, the FR remained hesitant to take effective action even when the engagement with INBS resulted in little material change. As a result, the very significant risks inherent in INBS's business model described above had time to develop essentially undisturbed. [4.3.4]
- Had the FR rigorously enforced its recommendations to improve structures and process, it is possible that Anglo would have grown its property lending in a more prudent manner. Moreover, determined public action by the FR early in the Period could possibly

have meant that other banks' prudential standards would not have deteriorated to such an extent over the Period. [4.3.5]

Findings in relation to auditors

- Auditors' commentary regularly focuses only on issues which they consider relate to the accuracy of the historic accounts. In practice, this means that auditors look primarily backwards and at technical issues that may influence the accuracy of the accounts. The auditors clearly fulfilled this narrow function according to existing rules and regulations. [ES]
- In the absence of an express requirement for the auditors to do so, there appears to have been no challenging dialogue with the covered banks on their business models and their growing property and funding exposures. Such dialogue could have highlighted the business model risks and might have influenced the banks in relation to their growing vulnerabilities as the Period progressed. [3.9.5]
- The Commission finds it unfortunate that sufficient, timely and challenging auditor dialogue was not used to influence the banks' business models and lending practices. [3.9.6]

Findings in relation to the authorities

- The Commission found no evidence that the bulk of the problems within the banks received the necessary attention of the FR. The FR does not appear to have appreciated the funding and lending risks accumulating in the banking system which were evident from institution-specific returns made to it by the banks. [4.3.1]
- The real problem in FR was not the lack of powers but lack of scepticism and the appetite to prosecute challenges. [5.3.5]
- There was a major domestic policy failure at the CB in respect of the maintenance of financial stability. Not only did the CB seriously underestimate the nature and extent of the risks in the Irish financial system but it was content to express only nuanced and somewhat indirect concerns on possible risks rather than study contingent worst-case scenarios. [4.4.1]
- An active and suspicious CB would have had concerns over the macro-economic data emerging in mid-to-late 2005. At that stage, on the basis of available data at a macro level, there were more than ample grounds for the CB to have pursued a closer and more intensive dialogue with the FR than actually occurred. The aim would have been to determine, in sufficiently good time, whether the macro-economic warning signals also indicated a pattern of unsound lending behaviour by banks. [4.4.4]
- An independent and effective CB must first take the steps necessary to ensure that it has an accurate picture of the financial market. It must be willing to take unpopular actions. Failure to perform either of these tasks is, in the Commission's view, difficult to reconcile with the responsibilities of an independent CB. [4.4.11]
- The Department of Finance did not see itself as concretely involved in financial stability issues. It did not have the necessary professional staff for this. It saw itself as preparing legislation to be implemented by the other authorities but appears to have avoided addressing other financial market issues. [5.3.9]

- The Department’s approach in dealing with FR was based on the principle that the FR was independent of DoF in respect of operational matters, a principle very much in line with international practice. [4.5.11]
- Had the Department of Finance taken a greater interest in financial market issues early on, preparations for dealing with financial crisis would have been more comprehensive. [5.3.10]
- The relaxed attitude of the authorities was either a result of not understanding the data or not being able to evaluate and analyse the implications correctly. [5.3.2] The external watchdogs generally remained inactive and the new banking model was introduced and implemented. There was no strong reaction from the National Authorities when management prudence eroded within the Irish Banking system, as evidenced by the very rapid growth in lending and wholesale funding. [5.4.9]
- Given the information provided the Commission understands the Governments decision to provide a broad guarantee for the banks. [5.3.13]
- Discussions for alternative measures before and on 29 September 2008 were conducted on the basis of very deficient information. If more relevant information on and analysis of the underlying position of some of the banks had been available, discussions and policy recommendations may have been different. [5.3.12] The lack of information on bank exposures and the risk of future impairments among the Authorities over time had profound implications for the decisions actually taken. [5.3.14]

- The nationalisation of Anglo, some three months after the introduction of the Guarantee, occurred finally only after a series of announcements by the authorities outlining alternative plans which in the end had to be abandoned. This did little to build market confidence in Irish banks or in government policy and forecasts. Combined with the emergence of governance scandals at Anglo it created a sense that the authorities did not understand the extent of the problems and that further issues could emerge. Given the broad guarantee, doubts about sovereign creditworthiness and thus the credibility of the Guarantee began to crop up. This may have contributed to the continued erosion in the liquidity position of banks in the period that followed, despite the existence of the Government Guarantee. [4.8.11]