



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

**Settlement Agreement between the Central Bank of Ireland (the “Central Bank”)
and Irish Nationwide Building Society (“INBS”)**

Following Central Bank Investigation INBS admits widespread breaches

INBS has entered into a settlement agreement with the Central Bank.

This follows the conclusion of the Central Bank’s most significant and extensive regulatory investigation to date. The investigation commenced in 2010 and focussed on INBS’s commercial lending and credit risk management processes. It related to INBS and certain persons who were concerned in its management between 1 August 2004 and 30 September 2008 (the “Relevant Period”).

On foot of the investigation, the Central Bank formally referred the case against INBS and the relevant individuals to Inquiry¹. This is the first such referral under the Central Bank Act 1942 (as amended) (the “Act”). This settlement concludes the case as against INBS. The case against the relevant individuals will proceed to Inquiry.

As part of the settlement, INBS has admitted to having committed multiple breaches of financial services law and regulation, including persistent failure to comply with its own internal policies and procedures during the Relevant Period. As a result, the Central Bank has reprimanded INBS and imposed the maximum applicable fine of €5 million. As INBS does not have any assets, it would not be in the public interest to pursue the collection of the fine and, accordingly, the Central Bank will not do so on this occasion.

The Director of Enforcement, Derville Rowland, has commented as follows:

“The collapse of INBS cost the Irish taxpayer €5.4bn. It was a matter of significant public interest to ensure that a thorough investigation was carried out by the Central Bank to examine key issues arising within INBS between August 2004 and September 2008.

This investigation by the Central Bank is unparalleled in its degree of complexity and scale to any case which preceded it. It has taken a number of years to bring this investigation to fruition and distil it into the case recently referred to Inquiry.

INBS has admitted multiple failings at several levels of its commercial lending process, from operational lending, to credit review, its Credit, Provisions and Audit Committees all the way to its Board of Directors. INBS's admitted failings amount to a consistent and, at times, wholesale disregard for its own policies and procedures.

It is imperative that all regulated firms comply with financial services law and regulation and have robust systems and controls in place to continuously test and ensure compliance with their internal processes and controls. It is not sufficient for firms merely to have documented policies and procedures; the implementation of and compliance with those policies and procedures must be rigorously and systematically monitored and reviewed. Despite supervisory measures taken by the Financial Regulator at the time, INBS, by its own admission, failed in this regard.

Breaches of this nature are very serious and the Central Bank will continue to use the full extent of its Administrative Sanctions enforcement powers to seek to hold those responsible to account. An Inquiry is due to be held by the Central Bank to establish whether certain persons who were concerned in the management of INBS participated in the commission of the breaches.

The Central Bank will not hesitate to use the powers available to it to take the necessary enforcement action against firms with deficient compliance practices and against those responsible for the management of such firms."

Background

The backdrop to this investigation was the deterioration of INBS's financial stability, which ultimately led to its collapse. INBS's commercial loan book grew in value by 128% from around €3.6bn at the end of 2004 to around €8.2bn at the end of 2008. Throughout this period, commercial lending made up the majority of INBS's lending to its customers. The commercial loan book represented 65% of the total value of the loan book at the end of 2004 and this had increased to 78% by the end of 2008.

Between 2008 and 2010, INBS suffered financial losses in excess of €6bn, primarily arising from the impairment of its loan book. Under the National Asset Management Agency Scheme, the INBS loan book attracted the largest percentage discount of any of the participating institutions. The cost to the Irish taxpayer for INBS was €5.4bn.

Central Bank's Investigation

The Central Bank's investigation focussed on INBS's compliance with its own policies and procedures for commercial lending and credit risk management during the period 2004 to 2008. Over the course of the investigation, INBS's ownership structure changed and there were ongoing large scale personnel changes made within INBS. This resulted in the loss of individuals with first-hand knowledge of INBS's operations, policies and procedures during the Relevant Period.

The Central Bank gathered hundreds of thousands of documents as part of its investigation. Successive tranches of new evidence were identified by INBS / Irish Bank Resolution Corporation (in Special Liquidation) ("IBRC") during the course of the investigation, most recently in May 2015, which necessitated repeated reassessment of the detail of the investigation. In excess of 200 statutory requests for information were issued to witnesses and INBS / IBRC and 21 formal interviews were conducted including interviews in Ireland, Northern Ireland and England. There are approximately 110,000 specific documents which underpin the breaches, including documentation relating to specific commercial loans, contemporaneous reports from INBS's internal and external auditors and INBS's corporate governance documents. This corporate governance documentation included minutes and packs for meetings of INBS's Board of Directors and numerous internal committees conducted during the Relevant Period. In addition, the Central Bank reviewed electronic data forensically copied from INBS's systems including network drives, emails, back up servers and archives.

In order to complete the investigation, considerable further work was required on the part of the Central Bank to analyse the evidence, refine the scope of the investigation and isolate the suspected breaches which were ultimately referred to Inquiry.

The breaches

INBSⁱⁱ has admitted to breaching seven different aspects of its commercial lending and credit risk management processes, namely:

1. the initial loan application stage;

2. the loan approval process;
3. the taking of security, obtaining valuations and adherence to maximum Loan to Value ratios (“LTVs”);
4. the monitoring of commercial lending;
5. the role of INBS’s Credit Committee;
6. reporting obligations to the Board of INBS relating to commercial lending; and
7. the requirement for a formal credit risk policy relating to the establishment of profit share agreements.

These breaches, admitted by INBS, are underpinned by evidence of more than a thousand alleged instances of INBS breaching its own policies and procedures relating to commercial lending and credit risk management.

INBS has admitted to breaching three separate pieces of legislation / regulation in relation to these seven aspects of its commercial lending business (giving rise to a total of 21 contraventions):

- a) Regulation 16(1) of the European Communities (Licensing and Supervision of Credit Institutions) Regulations 1992 (S.I. No. 395/1992) (as amended) (the “1992 Regulations”)ⁱⁱⁱ;
- b) Section 76(1) of the Building Societies Act 1989 (as amended) (the “1989 Act”)^{iv}; and
- c) Part 1 of the Credit Institutions Regulatory Document Impairment Provisions for Credit Exposures dated 26 October 2005 (the “2005 Regulatory Document”) which was imposed as a condition on INBS’s authorisation pursuant to Section 17 of the 1989 Act^v.

These breaches, all of which are admitted by INBS, are explained in further detail below. These breaches all relate to the period between 1 August 2004 to 30 September 2008, with the exception of the sixth breach below (namely, reporting to the Board) which concerns the period from 21 December 2005 to 30 September 2008.

1. The initial loan application stage

This relates to the first stage of INBS’s commercial lending process. It concerns INBS’s admission to an internal systemic failure to ensure that commercial loan applications were processed in accordance with INBS’s own policies and procedures. This includes instances where no commercial loan application was prepared for certain loans or situations where applications were only prepared after

funds had been drawn down by borrowers. It also relates to loans where required information was not obtained from borrowers which would have allowed INBS to assess that borrowers' repayment capacity and instances where credit grades were not assigned to commercial loans as part of INBS's credit decision making process.

2. The loan approval process

This concerns failings, admitted by INBS, in a critical stage of its commercial lending process – its approval process, both in relation to the initial approval of commercial loans and the approval of subsequent variations to those loans. It also concerns the output of INBS's approval process, namely the commercial mortgage offers ("CMOs") issued to borrowers which, it is alleged, failed to comply with internal policies.

There are numerous alleged instances where loans, including additional advances, were not approved by the Board of Directors, were not recommended or approved by the Credit Committee and/or were not approved in accordance with INBS's urgent credit decision approval procedures. As such, INBS admitted that loans were being granted to borrowers without going through the controls which INBS itself had put in place. In addition, there are instances where, even when loans went through the approvals process, that process appears to have been deficient. For example, it is alleged that loans were being approved at Credit Committee meetings at which an insufficient number of people were present and that commercial loans were not being given adequate consideration by the Credit Committee or the Board.

There are multiple alleged instances of variations being made to loans without the requisite approval being obtained, including extensions to the term or moratoria on loans, or changes to security or repayment terms on loans. In addition, it appears that updated CMOs were not being issued following variations to loans as required by INBS's policies.

Finally, it appears that there were multiple deficiencies with respect to the CMOs being issued by INBS, for example, CMOs being issued prior to approval, funds being advanced to borrowers before CMOs were signed properly, CMOs containing different terms to those which had been approved by the Credit Committee or the Board or, at the most basic level, CMOs not being appropriately signed.

3. The taking of security, obtaining valuations and adherence to maximum LTVs

This relates to INBS's admitted failure to adhere, on a systematic basis, to its own policies in relation to the taking of security, the obtaining of valuation reports and in relation to LTV limits.

There are instances where it is alleged that no security at all was taken for certain commercial loans or where, for borrowers which were private companies, personal guarantees were not obtained from the shareholders or directors.

In a number of instances, it appears that INBS did not obtain valuation reports on assets which were being used as security before monies were advanced to borrowers.

While INBS had set specific LTV ratios in its policies, it appears that those limits were exceeded for a number of loans. Further, while INBS had set out a procedure for approving exceptions to policy such as these, it appears that it did not follow this procedure for certain loans with high LTVs.

4. The monitoring of commercial lending

INBS has admitted that it failed to ensure that commercial lending was effectively monitored in accordance with its internal policies, as required. There were alleged failings at a number of levels within INBS with respect to the monitoring of commercial loans, firstly by the commercial lenders themselves who did not monitor the loans in their portfolio, by the managers who failed to ensure that such loans were monitored and by INBS's Credit Review Function. For example, it is alleged that INBS's Credit Review Function was not reviewing its top 100 commercial creditors, or group of connected creditors, known as "Large Exposures" and, for the loans which were being reviewed, it is alleged that the output of the reviews was not being properly communicated to the lenders responsible for the loans. Finally, there were also alleged failings in relation to the Provisions Committee in circumstances where the results of the credit reviews which were performed were not being taken into account as part of INBS's process of provisioning for loans.

5. The role of the Credit Committee

INBS has admitted that its Credit Committee was not performing its functions in accordance with internal policies. One of the Credit Committee's functions was to consider non-performing commercial loans or those in large arrears, as well as loans arising from the credit review process. INBS has admitted that this did not happen. In addition, the Credit Committee should have been considering reports on INBS's exposure to specific sectors or customers but failed to do so. Finally, it appears the Credit Committee was not considering issues raised by INBS's Internal Audit Department, other advisors such as KPMG and/or regulators such as the Central Bank.

Had the Credit Committee considered this information, it would have been in a better position to understand the risks attaching to INBS's commercial loan portfolio, to identify emerging risks or market trends and use this information in considering loan applications.

6. Reporting obligations to the Board of INBS relating to commercial lending

Under its own internal policies and procedures, INBS was required to provide certain reports relating to commercial lending and credit risk management to its Board of Directors. INBS has admitted to an internal systemic failure to ensure that the relevant reports were provided to the Board of Directors between 21 December 2005 and 30 September 2008, including:

- i. reports on exceptions to commercial lending policies. Such reports would have given the Board an insight into, and an overview of, the extent of commercial lending which was outside the scope of lending policy. This would have allowed the Board to assess the consequential impact on the credit risk profile of the commercial loan book;
- ii. a quarterly review of commercial lending (for five quarters between 2005 and 2008). The quarterly review would have given the Board information on, among other items, INBS's Large Exposures and on the sectoral and geographical profile of the commercial loan book, thus allowing it to monitor and manage credit risk and assess strategy;
- iii. the results of annual credit risk stress testing. This report would have facilitated the Board in assessing INBS's ability to withstand potential loan losses and thus would have informed the Board's risk appetite and overall strategy; and
- iv. reports on compliance with geographic concentration risk limits. Such reports would have facilitated the Board in understanding, monitoring and managing the geographical concentration risks in INBS's commercial loan portfolio.

7. The establishment of Profit Share Agreements

INBS entered into profit share agreements with commercial borrowers which typically provided that, upon the sale of the asset being financed, the profits arising from the sale (after costs) would be shared between the borrower and INBS, for example, on a 70/30 basis respectively.

Profit share agreements were in place in respect of a significant proportion (65% by value as at 26 September 2008) of INBS's commercial mortgage book. INBS has admitted to an internal systems and controls breach by failing to ensure the establishment of a formal credit risk policy to govern INBS's decision making process and criteria for entering into or establishing profit share agreements. As a result, INBS failed to put in place an important internal control in relation to a significant aspect

of its business and failed to ensure that the sophistication of its risk management processes was appropriate in light of INBS's risk profile and business plan.

Penalty decision factors

The sanctions imposed in this case reflect the seriousness with which the Central Bank regards the breaches admitted by INBS. In deciding the appropriate penalty to impose, the Central Bank has taken the following into account:

- the serious internal systemic weaknesses of the management systems and controls;
- the sustained period of time over which the frequent breaches occurred;
- the high frequency of the breaches;
- the degree to which the breaches depart from the required standards in relation to compliance with management systems and internal controls; and
- the need for an effective deterrent impact on other regulated entities.

The Central Bank confirms that the matter is now concluded as against INBS.

Next Steps

The Central Bank will be holding an Administrative Sanctions Inquiry to establish whether certain persons who were concerned in the management of INBS during the Relevant Period participated in the commission by INBS of the above breaches. This Inquiry will be held in accordance with the Central Bank's powers under Part IIIC of the Act.

Enforcing compliance

Firms are expected to embed within themselves a culture of compliance, adopt a robust control framework and hold themselves to the highest standards of corporate governance and risk management. Where this occurs, it encourages a more ethical, accountable and transparent financial sector, which benefits Ireland as a whole. Where there are failings, such as those admitted by INBS, the Central Bank will use the powers available to it to take necessary enforcement action.

In line with the expansion of the regulatory agenda in Ireland in recent years, the Central Bank acquired significantly enhanced supervisory and enforcement powers under the Central Bank

(Supervision and Enforcement) Act 2013. The Central Bank utilises these powers to the fullest extent as an effective means of deterring poor behaviour by firms and raising the standards of compliance across the financial services industry. These powers have been accompanied by a cultural shift in financial regulation in Ireland over recent years. This has facilitated the Central Bank's move towards a tougher, more intrusive and sceptical risk based regime of financial regulation, of which enforcement is a key component.

Notes to Editors:

ⁱ Part IIIC of the Central Bank Act 1942 (as amended) provides the Central Bank with the power to administer sanctions in respect of the commission of prescribed contravention(s) by regulated financial service providers and the participation in the commission of the prescribed contravention(s) by persons concerned in their management.

Where a concern arises that a prescribed contravention has been or is being committed, the Enforcement Directorate ("Enforcement") of the Central Bank may investigate. Following an investigation, an Inquiry may be held where there are reasonable grounds to suspect that a prescribed contravention has been or is being committed. The purpose of the Inquiry is to (i) determine if the regulated financial service provider has committed the prescribed contraventions and, where relevant, determine if any persons concerned in the management of the regulated financial service provider have participated in the commission of the prescribed contravention and (ii) determine the appropriate sanctions.

The Administrative Sanctions Procedure (pursuant to Part IIIC of the Act) provides that, any time before the conclusion of an Inquiry, the matter may be resolved by entering into a settlement agreement. This is a written agreement which binds the Central Bank and the regulated entity.

Following an investigation conducted by the Central Bank under its Administrative Sanctions Procedure, the Central Bank has determined that it has reasonable grounds to suspect that INBS has committed certain prescribed contraventions and that certain persons who were concerned in the management of INBS during the Relevant Period participated in the commission of those prescribed contraventions.

A Notice of Inquiry has been sent by the Central Bank to INBS and certain persons who were concerned in the management of INBS notifying them that an Inquiry will be held by the Central Bank to establish whether certain prescribed contraventions have been committed by INBS and

whether certain persons participated in the commission of those prescribed contraventions by INBS. Given the settlement with INBS, this matter has now concluded in respect of INBS. However, the Inquiry will proceed in relation to certain persons who were concerned in the management of INBS.

ⁱⁱ On 1 July 2011, the High Court approved an application by the Minister for Finance pursuant to Section 34 of the Credit Institutions (Stabilisation) Act 2010 for the transfer of all assets and liabilities of INBS to Anglo Irish Bank Corporation (“Anglo”) save for certain excluded liabilities, including liability for regulatory actions, such as the subject of this settlement, which remained with INBS. On 13 July 2011, the Special Investment Shares held by the Minister for Finance in INBS transferred to Anglo with the effect that INBS became a wholly owned subsidiary of Anglo on that date. As part of its restructuring, Anglo was renamed IBRC in October 2011. On 28 July 2011, INBS’s authorisation to raise funds under the terms of Section 17 of the 1989 Act was revoked in accordance with Section 40(1)(a) of the 1989 Act. This revocation, however, did not affect its status as a registered building society and INBS continues to be subject to the obligations imposed by the 1989 Act. The current directors of INBS have entered into this settlement agreement with the Central Bank on behalf of INBS.

ⁱⁱⁱ Regulation 16(1) of the 1992 Regulations required every credit institution to manage its business in accordance with sound administrative and accounting principles and to put in place and maintain internal control and reporting arrangements and procedures to ensure that the business was so managed. INBS admitted to breaching Regulation 16(1) of the 1992 Regulations by failing, among other matters, to ensure compliance with its internal policies and procedures. The 1992 Regulations were revoked by Regulation 161 of the European Union (Capital Requirements) Regulations 2014 (S.I No. 158/ 2014) with effect from 31 March 2014. However, Regulation 162 of these Regulations specifically provides that the revocation does not affect enforcement action brought by the Central Bank such as this.

^{iv} Section 76(1)(b) of the 1989 Act requires every building society to establish and maintain systems of control of its business and records and systems of inspection and report thereon. INBS admitted to breaching section 76(1) by failing, among other matters, to ensure compliance with its internal policies and procedures.

^v Part 1 of the 2005 Regulatory Document sets out specific obligations for credit institutions and their board of directors / senior management in the context of credit risk policies and procedures. These obligations were imposed on 10 July 2006, pursuant to Section 17 of the 1989 Act, as a condition on INBS’s authorisation. INBS admitted to breaching the 2005 Regulatory Document by failing, among

other matters, to ensure compliance with its internal policies and procedures. The breaches of the 2005 Regulatory Document admitted by INBS took place from 10 July 2006 until 30 September 2008.