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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Alan Merriman

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

ALAN MERRIMAN - WITNESS STATEMENT

1. INTRODUCTION

I refer to the direction to attend and make a statement in writing pursuant to Section 67(1) of the House of the Oirechtas (Inquiries, Priveleges and Procedures) Act 2013 as received by me on 1 July 2015 (the "direction").

2. BACKGROUND

I joined EBS Building Society in July 2005. I was 37 at the time of my appointment. Prior to this I had been with Pricewaterhousecoopers for the previous 17 plus years, where I was the partner leading the Irish banking and insurance audit & advisory practices. As a partner in PwC I had the opportunity of working for many of the Irish banks – both audit work and on the advisory side. My clients included Bank of Ireland Group, First Active, Permanent TSB, EBS, ACC Bank, Anglo Irish, the Central Bank and many of the international banks based in the IFSC.

Joining EBS was a great opportunity to test myself in industry and to work somewhere with common good where I might perhaps make a meaningful difference. I joined as Finance Director, with a wide brief, mainly to help the Society advance its ongoing professionalisation across its platform and with the strategic challenges that it was then grappling with. I viewed mutual status as a big positive. The Chinese curse of beware of what you wish for comes to mind.

3. EBS CONTEXT

Explaining the EBS context is perhaps the most valuable contribution I can make. EBS was different. I think its important to acknowledge this. A member owned non profit organisation. The last remaing true building society in Ireland. It was established by teachers, was popular amongst civil servants, teachers, guards and nurses amongst others and its people, whether at branch level or at head office – root and branch had a DNA and culture of being community based and Member focussed. It was not focussed on profit. Rather it was trying to serve Members better through superior service, real trust and competive pricing compared to the banks and to be relevant. It was a very democratic organisation with a diverse board and true member representation. It thought of itself as the alternative to the commercially driven banks. It had a great culture and spirit.

Neither was it perfect. By 2005 member value was not very tangible, trust and Member satisfaction were declining and external stakeholders were increasingly sceptical about the Society's future as an independent organisation. With the likes of Danske Bank aggressively pricing for the high credit quality refinance mortgages and the likes of Bank of Scotland, PTSB, Ulster and Bank of Ireland aggressively targetting EBS's traditional heartland – the first time buyer market – EBS was being squeezed. Irish Nationwide the other "mutual" clearly had different values but was held up by many as the more 'commercial' organisation with a lower cost base and a focus for development deals that was "showing up" the management in EBS. This pressure to ensure the Society continued to be relevant and for Management and the Society to perform at a new more dynamic level was evident from my very first Board meeting at which the 2005 long term strategic plan was approved.

Whilst the perception from the outside would be otherwise, let me say that managing a mutual was hard. Judging Member value is ambiguous. What the Members' want can differ very starkly amongst themselves and sometimes the clarity of being profit driven seemed much simplier to me than working to a Board of very diverse talents and views as to what would be best for EBS as a mutual. Savers looking for better rates, borrowers looking for cheaper and bigger loans, everyone wanting better service, but lower costs – all drawing from the same small shared pot. Paradoxically too for EBS, the tiger economy weakened its positioning and brought very different challenges for the Society. For instance, new foreign competitors attracted by high growth changed the mortage market, the trade unions and National Partnership agreements brought very high annual wage increases and so for EBS – it was challenged to make all ends meet. Savers were not getting much value as interest rates declined and borrowers, who tended to be more favoured – and for whom we could say were achieving some pricing benefits with EBS - this was falling and was marginal at best. And it was clear that the bigger players – which effectively meant everyone else - were able to tap cheaper funding, get greater economies of scale, ride the tiger economy in other very profitable ways outside of mortgages and cross subsidise their mortgage business from other products such as consumer or SME lending. They the banks had ready access to capital or international parents willing to invest in the high growth Ireland – and they were winning, or at least EBS was losing as evidenced by EBS's natural market share steadily eroding bit by bit.

The Board believed in Mutuality and wanted to preserve it. The Members – based on surveys and feedback said they wanted to preserve it - and whilst the concept was very appealling and most everyone could sign up to it, at least aspirationally, the reality of delivering on it – was very different. The truth, whether it was well understood or not, EBS was fighting for survival – not only in 2009 or 2010 but also back in 2005 and even before this. This I believe was understood relatively well in Department of Finance and at the Central Bank/Financial Regulator. And change for EBS was seen as necessary, a least from without if not fully within.

I share this perspective with you – so that you can consider that what EBS did (and did not do) in terms of strategy and how this evolved was very much motivated to help it survive and be relevant to its Members. Retaining a mutual in Ireland. The Board took this very seriously. Had it not competed in the market – EBS would end up extinguished. By definition as a home lender this meant being able to offer attractive mortgages to our Members – both in pricing and in credit terms – had it not done so – it would have lost substantial new business and Members and this in turn would have meant a downward spiral of less value for existing members, reduced income and lower profits, necessitating deeper headcount cuts and loss of talent, cost restructuring, branch neglect and closures, and further weakening of the EBS offering, etc.

You do not need to be a banker or politican to understand this. Faced with choices – the vast majority of businesses and the very essence of human nature itself is that you will do, within moral and commercial reason, what is needed to survive and keep the dream alive. EBS was no different. EBS had effectively little choice but to compete and fight.

4 CHALLENGES AHEAD – KNOWN & UNKNOWN

I knew pretty much immediately after joining in July 2005 that EBS was more challenged than I had understood. But having such concerns and bringing about much needed change to address these concerns was a different matter. For instance, in 2006 management tried to convince the Board that considering a partner –whether a mutual or otherwise may be necessary and changes to legislation to enable this would be sensible and ought to be pursued by the Society. The Board disagreed. In January 2007 – I advocated strongly to the Chairman and CEO that we should accept an offer we had received from AIB to 'merge' with EBS – I was in a minority of one and the Board did not engage on it with any seriousness. Throughout this time in advocating these positions, I was principally concerned about longer term capital and funding challenges and what I referred to as a death of a 1,000 cuts, or the downward spiral. Being part of a team but with a strong contrary view to the 'group think' is very tricky. In summer 2008 the Board after much heated debate finally agreed that preserving mutually as unlikely but even then they felt management was too negative on our outlook and the challenges ahead. Clearly matters only got worse.

As negative as I was, I did not anticipate the extent of the cliff which the global economy, and Ireland and EBS with it, went over. Property prices falling by 60% back to levels below those of nearly a decade earlier and unemployment extending to over 15%. Such a scenario and dramatic collapse I viewed as highly unlikely back in 2005 and 2006. For me, my experience of 2005 was of PwC having to scout around the world to try and recruit staff; Foreign Direct Investment still strong; and low interest rates and strong demographics to boot – so the immediate outlook seemed quite constructive and whilst it inevitably had to slow down - I was in the soft landing camp and yes I saw life getting tougher especially for EBS, but certainly no where close to what actually transpired.

Even in early 2009 before I left EBS and as bad as it was then, I did not anticipate that it was going to be as shocking as it got. I sat in many meetings with the Central Bank and the Regulator during 2008 and 2009 and at the highest of levels and can assure you – they assured us – that these issues would pass and we just had to put our heads down and get through it. And to be fair to the Central Bank and the Regulator, whom like EBS had limited resources – the U.S. Fed with all its intelligence and hundreds of economists did not see this great recession crisis coming either. Neither did others such as OECD, World Bank, etc. The fact is the tail risk came and the Irish banking model as it had evolved over a substantial period of time and EBS along with it could not withstand it.

5. LINES OF ENQUIRY

B1- Integrity of Financial Reporting

We always endeavoured to report faithfully. I enjoyed a good loyal and bright team who worked incredibly hard during all this time to professionalise further EBS internal workings, systems and controls. There was a lot of transformational change going on in EBS over this time, ranging from the introduction of IFRS, Basel II, organisational change, special projects, capital and funding transactions and cost restructuring work which would have drawn heavily on the already busy and stretched Finance Function.

Accounts for financial institutions are complex, it is far from bean counting. In summary, I can attest that EBS had a strong framework for oversight and approving the accounts – this extended, inter alia, to extensive planning work, careful analysis, detailed papers on judgement issues for the Audit Committee, and private meetings between the Audit Committee and E&Y to openly discuss any key concerns. Dargan Fitzgerald the E&Y partner has already confirmed his positive view on the workings within EBS in this regard.

The only time – as Finance Director – I ever came under any real pressure or challenge on the accounts was in 2009 when reporting on the 2008 results. The impairment provisions especially on the development finance book were disturbing to say the least and we had to keep moving the loan loss number up as we learned more and as the economy detiorated further. We changed our views with the fast moving facts. This unnerved some of the Board who were very uncomfortable with not only the absolute level of provisions that we were reporting but also why our provisions seemed relatively so much higher than the banks were making publicly known. Understandly this led some of the Board to question whether we were being naïve or worse still was EBS lending actually worse than the other banks. Our view was that we did not know but perhaps because we had a smaller book and had stopped commercial lending in April 2008 due to earlier concerns we had a much better understanding of our stressed book than perhaps the banks had. However being ahead of others in understanding the damage that was unfolding was also undermining confidence at board level as to what was the right number. E&Y had no difference of opinion with our provisioning. The Central Bank and the Regulator did though – in that they were concerned that our provisioning might cause wider difficulties for the other banks and we were cautioned at the highest of levels to be very sure that what we provided was really needed. Needless to say this feedback to the Board only served to reinforce some views about our possible naivety or lack of commericiality. Nevertheless management held to our views, stayed true to the integrity of our reporting and provided what we believed was warranted at the time and that could be justified under IFRS, and the Board approved the accounts on this basis. The rest you know – the provisions – whilst appropriate from a historical accounting perspective – where far too light compared to what was ultimately needed. So yes in my view the intergity of the accounts in EBS was robust during these times and there was no manipulation by Management or the Board of reporting earnings.

B2a - Appropriateness of Property-Related Lending Strategies and Risk Appetite

EBS was a home lender. This was its core business. Mortgage lending always dominated and was followed by commmerical lending (which started in 2001 and was stepped up further in 2005). There was very little else.

By definition then EBS was consequently effectively very reliant on the health of property market and the employment market as it had been for many decades. The fact that the country and its fiscal budgeting as a whole was too – was maybe less well appreciated. Building Society legislation restrained what EBS could actually do and diversifying into new business lines was challenging. Mortgages for our members. Commerial lending to non members - with the idea of earning higher margins that could then help reduce pricing on mortgages to Members. And driving up ancilliary income is what EBS had to work with. It was not an asset manager, did not have life assurance products of its own, did not do SME lending or corporate finance. It was a home lender, funded only in part by retail members and the rest coming from the Markets in one way or the other.

So in terms of what we did do, credit terms were of course a key value proposition for our Members and EBS positioned itself in particular to assist First Time Buyers. Helping those Members get on the housing ladder was a key raison d'etre for EBS – not to do so was against the grain as to what EBS was about. So the EBS risk appetite has to be judged in this context. We lent to our Members to help them get on the ladder. We lent as much as we felt they could reasonably afford in line with the Market and that they too were willing to borrow to invest in their new home and family's future It was not for profit, it was to support community and family.

Credit terms and risk appetite were within those offered generally by the market and the competitor analysis we did supported this. Yes we competed by stretching a little here and there from time to time but in a measured way and with full board oversight. The Society as a financial safeguard also paid for insurance to help mitigate credit risk, and all mortgage credit changes also came under the scrutiny of Genworth and this too acted as a further third party check and balance.

B2b - Appropriateness of Credit Policies, Delegated Authorities and Exception Management.

EBS had a separate risk function and Head of Risk to bring independence and rigour to credit policies and support the Board in this critical area. All polices necessitated Board approval and there was a clear exception management process in place. Key credit changes such as the step up in development lending and the move to 100% mortgages were well debated at all levels of the organisation and up to and including the full Board. Risk as well as the business always has a strong and independent voice.

Overall - policies, sectoral limits, exception to policy reporting, stress testing including against specified Central Bank and Financial Regulator set parameters were all applied. History has now shown failings but at the time – they were considered robust and provided comfort as to capital adequacy and loss absorption capacity. All material commercial and development loans over certain thresholds were individually approved by a special Board Credit Approval Committee which included a majority of non executives . Risk oversight in EBS was the responsibility of many, not any one individual – but especially the Executive team and ultimately the Board itself collectively. It was certainly not embodied in any one individual.

E&Y have already provided independent expert testimony to the Committee that in their opinion EBS governance and controls was strong and indeed compared well to what one might expect for an organisation of our size. Certainly the EBS risk function and control environment generally evolved considerably during the period 2005 to 2009 with substantial catch up and investment in people, systems and processes in a multiude of different areas.

The regulator, Fitch and Moodys were all briefed and understood our limits relating to residential mortgages, commerical and development finance and no concerns were expressed about these non residential mortgage strategies. All understood the necessity for EBS to expand its business and improve profitability. I would go as far to say we were encouraged to expand and become more commerical.

Risk management is a continuous process with improvements and better ways of doing things always emerging. My EBS experience was no different in this regard. It did lots of things very well, but also had lapses and was learning continuously.

B2c -Analysis of Risk Concentrations, Adverse Economic Scenarios and the Impact on Capital Structure.

EBS had a similar risk governance framework to the banks and was subject to continous supervision from the regulator and probing from the Rating agencies on our polciies and risk management framework. We took risk management very seriously and invested heavily in people, processes and the likes of Basel II. During my time with EBS, until the crisis hit, our external credit ratings actually improved.

EBS as a domestic home lender, was concentrated in mortgages in Ireland. Realistically even with the benefit of hindsight no matter how this might have been managed or better mitigated – the great recession and its consequential impact on banking models as they had evolved would regardless have had a mortal impact on EBS. Whilst its Development Finance lending book is often highlighted as what brought EBS down, view this as exaggerated or at best overly simplistic. It is undoubtedly the weight that sank us. But even without it, I believe the same outcome would have been inevitable in that other exposures or business model vulnerabilities would have caught up with EBS one way or the other too.

Like a fraud or the cockroach – when one is discovered and the post mortum rigourously done – the underlying weakness or cause was not just the one but rather a multitude of collective weaknesses or vunerabilities or cockroaches. So if it was not the development finance book – it would have been the buy to let mortgages, or the pure commercial lending book, or the high LTV first time buyer book, or the downward spiral hitting bottom as new business and income eventually collapsed. Or liquidity and/or funding knock-outs. Or as I say a combination of all these.

Let me deal with the Development Finance book though. It was circa €500m and policy was to contain it to no more than 3% of the entire book. Yes just 3%. Whilst this level seemed reasonable – by contrast when a great recession brings a 60% to 80% correction in land prices and little or no transactions and you are simultaneously effectively forced to sell –

the severity of losses even from such a small book are lethal. So whilst business being written at 65% or 70% LTV ratios at the time in a growing economy seemed very reasonable – the impact this business would subsequently have on incurred losses in due course was very damaging. Whilst this type of possible loss impact was I think generally understood – no one within EBS was antipicating such severe moves. And if we had – then our adjusted credit policies would have meant we were simply out of the market in its entirety as we would have got absolutely no business. A decision we did come to in early 2008, albeit too late, even whilst others kept going . As many other witnesses have commented – the reality is that the stress testing conducted did not envisage anything like the losses that actually transpired – and in part this reflects that the magnitude of adjustments was effectively unprecedented globally.

In January 2009 mangement undertook a very detailed post mortem review of the development finance business for the Board. This covered the rationale for stepping this business up further in 2005 and addressed questions around strategy, risk concentrations, governance, execution, reporting lines and integrity of reporting. The analysis pulled no punches – of course mistakes were made and to quote "these together with a sharp property price correction and wider global dislocation events have left the Society overly exposed to this hard landing".

B3b - Analysis of Liquidity Risks under Adverse Scenarios.

EBS took liquidity risk very seriously. We operated under a variety of safeguards including legislative requirements; regulatory requirements and our own internal assessments. Liquidity management was the responsibility of the Head of Treasury and also overseen by the Head of Risk. Management at various levels, the Board and the Risk committees reviewed liquidity risk and policies frequently. Enhancements were continuously being made. Residential mortgages generally were viewed as a good source of collaterial to tap funding and deal with liquidity emergencies if necessary. Numerous initiatives were invested in and executed throughout this time to protect liquidity, widen funding and in so doing improve the Society's capacity to deal with liquidity stresses.

B3e - Capital Structure and Loss Absorption Capacity

EBS as a mutual did not have the same access to capital that other financial institutions such as the banks enjoyed. In this sense it was very reliant on retained earning and continuing annual profitability to support risk weighted asset growth. This for me was the key to understanding the quality of earnings or in a mutuality context the sustainability challenge facing EBS.

We did raise Permanent Interest Bearing Shares which added to loss absorption and helped sustain balance sheet growth for a while. And these were well oversubscribed at the time – showing strong (albeit misguided) international belief in the status of and future wellbeing of the Irish housing market and EBS. We also found other ways to optimise our capital ratios and funding such as securitisation and covered bonds (again with lots of international interest). Our total capital ratios were well above regulatory minimums and supported A ratings from both Fitch and Moodys.

The survival challenge as I saw it was circular in that we needed to issue new mortgages to stay relevant in the market place and bring in fee income as margins eroded and costs escalated in the tiger economy. The weaker earnings from lower margin business in turn hurt core capital and whilst we could find relief measures I grew increasingly concerned about the long terms consequences of this. This ultimatetly led to Managment collectively expressing such concerns to a specially convened Board in 2006 and advocating a needed change in thinking and legislation to allow for strategic flexibiilty. The Board as I explained earlier were not convinced that the degree of risk was as high as Management believed and the Executive were directed to continue to focus on preserving mutuality and driving performance to ensure this. I subsequently sought advice from Arthur Cox and based on their advice raised the matter again at the following Board Risk Committee – expressing my grave concerns about the Board's decision and the challenges ahead. However again I was unable to persaude others on this.

Subequently, in early 2007, AIB made an approach to acquire EBS. The terms offered were in my view very attractive and included for example EBS brand being retained and an independent subsidiary and network. The offer from memory was €700m. Unfortunately it would mean the loss of mutuality but by then as I have explained I thought this inevitable anyhow. My rationale was simple, as much as I wanted to see mutuality work, I felt strongly that it was not realistically viable – our capital challenges, thinning margins, funding model and lack of flexibility and over-reliance on property products as we competed in a very aggressive market would eventually catch up with us.

Again I share these insights – so that you can understand that capital and loss absorption were key agenda matters and the Finance, Treasury, Risk and Strategy teams within EBS and the Executive Management as a whole did foresee dangers. This led to very robust exchanges at Management and Board level – however ultimately the Board as a whole were more optimistic than Management and I would reiterate that as pessimistic as I was – neither I nor anyone else in EBS foresaw the extent of the great collapse that did eventually occur.

B6a - Effectiveness of Internal Audit Oversight and Communication of Issues

EBS similar to all financial institutions had its own internal audit function. The department was staffed by competent professionally qualified auditors, and broadly speaking divided its work into branch inspections and Head Office related work. The department had a direct reporting line to the Chairman of the Audit Committee and its plan and reports were routinely reviewed and discussed at Committee level including in private. The scope of all work was independently set of management. This work was valuable and the work and status of internal audit within EBS was well regarded. During my time at EBS quite a number of audits led to material findings that gave rise to full discussion at Audit Committee and Board and changes to better ensure controls to support risk appetite.

B6b - Effectiveness of the Oversight of the Prevailing Risk Culture

Similar to every other area, the independent risk area and the prevailing risk culture throughout the organisation were under the scope of the Internal Audit Function. What they choose to focus on – was subject to their own views on risk assessment and rotational emphasis. In addition to unit reviews, Internal Audit would also undertake thematic reviews as part of their annual programme. Internal Audit also would have been party to reviewing various corporate governance reviews such as Turnberry. As E&Y already attested too, and I agree, EBS had strong governance in place and this extended to the workings of internal audit and their supporting effective risk management. Internal audit through all their work would have had a strong sense of the prevailing risk culture and reported on this to the Audit Committee continously. Whether risk management was effective or not is another matter but I am satisfied that any failings were not as a result of internal audit deficiencies in identifying these or indeed lack of oversight of the prevailing risk culture. Ultimately accountability rests with management and the Board not the internal auditors.

B7a - Impact of prevailing Accounting Standards in Recognising Risks

As extensively covered already by the Committee in earlier sessions – I would simply note that IAS 39 was unhelpful. The reality is that accounting is a rear mirror view and not as well placed as one might like to assist in predicting future outcomes and/or highlighting and helping users understand all risks. However I would also note that voluntary disclosure theoretically could have mitigated some of the weaknesses in financial accounting standards and/or the regulatory system could have required more capital as a buffer to be held regardless of the accounting convention.

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.

Prior to the crisis I do not recall any of the external audits ever raising any key concerns about significant risk exposures to areas such as property, funding and liquidity. They will also tell you that this is outside their statutory remit. Having said that, if they had had any such material concern – I would have expected them to raise it, at least informally with myself and/or the Chief Executive or in private with the Audit Committee. Auditors whilst not bankers do have the benefit of having access to many financial institutions – domestically and internationally and in so doing and as global businesses themselves - understanding international best practices and risk warning indicators. They are also trained and disciplined in prudence and risk management. My belief is that E&Y prior to the crisis had no such material concerns relating to EBS exposures including property, funding and liquidity.

R3b- Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the Banking Institutions

I have no particular insight to bring to bear here. From what I saw first hand the Central Bank and the Financial Regulator worked relatively closely together during the crisis. There was continuous dialogue with all authorities including the Department of Finance. The only thing I would add is that just like in EBS – any failings I would attribute to each authority as a collective and not to any one individual. For a bank or building society to be reliant on one individual is very poor goverance, for a supervisory authority even more so. So I would be more critical of collective failure than individuals.

6 CONCLUDING REMARKS

EBS as a whole and its Members were casualties of this crisis. They were not the making of it.

I believe with strong conviction - given the circumstances and what EBS had to work with – that regardless of what strategy evolution EBS adopted during this time – other than perhaps a trade sale to a large overseas financial institution (which was not the preference of the Board nor the Members) the Society and its values would have been lost one way or the other. This would have necessitated legislative change.

Like with a tsunami, EBS was essentially in the wrong place at the wrong time. Hamstrung by legislation, its concentrated lending business, its reliance on wholesale funding and trying to compete with much larger and commerically short term driven organisations both domestic and international who were stretching credit standards and aggressively pricing mortgages – meant that the continuation of the market as it then was - never mind the crisis - was life threatening for the Society. The business model was stretched.

EBS did what the Board collectively thought best to survive and to then hopefully allow it prosper in due course. In so doing it was trying to be true to its Founders and Members and all stakeholders by preserving the optionality of a Mutual continuing in Ireland and remaining relevant in the market place. It ultimately did not succeed, which is I think a real loss to the country as harder times bring an appreciation back to community support and family. The EBS brand being retained by AIB – is testmony to the goodwill that the Society had amongst its Members and more generally.

I think banking generally will change radically for the better in the decades ahead – the move to mobile and new technology will I think disrupt the incumbants and empower the consumer. I think we are in the early innings of some transformational changes. Whether the Lendingclub.coms or Starbucks become the new modern day substitutes for EBS and take on the baton of offering a better alternative to the banks - time will tell.

I hope these personal insights help the Joint Committee in its deliberations.

Alan Merriman
8 July 2015