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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉI- REACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Déardaoin, 15 Eanáir 2015

Thursday, 15 January 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D'Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O'Keeffe.
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

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Professor Patrick Honohan

Chairman: As we have a quorum, the Joint Committee of Inquiry into the Banking Crisis is now in public session. Today's agenda is item No.1, a discussion with Professor Patrick Honohan on the report for the Minister for Finance by the Governor of the Central Bank entitled The Irish Banking Crisis, Regulatory and Financial Stability Policy 2003 - 2008. I welcome everyone to the third public hearing of this committee and, in particular, I welcome the Governor of the Central Bank, Professor Patrick Honohan.

The tenth Governor of the Central Bank of Ireland, Professor Patrick Honohan, was appointed on 26 September 2009. Before his appointment as Governor, he was professor of international financial economics and development at Trinity College, Dublin, from 2007. Prior to this, he spent almost a decade at the World Bank where he was senior adviser on financial sector policy. He was previously a research professor with the Economic and Social Research Institute, ESRI, economic adviser to the former Taoiseach, the late Dr. Garret FitzGerald, and spent several years as an economist at the Central Bank of Ireland and at the International Monetary Fund, IMF. A graduate of University College Dublin, UCD, he received his PhD in economics from the London School of Economics in 1978. He has taught economics at the London School of Economics, the University of California, San Diego, the Australian National University, UCD and Trinity College, Dublin. In recent years his research has mainly focused on monetary and financial sector policy.

In February 2010, the then Minister for Finance, the late former Deputy Brian Lenihan, requested the Governor of the Central Bank to conduct a preliminary investigation into the performance of the respective functions of the Central Bank and the Financial Regulator over the period from the establishment of the Financial Regulator to the end of September 2008. Governor Honohan's report was published at the end of May 2010. It is important to remind the committee that Professor Honohan is here to discuss his report alone. We will have an opportunity to discuss other matters with him, including the bank bailout, during the next phase of the inquiry which will commence in April 2015, at which time we expect the Governor to appear before this committee again.

I wish to advise the witness that by virtue of section 17(2)(l) of the Defamation Act 2009, he is protected by absolute privilege in respect of his evidence to this committee. However, if he is directed by the committee to cease giving evidence on a particular matter and continues to do so, he is entitled thereafter only to qualified privilege in respect of his evidence. He is directed that only evidence connected with the subject matter of these proceedings is to be given and is asked to refrain from discussing named individuals in this phase of the inquiry. Members are reminded of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the Houses or an official either by name or in such a way as to make him or her identifiable.

I now invite Professor Honohan to make his opening remarks.

Professor Patrick Honohan: The report that I submitted to the Minister for Finance in May 2010, entitled The Irish Banking Crisis, Regulatory and Financial Stability Policy 2003-2008 responded to a request by him for a "preliminary investigation of the performance of the re-

spective functions of the Central Bank and Financial Regulator” over that period. Drawing on internal files as well as interviews with key officials, the report was able to provide answers to two questions. First, why was the danger from the emerging imbalances in the financial system that led to the crisis not identified more clearly and earlier and headed off through decisive measures? Second, when the crisis began to break, were the best containment measures adopted? The report noted the relevance of factors other than the performance of the Central Bank and the Financial Regulator, including the performance of directors and senior management at the banks, their auditors and accountants as well as pro-cyclical elements of Government policy. However, in line with the terms of reference, it focused on the design of micro-prudential aspects, the approach to overall financial stability and the failure to undertake decisive and effective remedial measures.

The report runs to 130 pages, as members know, so what follows is very telegraphic. As far as micro-prudential policy is concerned, the supervisors did not accumulate enough relevant information for several reasons, the first being an excessive reliance on a regulatory philosophy that implicitly trusted that well-governed banks could be relied upon to remain safe and sound. This approach emphasised process over outcomes and downplayed the quantification of risk. The second reason was a deficiency in skills and staff resources. There should have been a greater degree of intrusiveness and assertiveness and a less deferential approach to the banking industry. This would have disrupted the pattern of inconclusive engagement with the banks, a pattern which spilled over into the macro-prudential area, reflected in the fact that the belated and relatively modest tightening in 2006 of capital requirements for high loan-to-value mortgages was adopted only after prolonged and agonised debate.

In terms of the analysis of systemic risks, the language of successive published financial stability reports was too reassuring, representing a triumph of hope over reality. Much has been made of the institutional separation of the regulatory authority from the rest of the Central Bank. The 2003 legislation that did that created the risk of ambiguity with regard to which entities were responsible for what. Certainly communication between the macro-economic specialists assessing systemic risks and the micro-prudential supervisors dealing with individual banks was not fully effective. Each side subsequently felt that they would have acted more vigorously had they been more aware of what the other knew. That probably reflected a lack of mutual understanding of the methodology and professional language as between economists and supervisors more than the institutional separation, which was by no means rigid. In the end, senior officials in both institutions or both parts of the institution, as well as many elsewhere, both at home and abroad, were too optimistic about the strength of the economy and the Irish banks. One should recall that several other central banks and financial regulatory authorities suffered similar failures in the run up to the crisis. However, with the exception of Iceland, they had not allowed the scale of their banking systems to get so completely out of control as happened in Ireland.

The report’s section on crisis containment includes an assessment of the 29 September 2008 decision to guarantee substantially all of the liabilities of the banks. While several other countries followed suit in subsequent days with more limited guarantees, the guaranteeing of subordinated debt of the banks was clearly a mistake. The formal guarantee, backed by legislation, of all long-dated debt was also unnecessary and bound to constrain the authorities’ ability to restructure or wind down failed banks before the expiry of the initial guarantee. That is the best summary I can give of that but I am sure that members will want to discuss it in more detail.

With the benefit of hindsight, had the regulatory authorities had any notion that heavy losses

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- or rather such heavy losses - could be involved, an alternative strategy, as mentioned in a footnote in the report, of putting Anglo Irish Bank and Irish Nationwide Building Society into liquidation on 29 September while standing behind the rest of the system should have been more favourably considered. I am not saying that it should have been done but it should have been more favourably considered given how resistant external authorities subsequently proved to be to the imposition of losses on unguaranteed senior bank debt of failed banks. External partners might, at that moment, have responded to such an idea with compromise proposals that might have alleviated subsequent pressures on the Irish Exchequer. More generally, greater consultation with EU partners would have been highly desirable and could have helped Ireland to be less on the back foot in subsequent negotiations.

Despite the passage of time, I have seen no reason to alter the assessments I made in May 2010. Obviously there are a few bits and pieces that one might add but overall, there is no reason to alter the assessments. I wish to add a footnote here on costs. At the time of the report, only a broad indication of the potential fiscal costs could be attempted, given the unprecedented scale of troubled loans and the fact that so few had yet been worked through. At that point in May 2010, only a handful of NAMA's loan purchases had been priced, for example, and there were other complexities. Even now, five years later, a precise estimate is not yet possible. Current valuations of the State's banking shares suggesting a figure for the net long-term fiscal costs of bank recapitalisation of the order of 22% of 2008 GDP may be compared with the phrase, "in excess of 15%" used in that report. Moreover, the latest figure of 22% still is within the maximum of the range I conjectured here in this room before an Oireachtas committee hearing in the summer of 2009, before I became Governor. Consequently, broadly speaking, even in that case I do not really need to make a substantial alteration of the assessment. We could talk again about costs as the costs of the crisis are much bigger than the costs simply of the bank recapitalisation.

Accordingly, extensive changes have taken place within the Central Bank, in view of those conclusions, to ensure that identified shortcomings have been removed as far as possible. While not strictly the topic for today's hearing, if I may I wish to include some words on this point for completeness. On institutional reform in the Central Bank since 2009, the 2010 legislation, that is, the Central Bank Reform Act 2010, confirmed the reintegration of the regulatory and supervisory apparatus fully within the Central Bank. The separate authority was abolished and its powers transferred to what used to be the board but now is the renamed Central Bank Commission, with most regulatory powers delegated to the deputy governor financial regulation. The legislation also introduced some changes, including a clearer definition of the goals of the Central Bank. Extensive actions were launched to enhance the Central Bank's capacity and ensuring its delivery of an intrusive and effective risk-based financial supervision, as well as a proactive approach to systemic financial stability policy. These have been addressing, *inter alia*, the identified issues of insufficient co-operation and limited communication between different divisions and sections, an unduly hierarchical structure and deference to authority and a reluctance to carry decisions to conclusions and effective action. There have been significant changes in the policy approach. For example, banking is no longer de facto exempt from enforcement actions as it was in practice before 2008. Banks now know that regulatory breaches leave them open to penalties. Thanks to the new legislation, the Central Bank's focus no longer is blurred by the potentially conflicting objective of developing the financial services industry. There has been substantial expansion of staff on supervision and regulation, responding both to objective assessment against comparators that more staffing was needed and to public demand that underachievement could not be tolerated. This included injecting new energy and a fresh approach by opening up the numerous senior appointments that needed to be made to candi-

dates outside of the bank.

I will not elaborate here on the additional powers that have been sought by the bank and granted by the Oireachtas on various regulatory and resolution issues. However, as far as bank supervision is concerned, the European Union's single supervisory mechanism, SSM, has since November 2014 taken over much of the decision-making, while implementation remains primarily a locally-managed task. There are improved decision making processes in regulation in the bank, including separation of policy and risk, as well as enforcement functions from supervision, significant strengthening of the legal division and an emphasis on better working interaction between the macro and microprudential staff. There is an extensive and continuing programme of cultural renewal engaging all staff and using many tools including a clearer definition of mission, performance management, all-staff meetings, monthly cascade briefings, investment in information technology systems, leadership training etc., all to ensure a more effective working environment that is more conducive to, among other things, constructive challenge internally. Current plans involve even greater use of on-site inspection of banks, as well as a thoroughly overhauled organisational structure to decentralise further decision-making, co-operative working and career progression.

I will conclude by noting no regulatory system can or even should attempt to eliminate all possibility of failure and regulation and supervision must be able to change with a constantly-changing financial industry. However, I think the more assertive and risk-based system of prudential supervision we now have in place has struck the right balance and will help ensure that the banking system helps the economic performance of Ireland, rather than causing the economic destruction which we all have been seeking to repair and rebuild.

Chairman: I thank the Governor. Before I begin, I will go through the lead questioners, who are Deputies O'Donnell and Michael McGrath with 20 minutes each. They then will be followed in ten-minute slots by Senator Barrett, Deputies John Paul Phelan, Eoghan Murphy and Pearse Doherty, Senator Michael D'Arcy, Deputy Higgins and Senators O'Keeffe and MacSharry. To commence proceedings and before I bring in the lead questioners, can the Governor explain to members how much the guarantee actually has cost to date?

Professor Patrick Honohan: I am ready for this question because it is something that has fascinated me as I often have worked on this thing for other countries. There are larger questions than how much the guarantee cost.

Chairman: For the moment, can the Governor state how much it cost?

Professor Patrick Honohan: The best estimate is around €40 billion in terms of net long-term costs, taking account of the recoverable amounts, the amounts paid in guarantee fees, the amounts of recoverable in terms of when the Government sells shares in banks. So there is €64 billion whittled down eventually to approximately €40 billion. However, there are so many "ifs and buts" that we could spend the whole morning on it.

Chairman: I have just one further question before I bring in Deputy O'Donnell. On page 115 of Professor Honohan's report, in section 8.9, he refers to the crisis management manual. I understand it also was known colloquially as the Black Book.

Professor Patrick Honohan: Yes.

Chairman: Professor Honohan has stated it was not employed to any significant extent during the actual crisis. Can the Governor explain to the committee what the manual was, who

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prepared it, what agencies were involved in the preparation and what it included?

Professor Patrick Honohan: The manual was created many years ago. It was a crisis management manual on here is what we will do if something happens. It was revised from time to time but as General Eisenhower apparently said, plans are useless but planning is vital. It was full of things like “we will call in all these people and discuss things”, as well as the telephone numbers and contact details. It really was not very actionable but presumably, the process of drawing it up and revising it made people aware of the sorts of decisions they would have to take at the time. There is no reason, although I would not wish to put it in the public arena, that the committee could not see-----

Chairman: Professor, we are here in the public arena.

Professor Patrick Honohan: I know but in case the committee was desperately keen to see this report, I am sure we could get the copy as it was in 2008.

Chairman: Can the Governor give members a brief summary as to what were the actions indicated in it and why it was not used?

Professor Patrick Honohan: As far as I know, when I looked through it a long time ago, basically it was a list of contacts suggesting that this person would need to be called, this is the telephone number and we should take account of talking to the European Commission and the Department of Finance. It was that sort of operational outline of what do we do if there is a problem. Other documents were prepared apart from the Black Book, which I think became known as the Red Book.

Chairman: Were they used?

Professor Patrick Honohan: Yes. Documents were prepared in 2007 and a lot of work went on at that stage to say what happens if we have a Northern Rock. A run on Northern Rock, a small mortgage bank, had happened in September 2007.

Chairman: But the Black Book was in preparation to anticipate a crisis.

Professor Patrick Honohan: It was long before that.

Chairman: I think it had simulated crises and other things coming down the track-----

Professor Patrick Honohan: Yes, in general terms.

Chairman: -----whereas by 2007, the whole crisis actually was in full-blown swing at that stage.

Professor Patrick Honohan: Yes.

Chairman: So in terms of the documentation preparation for a crisis, is the Governor confirming to the committee this morning that the aforementioned documentation, the Black Book, was not instigated? To use the Governor’s own analogy with General Eisenhower, Jack Nicklaus once said that the more he practised, the luckier he got. While the Black Book was practised, was it actually used?

Professor Patrick Honohan: I do not think so.

Chairman: I thank the Governor.

Deputy Kieran O'Donnell: I welcome the Governor, Professor Honohan. To revert to his opening statement this morning, he spoke about an alternative strategy, as distinct from the blanket guarantee. Had the guarantee been managed differently, would the Irish citizens now be on the hook for €40 billion, which is what the Governor has estimated to be the cost? As I find that to be an outstanding statement, the Governor should elaborate on this. Had Professor Honohan been Governor at the time-----

Professor Patrick Honohan: It is not fair to my predecessor to say what I would have done. Moreover, it is very hard to say what I would have done. However, on the specific question of whether all that sum of money could have been avoided, the straight answer is “No”, it certainly could not all have been avoided. Could it have been whittled down a bit more? Yes, I think so. A lot of whittling-down has been happening, with many public servants and others working very hard to whittle down that €64 billion, imposing losses eventually on subordinated debt holders and achieving other things. There has been a great deal of very sophisticated work, which has helped to bring it down, but it would have been very hard to avoid it all. We saw various points at which it was difficult to do things.

I mentioned two things specifically. One was subordinated debt. The sums of money involved there, for example in Anglo Irish Bank, were relatively small. All these numbers can be got precisely, but it is around the €2 billion mark and some of that was subsequently exchanged for lower amounts. The order of magnitude of that part is not great, but the reasoning given for guaranteeing subordinated debt was very weak. Nobody else guaranteed subordinated debt, so that could have been done-----

Deputy Kieran O'Donnell: In that context, looking through your report, the first suggestion of guaranteeing dated subordinated debt - it was lower-tier, tier 2 - was when the banks came in on the night before, that appears to be the first place it was mentioned. It was not a part of the crisis management in terms of the options that were being looked at.

Professor Patrick Honohan: This is not exactly the case. When the advisers were engaged by the Department of Finance, Merrill Lynch in particular, they looked very closely at this question. I think that was the first time the question of subordinated debt came into-----

Deputy Kieran O'Donnell: What was the reason given?

Professor Patrick Honohan: The reason given was that dated subordinated debt was regarded in the market as almost as good as senior debt - as it was said, “We’ll never be haircutted on this” - so banks issued it at an interest rate that was not all that much higher than the best interest rates. People who were investing in that did not think of themselves as taking large risks, so the investment advisers were saying to the Government, “Be careful about not guaranteeing this, because you could cast doubt that will affect those kinds of investors”. That was the reasoning. In the end, the advice of Merrill Lynch was very complicated - “If you do this, then you should guarantee the loan, if you do that, then you shouldn’t”. I am not sure that was talked through in a very thorough way, because Merrill Lynch was engaged eight or nine days before the guarantee.

Deputy Kieran O'Donnell: In your report and certainly in your presentation, you state that “external partners might have responded to such an idea with compromise proposals that might have alleviated subsequent pressure on the Irish Exchequer” if they had been properly consulted. Around the guarantee, from your investigations, were discussions held with the ECB?

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Professor Patrick Honohan: Not on the guarantee as far as I know. There were discussions. Obviously, the whole of Europe and the whole of the financial world was in a chaotic situation in those few weeks. It is important to remember that was the context. There were discussions with the ECB, explaining “we have difficulties too, we have banks running out of liquidity”. This was the story communicated-----

Deputy Kieran O’Donnell: Who were these communications with?

Professor Patrick Honohan: They would have been at the highest level in the ECB, between my predecessor and Mr. Trichet. The message that came back was, “You have to look after your own banks. We don’t have a European system”.

Deputy Kieran O’Donnell: In your report, you say that no bank should fail.

Professor Patrick Honohan: I do not say that, but that was the policy.

Deputy Kieran O’Donnell: That was the policy. You said that it did not emanate from the Central Bank. Who made that decision?

Professor Patrick Honohan: There was a decision at European level subsequent to that.

Deputy Kieran O’Donnell: Prior to the guarantee, who made that decision, in the Irish context?

Professor Patrick Honohan: The reason I mention this is that people tend to blur in their minds - there was a great public statement that no major bank was to be allowed to fail. That was subsequent, but the thinking was probably there as well, namely, “We can’t have any bank failing before the public statement”. I think that discussion happened informally in the European Central Bank.

Deputy Kieran O’Donnell: The Central Bank did not come up with that policy. Who came up with that policy?

Professor Patrick Honohan: I think the Central Bank shared that policy view for several months before. It said, “We cannot have a Northern Rock”.

Deputy Kieran O’Donnell: You said specifically in your report that they did not initiate that policy.

Professor Patrick Honohan: They bought into it.

Deputy Kieran O’Donnell: Who initiated it?

Professor Patrick Honohan: Good question. I do not know. It was in the air. People saw Northern Rock as a bad mistake and they also saw Lehmans as a bad mistake.

Deputy Kieran O’Donnell: Did it emanate from the Department of Finance? Did it emanate from a political level? Where did it come from? The context I am putting it-----

Professor Patrick Honohan: I think this was an official-level discussion, informed by discussions worldwide. This was the mood. Certainly after Lehman Brothers failed, there was this European reaction that America had done terrible damage to the rest of the world by letting Lehmans fail. Indeed, they let another bank fail a few days later.

Deputy Kieran O'Donnell: Would you have shared that view? You completed a paper in the summer of 2009, Resolving Ireland's Banking Crisis, where you effectively said that independent observers would state that Anglo Irish Bank was not a systemic bank, yet a couple of months later in the report you did for the Government, you say it was systemic. What in the interim made you change your mind, so that it went from not being systemic in the summer of 2009 to being systemic? In that context, you might elaborate that in the context of dealing with the ECB-----

Professor Patrick Honohan: We have to be very careful. I do not mind changing my mind, but I do not think I changed my mind on this one and I would have to see the exact words.

Deputy Kieran O'Donnell: On mature recollection.

Professor Patrick Honohan: There are a number of things one could say about Anglo Irish Bank. It is a bank that Ireland could do without and, indeed, does well without now. If it had not been in the market, the Irish economy would actually have been much better, but it certainly did not need that as a channel for - in that sense, it was not an important player and contributor to the Irish economy. Separately, would liquidating and pulling Anglo Irish Bank out of the market and imposing losses have created a systemic risk and was it systemically important in that sense at that moment? Yes, absolutely. There is no dispute about that.

Deputy Kieran O'Donnell: If the decision had been taken on the night of the guarantee for the Irish Central Bank, through the Irish Governor, to provide emergency liquidity - which it could have done - for a week, and then engage with the ECB and European partners, would the outcome for the Irish public and the Irish taxpayer have been better?

Second, regarding the type of guarantee that was put in place, a blanket guarantee, it was a two-year blanket guarantee. It guaranteed all bar the kitchen sink. Was it a contributory factor to the fact that two years later, by September 2010, the Irish banks were not able to refinance the deposits that had been guaranteed? Was it a major factor in Ireland going into a bailout?

Professor Patrick Honohan: Yes-----

Chairman: Was it a self-fulfilling prophecy that this would happen two years later, when the guarantee ran out?

Professor Patrick Honohan: I think that is right. We were in suspended animation for two years. One of the things the guarantee did, and we were talking about the subordinated debt, but guaranteeing the senior debt had a double effect. It is not just a question of not paying those guys, but any restructuring of the banking system, like liquidating or closing, would have triggered immediate payment under the guarantee from the Government. That meant that doing something with Anglo Irish Bank or with INBS, all these things, could be considered at leisure, because there was nothing one could viably do until the end of September 2010 and by that stage the damage was done.

Deputy O'Donnell asked whether there should have been emergency liquidity. That would have been a good tool to use at that moment. It was being used elsewhere in Europe. It would have given a number of days to take a breath and deepen the analysis of just how bad the situation was.

Deputy Kieran O'Donnell: I assume that by doing that, the Governor would not have had to put any form of guarantee in place. He would basically have been providing emergency

liquidity to Anglo Irish Bank itself.

Professor Patrick Honohan: Yes.

Deputy Kieran O'Donnell: Was it in ways a pyrrhic victory going with the blanket guarantee with the taxpayer on the hook for €40 billion? Will Professor Honohan elaborate on that? Was it a self-fulfilling prophecy that the blanket guarantee would store up major problems for and completely-----

Professor Patrick Honohan: Yes, but they did not know that. They did not realise that. What they should have realised was that if even if the best estimate was that they would not lose anything, there was a risk and the tail of that risk was very large. That was the advice that should have been given to Government at the time and I do not-----

Deputy Kieran O'Donnell: By whom?

Professor Patrick Honohan: By the relevant officials, including the bodies that I am investigating, and I think that is right.

Deputy Kieran O'Donnell: Professor Honohan is, therefore, saying that the Central Bank at the time in his view should have extended the emergency liquidity to Anglo Irish Bank.

Professor Patrick Honohan: Yes, but let us be careful about this. It would be naive to say provide emergency liquidity just for a few days and the problem would have gone away. It would not have gone away by the weekend. It would have bought a bit of time for discussion-----

Deputy Kieran O'Donnell: Does Professor Honohan believe on the basis of his discussions with his ECB partners and the head of the ECB in his role as Governor that they would have positively engaged if they had been contacted by the Government at the time?

Professor Patrick Honohan: Certainly they would have permitted the ELA but would they have said, "Don't worry about that. We will pay for Anglo Irish Bank"? There was no hope but there could have been some possibility of hooking them in by saying "We don't want to pay for this and we're going to let it go. What are you going to do about it?" There could have been a very tough political negotiation, not with the ECB. It would have to have been political with the rest of Europe but Europe would not have been ready for that, as it has not proved to be ready in many cases since.

Deputy Kieran O'Donnell: Does Professor Honohan believe that if the Government and officials had approached the ECB, it would have facilitated an orderly wind-down of Anglo Irish Bank, which clearly was insolvent at the time, as well as INBS?

Professor Patrick Honohan: Our subsequent experience - and we will presumably deal with that in the later part of the inquiry - was that the ECB was not in a frame of mind to permit wind-downs which imposed losses on senior bondholders. This is not a slam dunk, easy decision. The ECB would have said "If you want some assistance on this, please address yourselves to the other governments in Europe" because central banks can only give liquidity assistance. It would have allowed the granting of the ELA for a week or several weeks but-----

Deputy Kieran O'Donnell: Does Professor Honohan believe if that engagement had taken place with the ECB, the cost to the taxpayer would have been less than €40 billion that has been incurred?

Professor Patrick Honohan: It could have been less than the €40 billion. The Cathaoirleach asked me what was the cost of the guarantee but the cost of all the austerity measures is much bigger than the cost of the guarantee. It would, therefore, be a mistake for people listening to our conversation to take from this the idea that money could have been saved and there would not have been any austerity.

Deputy Kieran O'Donnell: Would it be a fair comment to state that the blanket guarantee was a major contributory factor to Ireland having to enter a bailout programme because it stored up problems with banks having to refinance two years later?

Professor Patrick Honohan: Definitely go into the bailout but the bailout is only the protective cover around austerity that needed to happen.

Deputy Kieran O'Donnell: It brought a lot of austerity-----

Professor Patrick Honohan: It did not. I do not think so. The bailout reduced the austerity measures.

Chairman: I will bring the Deputy back to Professor Honohan's report because we will deal with the bailout during a later module.

Deputy Kieran O'Donnell: I refer to financial regulation and so forth. At what point in time prior to the guarantee does Professor Honohan believe the banks were insolvent? Was there a scenario in the context of financial regulation that the tail was wagging the dog in the relationship between the regulators and the banks?

Professor Patrick Honohan: Insolvency is a legal concept so we have to be careful about that. There are two concepts of insolvency known to law. The first is whether you can meet your payments as they fall due. As soon as they were not able to meet their payments as they fell due, they were insolvent in that sense but more important than that for banks is the other concept of insolvency, which is whether your assets are greater than your liabilities. It is very difficult to value assets and there are accounting rules for doing so. Normally they work reasonably well but when a bank gets into a situation which I describe in box 7.2 where the boom might go on but the bust might happen, there are two possibilities - a good possibility and a bad possibility and they are very far from each other. Accountants' valuations are no use in dealing with that so it is not a question of when they were insolvent but when regulatory action should have been taken to prevent them doing what they were doing. The answer is it should have been taken several years before that.

Deputy Kieran O'Donnell: When?

Professor Patrick Honohan: The damage was being done mainly in 2004, 2005 and 2006. If you came up with some great idea at the end of 2006, it would have been too late.

Deputy Kieran O'Donnell: The horse had bolted in 2006 and it was too late to impose the additional capital requirements.

Professor Patrick Honohan: Yes, although in fairness to some people who have been vilified in the media, they put in those measures. People are trying to identify who caused this. Actions were taken but they were too late.

Deputy Kieran O'Donnell: I refer to Professor Honohan's paper, Resolving the Banking Crisis. Was it not astounding that it was not picked up that Anglo Irish Bank's balance sheet

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was growing at an average of 37% over a nine year period between 1998 and 2007 and INBS's was growing at more than 20% annually during that period?

Professor Patrick Honohan: I am sure it was noted but it was not seen as much of a problem as it should have been because the risk analysis was shallow. Do they have a good risk committee? Do they have the proper approval mechanisms? Does the board approve these loans? Instead of saying, "Let's stand bank and look at this. Are the collaterals okay? Do they really have those collaterals? What happens if they all fall in value by 30% of 40%, which is what many people were saying all the way through the mid-2000s-----

Deputy Kieran O'Donnell: Does Professor Honohan believe during that period that the tail was wagging the dog?

Chairman: Will the Deputy put the question rather than make a statement?

Deputy Kieran O'Donnell: Was the financial regulation from 2002 onwards fit for purpose?

Professor Patrick Honohan: I am determined to avoid a small slogan but if we get into fit for purpose and regulations that failed, we will get a long list of international regulators whose record during this period was not all that good. The difference with Ireland and maybe Iceland is the scale. The scale is huge. I do not necessarily disagree with the characterisation but I do not want to use it because I resist reducing this matter to a slogan.

Deputy Kieran O'Donnell: Professor Honohan has stated, "While regulation has self-evidently failed...".

Professor Patrick Honohan: Absolutely.

Deputy Kieran O'Donnell: Does Professor Honohan then believe it was not fit for purpose at the time?

Professor Patrick Honohan: It is not the language that I would-----

Deputy Kieran O'Donnell: What language would Professor Honohan use?

Professor Patrick Honohan: That it had self-evidently failed.

Chairman: Professor Honohan said that between 2004 and 2006 things were getting rocky. What happened in 2003?

Professor Patrick Honohan: There was a slowdown in or around 2001 and 2002 and the pick-up in the housing market and the banks piling in with more lending started in 2004.

Chairman: With regard to the banks' balance sheets, their lending and the volume of money in the economy, cash started to circulate in 2003 and 2004 following the dotcom crash and not when Ireland joined the euro in 1999. What was happening in Ireland in particular around 2003?

Professor Patrick Honohan: I think it was a continuation of a trend which had started around 1998 - anticipation of the euro, interest rates coming down, the legacy of the great Celtic tiger period where there was a shortage of housing and people wanted housing. That trend was there, interrupted by the recession and then resumed in a global environment where it was so easy for banks to source cash.

Chairman: On that basis and to verify Professor Honohan's opinion on it, would it be fair to say that it was not the entry into the euro in 1999, low interest rates and a unified currency across the region that instigated all this credit immediately? It was three or four years later that the credit cycle actually started happening in the country at a worrying level.

Professor Patrick Honohan: I would be inclined to think that it started but had not got out of hand when the euro came in but if we look across other countries that are not in the euro - Latvia is in the euro now but was not then; Iceland is not in the euro - we see a pattern of countries which, even though they were not in the euro, also benefiting from this great surge in availability of cheap capital around the world. The combination of the euro and the Celtic tiger period was the ingredient to sell Ireland and make people think that Ireland is different, that we were good before but now we have the euro as cheap money, and the Celtic tiger is fantastic. There was a narrative pushing the boom in Ireland. There was a different narrative in Iceland. There was a different narrative in Latvia. A narrative is needed to get these bubbles going because otherwise people will not believe in them.

Deputy Kieran O'Donnell: Chairman, may I ask another question?

Chairman: I will call the Deputy later. Deputy McGrath.

Deputy Michael McGrath: The Governor is very welcome. I thank him for attending. The Chairman asked the Governor at the start of the meeting the cost of the bank guarantee and he said in net terms it was in the region of €40 billion. I want to tease that out with him. In his view was it the guarantee itself that cost that or is he referring to the rescue of the banks?

Professor Patrick Honohan: That is a very good point. I thank the Deputy for correcting me because I should have made that point, and I suppose we teased it out to some extent with Deputy O'Donnell. It was not the guarantee. It was the banks getting into this mess because it was never going to be possible for the Irish Government to say, "There are a lot of losses in the banks but we do not care because something had to be done for at least some of the banks".

Deputy Michael McGrath: I accept that but going even further than that in terms of the management of the banking crisis, as the Governor knows, the guarantee was a two-year guarantee. At the end of September 2010 about €40 billion of senior bank bonds came out of guarantee and they were not covered by the eligible liabilities guarantee, ELG, which replaced the original one. Did the fact that every cent of that €40 billion - some secured, some unsecured but all unguaranteed now from September 2010 - had to be repaid contribute to the overall cost of rescuing the banks?

Professor Patrick Honohan: Absolutely. An important point is that people say the Irish Government guaranteed the €440 billion but only 10% of that was actually called, so it really matters which elements of the guaranteed amounts might not have had to be paid. There was an issue, and we can discuss this at great length now or when we talk about the bailout, around what could have been bailed in in 2010 and what might have been bailed in in the context of the new regulatory arrangements in Europe, bank recovery and resolution directive, BRRD, because the whole attitude in Europe towards bank failure has changed.

Chairman: There was a two year and two months period between the guarantee and the bailout, Governor-----

Professor Patrick Honohan: Yes. Nothing could be done.

CONTEXT PHASE

Chairman: -----so I would like to concentrate on the guarantee this morning.

Professor Patrick Honohan: Yes. In terms of the approximately €40 billion unguaranteed, some of it was secured so they would have been paid. It gets down to about €16 billion. A lot of that is with AIB and Bank of Ireland, and then we are down to €4 billion or €5 billion with Anglo and Irish Nationwide Building Society, INBS.

Deputy Michael McGrath: Yes.

Professor Patrick Honohan: We could definitely have a big conversation about those.

Deputy Michael McGrath: It is a fairly direct question. Did the fact that everything which was unguaranteed had to be repaid contribute to the overall bill of rescuing the banks?

Professor Patrick Honohan: Yes, but you might end up saying it is a €5 billion bill. Some people might say it is €10 billion or €5 billion. These are huge sums of money but they are small in terms of the overall.

Deputy Michael McGrath: There were €20 billion of unsecured senior bonds that came out of guarantee at the end of September 2010. They were not all INBS and Anglo.

Professor Patrick Honohan: Yes. I think it is 16 point something but when it got down to what you could have talked about, many of them were AIB and Bank of Ireland-----

Deputy Michael McGrath: That is an opinion as to what you could have talked about.

Professor Patrick Honohan: Yes, exactly.

Deputy Michael McGrath: Many people would argue you could have talked about everything-----

Professor Patrick Honohan: Yes but-----

Deputy Michael McGrath: -----that we were rescuing the banking system-----

Professor Patrick Honohan: If the Deputy is asking for my advice-----

Deputy Michael McGrath: -----and that everyone should share the burden.

Professor Patrick Honohan: -----in my opinion you are definitely down to sums below €20 billion.

Deputy Michael McGrath: Okay. The Governor makes a point in his report about subordinated debt, which Deputy O'Donnell teased out with him also, and there is a clear criticism of the inclusion of dated subordinated debt. In view of the fact that the heavy losses were subsequently imposed on junior bondholders to the tune of approximately €15 billion, what could actually have been saved if all subordinated debt had been left out of the guarantee entirely?

Professor Patrick Honohan: Relatively little more but-----

Chairman: Explain subordinated debt for the benefit of people watching.

Professor Patrick Honohan: When the banks source their money from different sources they get it from depositors, the ordinary plain people. They get depositors from big companies but it is the money that companies need to use, and they get deposits from financial institutions

and investment funds that are not needed on a day to day basis. They also get bonds which have equal standing with the deposits but they are required by international regulation not to rely wholly on this first tier of deposits and senior bonds. They are required to get some of their funding from risk-takers, especially equity holders, but also they are allowed to cover some of that requirement with bonds that explicitly state that they will not be paid in a liquidation until all the senior bonds are paid. They are an intermediate cushion of liabilities.

Deputy Michael McGrath: The Governor is also making the point about long-term debt. Is he referring to other senior bonds-----

Professor Patrick Honohan: Senior bonds.

Deputy Michael McGrath: -----that should not necessarily have been included in the guarantee?

Professor Patrick Honohan: That is right because with bonds you cannot just say, "I will have my money back". You have to wait until the bond matures. They were not posing a risk on a day to day basis for the bank that they will be pulled, like deposits could have been pulled, so it would have been very easy for the Government to say, "We are guaranteeing all the deposits and new bonds, subject to approval, but the old bonds can sit there and let us see what happens to the bank. Let us see how this plays out and, if need be, a bail in". Under the new rules-----

Deputy Michael McGrath: Would that have been credible? Would that have-----

Professor Patrick Honohan: Yes, I think so.

Deputy Michael McGrath: -----given sufficient confidence to lenders?

Professor Patrick Honohan: All of the other countries left out old bonds in their guarantees, as far as I am aware.

Deputy Michael McGrath: Okay. Should Anglo have been allowed to fail at the end of September 2008?

Professor Patrick Honohan: Yes. I think it should have been intervened. The management should have been removed. That would have been more clear if they had known the size of the problem but all the investment banks that looked at it saw that Anglo's business model was not credible in the market. It had run out of cash and it had a big problem with its portfolio, which would have eaten through its capital even though they did not think it would eat through the senior bonds.

Deputy Michael McGrath: Is the Governor saying that that decision should have been made even with the information available at that time or is he saying it with the information we now have about the insolvency-----

Professor Patrick Honohan: I think that decision should have been taken at that time, although I would have left it to the weekend to manage the situation in a particular way. Do not do it on a Tuesday night, and you would have used emergency liquidity assistance, ELA, to do that.

Deputy Michael McGrath: And then liquidate so that we would not be talking about a disorderly failure, as the Governor referred to in his report? He is talking about a liquidation.

CONTEXT PHASE

Professor Patrick Honohan: That is the big issue. Ireland got a bad rap for introducing a guarantee but it would have been an even worse rap internationally if they had said, “We don’t care what you think. We’re just going to liquidate it and to hell with the bondholders”. It would have been seen as the European Lehman’s and the Government would have been pilloried. That does not mean they should not have done it but they would have been pariahs in international circles. What they should have done was to say ELA and then say, “We have this bank going down. We cannot afford to guarantee. The risks are too big. You have got to risk-share with us. If you want to wind this down orderly you’ve got to put European capital into this bank and then we will liquidate it down”.

Deputy Michael McGrath: The Governor says in the report that a disorderly failure of Anglo, which he said was systemic at the time, would have in all likelihood meant the other banks running out of cash within days. He is not talking there about a liquidation. He is saying if the Government had done nothing Anglo just could not continue in business.

Professor Patrick Honohan: Yes. That is what I meant there but it is also true that with any kind of bad news story, the other banks were close enough to the edge as well and they would probably also have needed ELA. Actually, in the end, in 2010 they all needed ELA so it was just postponing. It was not the end of the world. It is not good, but it is not the end of the world in a crisis like that if you have to give a bank ELA.

Deputy Michael McGrath: What, in the professor’s opinion, is the main reason those involved in making the decision and the authorities and advisers did not know that Anglo was a busted flush, that it was insolvent at that time? Why did they not know that?

Professor Patrick Honohan: They did not know that because they had not thought of the problem in the terms I have described - boom continues or bust happens - in this bifurcated way, this bimodal way that the bad would be very bad. They did not know in detail what sort of securities and collaterals Anglo Irish Bank had for the lending. It took a lot of detailed work by the time NAMA started to buy these loans. They said, “These loans are not worth very much because the collaterals are not as good, because the personal guarantees of the owners are nothing like as strong as the banks thought they were.” People had not thought through the downside. Regulation is all about the downside. People will say, “Oh, the central scenario is for a soft landing.” It does not matter what the central scenario is - it should be of no interest to the regulator and the Central Bank what the central scenario is. For regulation purposes we ought to know what the downside is and whether we can cope with it.

Deputy Michael McGrath: Should they have known at that stage that Anglo was insolvent?

Professor Patrick Honohan: They should have done that, but were they doing the sort of----

Deputy Michael McGrath: Who should have known?

Professor Patrick Honohan: The regulator should have known. It happened in many other countries, just not on as large a scale. The regulator was following a type of approach which I think of as the London approach. It is the sort of approach that was being adopted in the FSA in London. They had big problems with their banks as well, but nothing that they could not absorb, whereas our one was far too big. There was a scale difference. Maybe at a certain point, when the numbers got so big in relation to the economy, the wider systemic risk people should

have said, “I do not care what you say about the balance sheets of the banks, that they have got enough capital. This must contain too big a risk. This has to be reined in.” They did not do it.

Deputy Michael McGrath: In the professor’s opinion, was there a genuine belief at that time that Anglo’s problems were short term in nature - cash flow, liquidity issues - that the underlying solvency of the bank was sound? Was that the genuine belief in September 2008?

Professor Patrick Honohan: It seems to have been. I have heard no official of the Central Bank saying, “Well actually, you know, to be honest, we knew they were gone.” I have heard nobody say that.

Deputy Michael McGrath: Nobody?

Professor Patrick Honohan: Nobody. I think of course, if one has been involved in supervising the banking system it is very difficult to turn around and say, “I think I have missed something here, something really big.” It was going to take a lot of evidence to convince them. The investment bankers who came in - of course very superficial - said there were problems but none of them said this bank was going to go down and is going to cost €X billion in over the capital. It is in the public arena. One of the notes says if the scenario is as bad as the scenario envisaged in this paper, then Anglo could burn through all of their capital. That was the worst scenario they said although they acknowledged that there were further risks. That is the problem with the guarantee - the risks are open ended.

Deputy Michael McGrath: When Professor Honohan talks about Monday, 29 September, on page 123, he says “it became clear that Anglo could not survive another day.” Was the position that stark? Was it that imminent that Anglo, without any intervention, would be gone the following day?

Professor Patrick Honohan: Yes. In fact, the previous weekend, the day-by-day projections indicated that they would be in deficit to the extent of €0.1 billion on the Tuesday, whatever day it was. When it got to the day before, they then thought they would be over €1 billion short. It was clear that they would not have enough cash, but that meant they would have to get emergency liquidity. Other banks in Europe were getting emergency liquidity.

Deputy Michael McGrath: In the course of preparing his report, did Professor Honohan come across any evidence or example of anybody in the Central Bank or the Financial Regulator conveying a message to Government, privately or publicly, in writing or verbally, that this was heading for disaster - the unsustainable model of lending that the bank was engaging with, the over-exposure to one sector of the economy - did anyone from the Central Bank or the regulator raise serious concerns and ring the alarm bells with the Department of Finance or the Taoiseach?

Professor Patrick Honohan: It is a little bit like the “wolf wolf” story. Central banks go around telling people that they really have to rein in things, really, this is going to end badly. They tend to overplay that, in good times and bad times, be very careful now. The messages are broadly correct but they have to be graduated and there was nothing along the lines of, “Forget about all the letters I have sent you, this is really serious and we are going to have to do something.” Actually, the Central Bank had powers to do things to stop themselves. It is not a question that they should have told the Government - yes they should have told the Government. One will find that there is a lot of documentation saying, “Look, I said here, this is a very risky situation,” and there are those things, but the message did not get through because it was

not communicated in a way that would have really rung the alarm bells. In preparing for this session I found a very interesting document on the PAC website that I had not noticed before. It is not an important document, it was probably prepared by a junior official in the Department of Finance. It is not signed but it is presented to the Minister on 3 September 2008. It includes this, third paragraph:

The overall conclusions of the financial stability report of the Central Bank for 2007 was that the shock absorption capacity of the banking system left it well placed to withstand pressures from possible adverse economic and sectoral developments. While it is too early yet to anticipate the context of the Central Bank-FSAI report for 2008...

So the advice being given, at least in this written document, to the Minister was capturing the relatively benign tone of a document which, if that is the message the Department of Finance was receiving from the Central Bank and communicating to the Minister, how could the Minister have expected that a decision like a guarantee was going to lead to the thing? I have the greatest sympathy for the people in the room, the political people on the night of the guarantee. One should recognise that in the context of the advice they were being given, the decisions they were taking are quite understandable.

Deputy Michael McGrath: Professor Honohan said that there was a failure of regulation. Was that due to inadequate legislation?

Professor Patrick Honohan: No. Obviously, legislation could have been improved and has been improved since then, but I believe that the powers were available.

Deputy Michael McGrath: Inadequate resources?

Professor Patrick Honohan: Inadequate resources devoted to regulation. That was a decision, it was not like, "Oh, we do not have any money----

Deputy Michael McGrath: The allocation of resources.

Professor Patrick Honohan: The allocation of resources. One of the things is a very striking figure here in my report telling one how many staff were devoted to knowing about the particular banks. There were three people on the Bank of Ireland team and, if I am not mistaken, they worked also on Anglo Irish Bank. Three people, that is sort of ridiculous for two banks which caused so many problems. Obviously we organise ourselves a bit differently now. We have five to ten times the number of people on this direct supervision of banks. It was because the approach was to say that a well-governed bank is going to be alright because those guys have the incentive to make it run okay. That is not true. Regulation is not just about making sure that the banks are being run in accordance with what the shareholders will want. The shareholders' interests and the State's interests are different.

Deputy Michael McGrath: Having said all of that, should we have been more prepared? There were clear warning signs in 2007 and in March 2008 of problems in the international banking system. Should we have been more prepared in terms of having resolution legislation prepared and ready to go in the event of something like what happened in September 2008 transpiring?

Professor Patrick Honohan: Resolution legislation is a good example. People were making efforts. Particularly, one will hear presumably from representatives from the Department of Finance. There was a lot of thought given to resolution legislation because in 2007 when

Northern Rock trouble arose, the British authorities realised that they had not brought their legislation up to date and had not been doing things that developing countries are doing, putting in ways of dealing with insolvent banks through a special liquidation procedure and a special resolution allocation. They started to work on that legislation, so why did we not do it? Well, the Department of Finance in consultation with the Central Bank said, "Yes, let's do this, we should have," and the Central Bank said to the Department of Finance, "you should work on this." The Attorney General said that it was all very well for the British as they do not have a constitution, but as we have a Constitution protecting private property the Attorney General did not think we could get the same legislation through here. Therefore, all of these things were considered but they were not brought to an adequate conclusion.

Deputy Michael McGrath: Did Professor Honohan encounter any evidence of overt or covert pressure from political masters towards those in the authorities responsible for regulating the banks and those responsible for prudential supervision? Was an environment created where questioning of the model was unwelcome? Was there any evidence of direct contact where people were slapped down for raising issues or questions and highlighting concerns?

Professor Patrick Honohan: This is a very important question. I would say there was. One of the influences here was the fact that in the legislation the Central Bank was there to promote the development of the financial services industry as well as everything else. If some junior staff member said that they did not think a bank should be allowed to do something, and they wrote a letter saying it should not be allowed to do it and signed it, so-and-so junior official, a telephone call would be received - evidence of this happening was provided - by a senior official saying the letter had been received. They would then say, "Well, this is a very important firm" or "We do not want to give the impression that we are over-regulating and I do not think there is a risk here." There was that type of environment. Of course, things like that will happen all the time; things will be escalated. However, what staff complained about was that it was done without the senior official saying, "Get the junior official to tell me about it. Let me understand what can we do and what we cannot do." It was more a decision taken at the top. That environment was created. The Deputy asked if there was political pressure. The Government wanted the development of the financial system and there is nothing wrong with its sound development, but it created that environment.

I put a footnote, No. 12, into the report. It refers a little to the surrounding atmosphere on the night and I talk about the idea that people were well liked in political circles. That was the closest I came to seeing something where one might have thought that perhaps they should not have been made that aware of how close they were, but that was on an emergency night.

Deputy Michael McGrath: On page 7 of his report Professor Honohan says that in an important sense the major responsibility lies with the directors and senior management of the banks that got into trouble. It was not part of Professor Honohan's report to examine the role of the banks, but is that his view if he were to have a hierarchy of responsibility for causing the banking crisis?

Professor Patrick Honohan: It is my view. Sometimes in discussions with people they might ask if I am entitled to have that view and if it is not just my personal view of the ethics of banking. I do not think banking and finance can work without a high ethical standard, a standard that tells top bankers that they have a heavy responsibility here, that this is not money they are being given to gamble with but money they are being given which forms the basis of a huge underpinning of the economy of society. Regarding developers, they probably think that the bank did give them money to gamble with - it is a different environment. I think there is a

heavy responsibility, but perhaps it is more an ethical than a legal concept.

One thing should be said. This inquiry will be looking into those dimensions of the banks, and to some extent Peter Nyberg looked at that as well. I am often puzzled over something. We all know that senior bankers, and I am referring not just to Anglo Irish Bank, were very well regarded. There were clever, able, serious, solid and honest people of integrity. How could they have got into this situation? The conjecture I am left with, and which the inquiry might wish to explore, is that in the back of their minds they might think, “Gosh, this could all go wrong, but if it all goes wrong there will be a rescue, it will not be that bad because a floor will be provided and the State or Europe will step in - something will be done and it will be all right”. Even though they might have accepted subliminally that there were risks, they brushed those aside. Of course, this gives the situation, and this is not the way they would have put it or even thought of it, of heads I win, tails you lose. That could explain why serious people said, “We are making a lot of money here, we are distributing it to shareholders and we are generating the economy. Yes, we are taking risks, but if the worst comes to the worst it will not be too bad for us.”

Chairman: Thank you, Professor Honohan. Before I move to the other questioners, three issues arose with the two lead questioners that I wish to tidy up so people do not repeat the questions. The first relates to the European Central Bank. Was contact made with the ECB at any time during the period leading up to the banking guarantee?

Professor Patrick Honohan: I believe there was, but not with a view to asking whether we should do a guarantee. I have no evidence whatsoever, and I do not believe it to be the case, that the ECB asked the Irish Government to guarantee the banks.

Chairman: Could you indicate what the dialogue with the ECB was, if it was not about that?

Professor Patrick Honohan: My understanding was that obviously there were a number of conversations within the ECB about the situation generally, but that there were specific bilateral consultations. I do not wish to be too specific on the discussions in general but it is mentioned in the report that Depfa Bank was in trouble that weekend as well, and its parent company, a German bank Hypo Real Estate. However, Depfa Bank was in Dublin.

Chairman: It cost €100 million to bail out. The Germany taxpayer took it over.

Professor Patrick Honohan: I think it will end up less, the same way our €64 billion comes down. I think it will come down a lot. There is a story there. There is a tendency for people to say that the Irish did something, but it was a factor. There were discussions around that. I believe it was a distracting factor for the Irish authorities in the days leading up to it and perhaps a constraining factor against the use of ELA, because there was no way the Irish Government was going to guarantee ELA given to Depfa Bank. There were conversations around that and there were conversations about what we were going to do if our banks ran out of cash.

Chairman: Was a guarantee part of that discourse?

Professor Patrick Honohan: No, I do not think so. I think it was just a general-----

Chairman: While there was contact with the ECB-----

Professor Patrick Honohan: My understanding is that there was no discussion with the ECB about the guarantee until the night or the early morning of that day. You will be able to

confirm that, but that is my understanding.

Chairman: The other matter is the area of risk assessment methods. Other members will go into that as we progress with the questions. However, there is the issue of the powers of the Central Bank and the powers of the Governor of the Central Bank at that time. Did the Governor have the power to issue specific directions relating to a wide range of micro-prudential policies, including credit concentration limits, during the time prior to the guarantee?

Professor Patrick Honohan: You are asking me a very specific legal question. Let me answer it in this way, and we can get more detail if you need it. The Governor had extensive powers to intervene in what the Financial Regulator was doing if he considered it necessary. He regarded that as a type of nuclear option and he never saw any reason to suspect that the Financial Regulator was not doing its job. Although he had last resort powers, they were not day-to-day powers.

Chairman: I am asking what choices he had before him.

Professor Patrick Honohan: He had extensive powers.

Chairman: Did he have the power to set credit concentration limits? I will be returning to this later.

Professor Patrick Honohan: I would prefer to get a legal answer to that because that is in the law. He certainly had over-riding powers and he could have steered them in that direction, even if he did not have those direct powers. I wish I knew the exact answer to your question, but it is easily found. He definitely had the powers.

Chairman: Will you refer back to the committee on that?

Professor Patrick Honohan: I will.

Chairman: Thank you. Senator Barrett has ten minutes.

Senator Sean D. Barrett: I welcome the Governor of the Central Bank, my former colleague in Trinity College Dublin, TCD, and I thank him for his report and presentation.

What the Governor refers to as the window dressing is when there were back-to-back deposit transactions between a subsidiary of Irish Life and Permanent and Anglo Irish Bank for €7 billion to make Anglo Irish Bank's books look better. Did the Central Bank sanction that?

Chairman: Sorry, Senator, you are leading a little by saying, "to make ... the books look better". Can you rephrase the question?

Senator Sean D. Barrett: It is a quote from the Governor; he wrote that. It is in order-----

Chairman: I am also mindful that matters that are with the Director of Public Prosecutions, DPP, at present would not be permissible for discussion in this inquiry this morning. Please continue.

Senator Sean D. Barrett: I am trying to inquire about €7 billion. It was passed between Irish Life and Permanent and Anglo Irish Bank. Was this sanctioned by the Central Bank?

Chairman: That is a matter of criminal investigation at present, Senator. You know it and I know it. It would be completely unfair to other members of the committee and certainly unfair

to the inquiry given what we have seen happen previously. A recent judgment more or less removed many years of the work of a tribunal because of a faultline being implanted into its work. Please move on to a different line of questioning. You know very well, as do other committee members, that matters before the Director of Public Prosecutions or subject to a criminal prosecution are not for discussion in this inquiry; they are outside the terms of reference.

Senator Sean D. Barrett: Professor Honohan states on page 42, “Though few would now defend the institutional structure invented for the organisation in 2003...”. Was this not the organisational structure the Central Bank wanted? Stephen Kinsella has written on how the McDowell report suggested a completely new organisation outside and independent of the Central Bank and how the Central Bank raised hell on high water to ensure that did not happen.

Professor Patrick Honohan: It is hard to say what the Central Bank wanted in those days, but there was a minority report in the McDowell report. If memory serves me, it was signed by the assistant secretary of the Department of Finance and the director general or perhaps the deputy director general of the Central Bank. They wanted something slightly different and they got part of their way. They wanted something like what is in place now under the 2010 legislation. In other words, bank supervision is a department of the Central Bank and fully integrated within it. They did not want a separate entity. At the time the Government and the Oireachtas decided not to create a completely separate identity and created this strange hybrid animal. The Central Bank got part of the way towards what it wanted.

Senator Sean D. Barrett: Professor Honohan shows on page 64 that having lobbied so hard the Central Bank devoted remarkably few resources to this task, which it did not want to be carried out independently, as per the McDowell report. The Central Bank had two people for AIB and Irish Life, three for Bank of Ireland and Anglo Irish Bank and only 15 people in all. There are approximately 1,200 staff in the Central Bank but only 15 were doing this task which the Central Bank viewed as so vital. The organisation did not give enough priority to a task which it had lobbied to be allocated to it.

Professor Patrick Honohan: I agree with that and I will try to explain why that might have happened. Much of the drive of the McDowell report was about consumer protection. More resources were given to the consumer protection side of financial regulation because that was where the push was and where people were interested in doing new work. The idea was to constrain the banks following the bad practices identified in previous inquiries in the 1990s. Consumer protection is very important and I think the bank was right to devote the attention to that area, but I do not think it should have neglected the prudential side as much as it did. It is part and parcel of this approach. If all the Central Bank wanted to check was whether there was a good governance committee and good approvals then it could do so with a lighter staff. Anyway, I fully agree with the premise.

Senator Sean D. Barrett: It was also extremely expensive. Professor Honohan’s report has shown that our bank supervision was costing twice as much, in respect of capital, as what it was costing in Germany. How did so little supervision cost so much money relative to Germany?

Professor Patrick Honohan: First, I am not going to try to defend the cost of regulation in general. It is an ongoing constant battle. In principle we could always imagine that another person would be very useful to have for regulation and we have increased the staffing a good deal since then. One comparison might suggest it was far more expensive than this or that country while in the same footnote there could be several other examples suggesting it was far

less expensive. The committee members can imagine which comparisons are emphasised by the head of financial regulation: the examples that show that it is far less costly than in Hong Kong or somewhere like that.

It is a difficult thing to get right but it is clear that three people looking at Bank of Ireland and Anglo Irish Bank and two people looking at another bank was wholly inadequate. However, many more things than banks are supervised. Ireland has the 15th largest international financial sector in the world. That requires a lot of very routine work on regulation, including approving new directors, approving business models and so forth. It is not only the banks. Very little attention was being given to the banks on prudential matters relative to the IFSC and all of that.

Senator Sean D. Barrett: Another finding on page 73 was that the supervision being carried out was pretty ineffectual. Let us consider case studies Nos. 1 and 2. The first was in August 2000. The Central Bank found that a bank had failings at every level from the chief executive and board to the staff at the desk but nothing happened for eight years. Why did the Central Bank want these powers when it was obviously not exercising them? In case study No. 2 Professor Honohan refers to how it took several months for a letter to be issued and at least as long for a response to arrive. Obviously the bank was not very good at this task, which it lobbied to be given as part of its opposition to the McDowell report.

Professor Patrick Honohan: I fully agree with that. I was glad to be able to pull out such concrete evidence from the files. I think we have been able to give chapter and verse and illustrate in a concrete way the things that were not working out well. There have been other inquiries in other countries throughout the world but we have been able to get down to brass tacks. This is a sorry story. Certainly, case No. 1 is a very bad story.

Senator Sean D. Barrett: On page 22 Professor Honohan states that entry to economic and monetary union really triggered the housing price surge. Did the Central Bank prepare papers for Government on joining the EMU, in particular when the United Kingdom, Sweden and Denmark decided not to join? Was this seen as a risk to banking in Ireland?

Professor Patrick Honohan: Now, I do not know that I know the answer to that question. It goes way before the scope of my inquiry. I would be surprised if the Central Bank had not provided some advice on the matter. Other people provided advice and wrote reports, including myself, in another incarnation. Anyway, I cannot answer that question. It goes way back. These matters would have been discussed in 1992, 1993 and 1994, a long time before the scope of my inquiry, so I do not know the answer to that question.

Senator Sean D. Barrett: In the paper on stress tests to which Deputy O'Donnell referred, Professor Honohan stated that the 2006 stress test was virtually meaningless. He expressed the hope that the Regulator did not take the very favourable results of this "bottom-up" self-test too seriously. When the people in this Parliament hear that something has passed a stress test it is important for us that this should actually mean something. How would Professor Honohan upgrade from the very unsatisfactory experience he recounted from 2006 to stress tests today? Should legislators have strong caveats when an organisation declared it has passed these stress tests?

Professor Patrick Honohan: There are certainly big differences. First, I am not a great enthusiast for stress tests because they are very partial. There certainly have been changes in the technology. Stress tests nowadays are accompanied or preceded by a detailed file-by-file

sampling and analysis of whether a given bank really has the declared loans, whether they are as good as they look and whether the summary management information that the stress tests are based on are soundly based on actual loans that are properly collateralised. This is the basis of an asset quality review, AQR. It is very costly. We have spent tens of millions of euro on asset quality reviews during the period of the bailout and heading into the single supervisory mechanism. The idea is that we know that the basic data is okay and revisions have been needed for that.

The stresses used in 2006 were not very strong. That is evident to everyone. One test was whether a bank would survive if there was a 5% fall in GDP next year and a given fall in house prices. The stresses were not severe enough. We can see the stresses now. They are quite severe in the latest test. In a risk environment, especially with the books that the banks have - they are still exposed with many non-performing loans - there is always uncertainty. There is a tendency for people to exaggerate. For example, in 2011 we did a very big, hard and expensive job for the stress test. It was much more elaborate than 2010. We can talk about 2010, but that will be for another day. However, we were not sure. Some people said, "Nothing can possibly happen from now on." However, it was a great relief, when we did the exercise in 2013-14, that we were okay.

Senator Sean D. Barrett: Professor Honohan mentioned, when one gets to the crisis period, that the Central Bank seemed to drop back in its role. Was there some kind of breakdown in communications when the Department of Finance decided to take over? A communication on the night of the rescue to the Governor was not replied to until 18 October. Was the Central Bank becoming marginalised at that time? I think Professor Honohan's report implies that.

Professor Patrick Honohan: From the evidence that I heard, it seems that once things became quite acute there was more, I would say, energy and drive shown in the Department of Finance and the NTMA. They seemed to be more equipped. They recognised the need for legislation and investment bank advisers and so forth. This is what I understood. We know that the regulatory people were caught by surprise. Therefore, it may be not surprising that they were then not able to drive the thing forward. That was as it was described to me in evidence.

Deputy John Paul Phelan: I thank the Chairman and welcome the Governor and thank him for his attendance and his work over the past five or six years. Previous speakers referred to the cost of the guarantee to the country. I am sure the Governor, wearing his economics professor's hat, has a figure in his head for the wider cost, not just of the guarantee but the cost of the banking crisis and the subsequent cuts and failure of availability of credit for business. Could he tell us what that figure is?

Professor Patrick Honohan: There was an article in the newspaper this morning by Colum Kenny, professor in DCU, asking exactly this question, namely, "Where did the money go?" We have had some shots at doing this. It comes up with a very big number. I do not have it to hand.

At a conference in the ESRI a few months ago, I gave a lecture and presented some slides on this matter. It is quite interesting. One has to compare what happened with an alternative. What is the counter-factual? The counter-factual I would suggest - a good counter-factual, if one thinks about this - is: had there been a very strict regulatory environment which inhibited the banks from doing all that lending in 2004, 2006, and so forth, how would it have panned out? Of course, the economy would have been hit by the post-Lehman's international crisis and so forth. One has to try to model that counter-factual and with a colleague, Thomas Conefrey,

we tried to work out how the economy would have moved. That is one thing, and it gives an overall number.

However, also, and very often neglected in this, there are distributional effects and that is what we have been focusing on a lot - the paying for the banking crisis. There are capital gains and losses as well as the different economic effect. The economy would have been weaker during the early 2000s. Wages would have been lower, there would have been fewer jobs, there would have been less immigration, there would have been fewer houses and so forth. In the post-crisis situation, we would have been in a higher position. So there is balancing gains from losses and then there are the distributional effects - the winners and losers. The winners were people who sold property at a good time. The losers were the people who bought property at a wrong time, the Government, the shareholders and the poor subordinated debt holders of the banks who would actually have got their money back in full instead of with a big haircut. So, it is a big story and very interesting.

Deputy John Paul Phelan: Professor Honohan will not or does not wish to put a figure on it. I can understand why he does not wish to as it is a big question for sure. However, if, and he kind of touched on it in his answer, the banks had been prudently regulated in the period that he inquired into, would the figure that he has not given have been significantly lower?

Professor Patrick Honohan: Yes, but there would have been losses in the early period. Those 2000s would not have been as good for many of the people for whom they were good years. Not everybody. I am not saying everybody in the country -----

Deputy John Paul Phelan: Would the final net cost-----

Professor Patrick Honohan: Yes. Very substantial and much more than the €40 billion.

Deputy John Paul Phelan: I wish to refer specifically to pages 48 to 51 of Professor Honohan's report, where he makes reference to directors' compliance statements and the role of auditors. Subsequent to the publication of the report - I think in June or July 2010 - Professor Honohan was before the finance committee and he highlighted a number of areas that would merit further investigation. One of these was the role of auditors. In his report, he details that the then Minister for Finance, in December 2006, made it known to the Financial Regulator that before introducing a regime which would force bankers and auditors to sign a statement confirming their compliance with proper banking practices that it was important that they, and this is a direct quote, "assess the competitiveness issue". Can Professor Honohan elaborate on how significant he feels the Minister for Finance's intervention was at that particular time in preventing the degree of banker and auditor compliance being put in place by the regulator's office?

Professor Patrick Honohan: Our impression was that it was quite important and even today the Department of Finance officials or the Minister often will have communications. We meet regularly with officials and then will say, "What about this and this?" and they may make some good points and these will be taken into account. In this case, I think it might not have been the only reason but it was probably the end of the matter. I could imagine, although maybe I am just extrapolating rather than having concrete evidence, that that was the end of it. The Minister's letter would have been the end of it. That does not mean that there was something wrong with that *per se*. The Minister has a legitimate interest. There is no evidence provided that it is politically motivated or that some friend of the Minister thought something on it. It is a policy that the development of the financial sector is important and the Central Bank had to take account of the development of the financial sector. I do not think it was a good decision

and I think the Minister's intervention was an important one. We included that at some length to illustrate the fact that the regulator was not acting single-mindedly, in the prudential interest nor in full independence.

Deputy John Paul Phelan: As a follow-up question, what difference does Professor Honohan think it would have made if the Minister had not intervened?

Professor Patrick Honohan: Everything would have been fine. No. We have introduced these compliance statements now and so on, but it is kind of funny because the whole approach to regulation was relying on good governance of banks and this was a little piece of the jigsaw of that good governance and they were not prepared to put it in. It suggests a lack of coherence. I have to say that around that time there were similar measures - it is not the same story - such as the Sarbanes-Oxley measures requiring statements of this kind. It was a very controversial territory. It is not surprising that they shied away from it in the end.

Chairman: Can Governor Honohan acknowledge in his response that there was a change in the regulatory practice in the ten years prior to the guarantee and that we moved from one type of regulation to what is principles-based regulation? I think Deputy Phelan is in that space. However, Governor Honohan is answering the question, but he is not acknowledging that we moved from one regulatory framework to another type of regulatory framework.

Professor Patrick Honohan: First of all, I do not understand that there was much of a change in the prudential legal framework between the time before the establishment of the financial services authority and afterwards. There has been a change since then of course.

Deputy John Paul Phelan: I wish to refer to auditors. Professor Honohan was not specifically charged with investigating the role of auditors. He has flagged this a number of times and I mentioned a 2010 appearance before the finance committee when he flagged that the role of auditors needed to be examined a bit more. However, I am sure that, as part of this report, he would have had some sort of a cursory look at the role of internal and external auditors in the financial institutions at the particular time that he was looking at.

Professor Patrick Honohan: I think their work was not central, in a sense. There were not very many interactions - or we certainly did not explore any interactions - between the regulatory authorities and the auditors. The auditors helped the management of the banks to produce the accounts on which, to a large extent, the regulator was relying for statements - repeated statements - that the banks were well capitalised. What did they mean by well capitalised? Well, they looked at the audited accounts and the percentages of capital were very high compared to the requirements and so they said they were well capitalised. What did that mean? Had the auditors really dug into the asset quality review type of work and had they made enough provision for expected losses? There was a great debate around that time - from 2005 - as to whether the provisions against future losses could include an estimate of future expected losses in respect of items which had not been identified as troublesome. That was very controversial and all in all, the information coming from the audits probably deteriorated as a result of those changed international practices. The auditors will probably say when they appear before the committee that it is not their business to look at down side risks and possible problems around the corner of low probability. They will say that their business is "fair and complete"-----

Deputy John Paul Phelan: Do you think it is their business?

Professor Patrick Honohan: Certainly, at the very least, if people who use audited ac-

counts understand the limited information they communicate, that would be helpful.

Deputy John Paul Phelan: Finally, in your report you specifically criticise the Financial Regulator and the Central Bank for failing to react to 2007 articles by Morgan Kelly. In May of 2011, after your report was published, Mr. Kelly wrote a stinging attack against you for throwing away Ireland's best cards in going on "Morning Ireland" and telling the people that-----

Chairman: Stop. We are into the morning of the bailout programme now and I have made this very clear, Deputy. That was two years and two months after Professor Honohan's report was published.

Deputy John Paul Phelan: Well-----

Chairman: There are no "well" or buts about it. There will be no show boating here and no breaching of the rules. We will return back-----

Professor Patrick Honohan: I will have great fun answering it in three months' time.

Chairman: You will get an opportunity to answer it at a later meeting. Deputy Phelan, you may be the lead questioner that morning and you will have 20 minutes to talk about the "Morning Ireland" programme but that is not up for discussion today. It is unfair to people who are watching this morning to be raising questions that people know are out of order.

Deputy John Paul Phelan: Well, it is-----

Chairman: I am not entertaining it today so put another question instead.

Deputy John Paul Phelan: I will refer back to the auditors then because I have asked all of the people who have been before us thus far about the role of auditors. Professor Honohan mentioned earlier in his opening remarks that not enough was done to ensure the collateral was there in the audited institutions. Did the banks' auditors review the lending processes, particularly in relation to ensuring that the collateral was there? He made a fleeting reference to it himself - which might have been slightly off-script - during his initial presentation or maybe it was in answer to the first question from Deputy O'Donnell.

Professor Patrick Honohan: It is probably over-simplifying it to ask "was the collateral there?". I would refer the Deputy to the examples from 2007, late in the day, of the multiple relationships between the five big developers and the five big banks and the way in which it turned out that the banks - and unfortunately the auditors because if they had known then the banks would have known - did not realise how much the other banks had lent to these particular borrowers and therefore would be able to claim some of their unpledged assets. The total picture of the security of the loans had not been seen by the auditors in those cases.

Deputy John Paul Phelan: Finally, again-----

Chairman: Very briefly, please, because we will be going into recess.

Deputy John Paul Phelan: In response to one of the previous questioners, you spoke about the three staff who were looking after Bank of Ireland, that this has changed and there are many more people involved now. It seems to me, as a layman looking in from the outside, that there was no connection made between the exposure that a bank had, taking Anglo Irish Bank as an example, to loans to a particular developer *vis-à-vis* loans by other institutions to the same developer. Has the practice within regulation changed now so that there is much more focus on

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the overall level of exposure to a particular individual, company or business rather than what seemed to be the practice heretofore, whereby people were in silos and there were only three, as referred to by the Professor, for Bank of Ireland and Anglo Irish Bank?

Professor Patrick Honohan: A number of things can be said about that. The banks should, from time immemorial, have been looking at what other loans their borrowers had but they got caught with the big developers. They obviously thought, “we are lucky to be getting some of his business” and did not do the due diligence they would do on the smaller person. They have enough systems to do it for big people. They do not actually yet have a comprehensive view of the credit position of the borrower unless the borrower is forthcoming on that. Our creation of a credit register - which is being developed - will help to give them that overall view.

Cathaoirleach, could I just say one thing about Morgan Kelly in regard to what is in the report?

Chairman: Sure and then we will have the suspension.

Professor Patrick Honohan: Deputy Phelan said that the Central Bank paid no attention to him. The problem was that they did pay attention to him and started to find ways of undermining the critique that he was accurately making about it. Actually, they said, “What? No”. That is important.

Chairman: Thank you Professor Honohan. I am now proposing that we suspend for a brief break, resuming at 11.20 a.m. Is that agreed?

Sitting suspended at 11.07 a.m. and resumed at 11.20 a.m.

Chairman: We will proceed with our engagement with Professor Honohan.

Professor Patrick Honohan: Could I come back on a point? Deputy O’Donnell proposed a contradiction between two things I wrote and I checked them in case I might be surprised. I am glad to say there was no contradiction. All I said was that Anglo Irish Bank “would not be seen by most independent observers as systemically important”. That is not the point. The point is that whether a bank is deemed systemically important is time dependent. A bank may be systemically important because of depositor runs in September 2008, however in spring 2009 the situation might be much more stable and one would have to focus on whether the bank is needed because it is helping the economy. Some people say Anglo Irish Bank was still systemically important in spring 2009 and its nationalisation in January was a systemic event which affected the world economy. There is literature on this. I do not think there was a contradiction. We do not want to undermine confidence in our work.

Deputy Eoghan Murphy: This morning, Professor Honohan made a number of references to Lehman Brothers and I want to go back to September 2008. On page 18 of the report on the banking crisis, Professor Honohan stated:

Some also still feel that, without the external shocks of September 2008, the system would have survived without imposing a cost to the Government. The report does not share this view.

Why does he not share that view?

Professor Patrick Honohan: By September 2008, the Irish financial system and economy had been placed in a situation of extreme vulnerability to any shock such as Lehman Brothers.

Although we tend to think that, because our situation was so severe, we were the only people affected by the crash that followed the collapse of Lehman Brothers, it had an effect on countries that had not put themselves into such a situation. However, our vulnerability meant that the collapse in construction activity, tax revenues and the imbalance in the public finances as well as the €40 billion cost to pay for the losses that had been built up over a number of years before it, was much more severe. We would have ridden out the collapse of Lehman Brothers with a much milder situation had we managed to avoid all those errors.

Deputy Eoghan Murphy: Is it a credible point of view to hold?

Professor Patrick Honohan: Absolutely, it is the standard point of view of expert observers.

Deputy Eoghan Murphy: I mean the idea that the system would have survived without imposing a cost to Government.

Professor Patrick Honohan: I apologise, I misunderstood. One shock or another would have caused it. Could the system have survived? There are risks on both sides. A sequence of good news could have hit Ireland over a number of years and caused it to survive. Looking back at history one wonders how great banks such as JP Morgan and Chase Manhattan survived in the late 19th and early 20th centuries. Given that they got over the crisis and became solid, it is possible for a very risky financial entity to suddenly become respectable and solid, build up profits over the years and get through a crisis. However, the chances of it happening were too low to allow it to take those risks.

Deputy Eoghan Murphy: Can we reject the idea of Lehman Brothers as a catalyst?

Professor Patrick Honohan: It was a catalyst but not a cause. It was a catalyst for when it happened, the circumstances and the fact that when it went down, it did so in a very adverse international environment. Had there been no bad news, had the world economy and the Irish economy been doing fine, and had our banking system fallen over for some domestic reason, would Europe have rushed to help us? Although Europe did help us to some extent, in the circumstance I have described it would have been absorbed much more easily. However, Europe has many other problems that are much more severe than Ireland. The environment would have been different.

Deputy Eoghan Murphy: How important was the rejection by the US Congress of the troubled asset relief program, TARP 1 at that time?

Professor Patrick Honohan: That is like Monday compared to Tuesday or Wednesday. It is irrelevant. It meant it had to do something on Monday night that it might not have had to do until a few weeks later.

Deputy Eoghan Murphy: When Professor Honohan speaks about the idea of emergency liquidity assistance buying us time and letting us get deeper into the problem, would it have been possible, with ELA, perhaps not to remove the cost to the State but to reduce the cost if we had gone down that avenue?

Professor Patrick Honohan: ELA would always have been back stopped by Government undertakings, and so forth. It would not have been the case that the ECB would take the risk onto itself. It would be just buying time. This was seen as a liquidity problem; it should have been solved with a liquidity instrument. While one was solving it, one might ask whether this

really was a liquidity problem and one could get the experts in to really take these banks apart. It took many more months before there was full clarity on the scale of the problem.

Deputy Eoghan Murphy: Even a short period of time, such as several days to a weekend, could have helped identify the issues Professor Honohan referred to earlier, such as Anglo Irish Bank not being worth saving.

Professor Patrick Honohan: Yes.

Deputy Eoghan Murphy: Time could have been important. Why was ELA rejected at the time?

Professor Patrick Honohan: The view of the Central Bank was that ELA was something that would be extended to a single bank which had gotten into trouble. It was facing a situation where it was likely that it would lend ELA to all the banks in the system. That was a step it felt it could not take. It said that such a step would be incredible, obvious to the market and damaging to Ireland and that it should instead look to something which would play to its strengths and the strength of the Government's finances. It could guarantee stuff. It believed it did not need the emergency liquidity assistance because the Government could instead provide a guarantee. I think that was the view taken. ELA for an entire system had not been contemplated in any country. We ended up with ELA for the entire system two years later.

Deputy Eoghan Murphy: At that stage, had other countries contemplated a system wide guarantee? Were they both unprecedented moves?

Professor Patrick Honohan: A system-wide guarantee was not unprecedented. In fact, it is the normal reaction of an unprepared public authority to say, "there is a problem in the banks, we will guarantee them." One can see this in history in respect of Japan, Turkey and elsewhere. The details of the guarantee are, of course, important because if instead of guaranteeing 440 one guarantees only 400, there may not be any net deficiency at the end. That is where the discussion about subordinated debt and the old seniors comes in.

Deputy Eoghan Murphy: The blanket guarantee is what one does when one does not know what one is doing.

Professor Patrick Honohan: It is a sort of procedure thing. That is what I would say to undergraduate students to get them interested in a thing but it is very facetious and obviously it is a serious issue in respect of which people are casting around for something which would be robust. I remind the committee that Ireland's debt ratio was very low at that stage and that we had a triple A rating. Everybody thought Ireland was a top country. Of course it was not going to say it would let its banks go rather than say it was in business. It was a natural thing to do, and it was what Merrill Lynch advised the Government at the time, as well the Central Bank.

Deputy Eoghan Murphy: In regard to Professor Honohan's knowledge of the intensive discussions that took place in September between the regulator, the Central Bank and the Department of Finance, which he wrote about in the report, does it come from interviews or documentary evidence?

Professor Patrick Honohan: Both. I probably reread more documentary evidence since then. As the people involved were all still there, I was able to speak with most of them. As I noted earlier, any documents which I had not paid attention to previously did not change the story. There are a few things I want to make sure I mention in the course of this meeting. One

or two things are worth adding - not changing but adding.

Deputy Eoghan Murphy: The report notes that the documentary evidence was sketchy. I am trying to ascertain if he relied more heavily on oral evidence given retrospectively.

Professor Patrick Honohan: Some of the documents that are interesting include the advisory documents from Merrill Lynch. A large number of documents were given to the Committee of Public Accounts by the Secretary General of the Department of Finance in late 2010. They are a very useful source because, while some of them are slightly redacted, they are un-*rethought*. They are exactly as they were received by the people concerned. There are some minutes of meetings. It would be wonderful if somebody had taken detailed minutes of meetings but it does not happen like that anywhere. Some notes were taken in meetings.

Deputy Eoghan Murphy: The report gives the impression that the meetings were under the *de facto* leadership of the Department of Finance and that the regulator played a less central role than might have been expected. Why was that? What was happening in the room during these discussions?

Professor Patrick Honohan: I think it was drive and energy. This question was raised earlier by Senator Barrett. At that stage, some of the decisions had to be taken by the Government and the Department of Finance was representing the Government. The question arose of who was going to pay for all of this. A Government guarantee was a matter for the Government. It was natural. Legislation needed to be prepared and that was a matter for the Government and, therefore, the Department. However, it is striking - this was why we noted it - that the Central Bank and the regulator were in the back seat. They were not pushed into the back seat; it *de facto* seemed to be the situation.

Deputy Eoghan Murphy: Could we interpret it as being because confidence in them had been lost? If confidence had been lost, was sufficient expertise in the room at the time?

Professor Patrick Honohan: I am sure different people would have held different views. From the evidence provided, perhaps it is fair to say that people like the Secretary General of the Department started to think they would be more confident of the advice they could get from the NTMA on financial market matters. They got a string of investment bankers, and while not all of them gave great advice at least they were known experts.

Deputy Eoghan Murphy: When Professor Honohan mentions the Department of Finance, is he referring senior officials alone or senior officials in conjunction with the Minister or other senior politicians?

Professor Patrick Honohan: I am referring in particular to senior officials, who included some very able and energetic people.

Deputy Eoghan Murphy: The report concluded that eventually a broad consensus was reached that a guarantee scheme for all institutions was the best approach. There were no dissenting view in the room.

Professor Patrick Honohan: No.

Chairman: On Deputy Eoghan Murphy's final point regarding consensus and dissenting voices, that does not appear to be the view held at European level. Just last week the Bank of England released its minutes of a meeting of the committee of its non-executive directors on

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15 October 2008, which stated, “Actions announced first by the Irish government and then the German government were both unclear and unco-ordinated and led effectively to a ‘beggar thy neighbour’ policy which froze the international banking system”. The minutes went on to state that while international co-ordination proved to be the route to a solution, the lack thereof also proved to be as much a trigger for the crisis as the failure of Lehman Brothers. Would Professor Honohan share that view or would he challenge it?

Professor Patrick Honohan: Yes, I think I would agree with that. International management of the crisis has been praised by many people close to the decision makers but I think it could have been better. It was fairly good after an interval lasting from late September to the first week or so of October, when it was not good. Towards the middle of October, with considerable thanks to the British authorities for catalysing international consensus, the international action was good but then it faded in quality approximately a year later.

Chairman: Does Professor Honohan consider the Bank of England’s “beggar thy neighbour” comment as being valid?

Professor Patrick Honohan: It was obviously in trouble at that stage because a couple of its banks were in major difficulties. Given Ireland’s triple A rating, would one trust a commercial bank which was receiving considerable negative press or the Government of Ireland’s guarantee? The bank regarded this as destabilising and a cause of additional outflows from the banks it was trying to nurse through ELA. It did not tell anybody that at the time but it provided ELA a few days later. That is why I refer to being put on the back foot by irritating one’s neighbours. It certainly worked against the Government’s negotiating position and bridges had to be rebuilt subsequently.

Deputy Pearse Doherty: Cuirim fáilte roimh an tOllamh Honohan. Professor Honohan is a bit of an expert on banking crises and he has written and spoken extensively on the subject in the past. At any time during 2008 were his views ascertained by the Government, the Department of Finance or the Central Bank?

Professor Patrick Honohan: No, and I will qualify my response. In 2007, I remember being approached by the Central Bank about a project to have a conference. I was asked what the conference should be about and I said it should be on the housing market but it was not sure about the topic. The project was not taken very far.

On 15 June 2008, I remember having a discussion with the then Minister for Finance, Mr. Brian Lenihan, along with a colleague, who was another professor, and I think somebody that the committee will meet later on. We talked about fiscal policy because the big topic was the adjustment of fiscal policy which was going wrong. We did not talk at all about the banks. It might have been earlier than August, say in June, but I could probably find the date.

I wish to make another point. In December of 2008 I was quite concerned. I had made public statements about why one covers subordinated debt. At that stage I really did not have a concept that this was all going to end up as big in terms of tens of billions of euro. I thought it was going to be quite important how the Government handled the recapitalisation. I wondered if it put in €2 billion or €3 billion of capital whether that would make the subordinated debt holders get off free. So I wrote to the Minister, got a response from his office in December and I talked to some of the officials at that time.

Deputy Pearse Doherty: In terms of the Professor Honohan’s conversations with the Min-

ister in the months before the guarantee, as a banking expert, did he raise any issues in terms of the banking model?

Professor Patrick Honohan: No.

Deputy Pearse Doherty: Professor Honohan has said to the committee that it was obvious that-----

Professor Patrick Honohan: I did not talk-----

Deputy Pearse Doherty: -----the banking model was unsustainable. Did Professor Honohan raise any concerns about those matters with the Minister?

Professor Patrick Honohan: I had one meeting with the Minister on the topic of fiscal policy. When I met him the next time, which must have been around Christmas 2008, he said, "Maybe I should have talked to you about banking".

Deputy Pearse Doherty: Maybe both of you should have talked about banking but I shall move on. What was the first large bank in the State to get into trouble?

Professor Patrick Honohan: That is an interesting question.

Deputy Pearse Doherty: Was it DEPFA Bank?

Professor Patrick Honohan: In terms of running out of liquidity, it was all around the same time. It was all that weekend so it is hard to say. They were more or less at the same time.

Deputy Pearse Doherty: We do not know the cost of rescuing the DEPFA Bank but it has not been borne by the Irish taxpayer. However, DEPFA Bank was an Irish regulated bank. Is that correct?

Professor Patrick Honohan: DEPFA was taken over by Hypo in early 2007. From then on the main regulator of DEPFA was the German regulator which sent across a big mission. There were some subsidiary regulatory actions with them. The main responsibility was with Germany so we have to be careful about that.

Deputy Pearse Doherty: The difficulties which DEPFA Bank got into would have occurred during the period up to 2007. Is that correct?

Professor Patrick Honohan: I would not deny that its business model was developed over a number of years. One must be very careful about the DEPFA-Hypo thing. I cannot claim to be an expert on it but it seems clear that it was not just the fact that DEPFA ran out of cash. It was the fact that DEPFA was married to Hypo which had serious loan loss issues. The fatal problem was that DEPFA had no cash because the market for short-term corporate bonds had dried up and its parent was heading towards balance sheet insolvency. Therefore, it was the marriage of those two things. DEPFA's portfolio was reasonably good. As far as I can make out, and if one tracks it back, DEPFA probably was not balance sheet insolvent and liquidity would have brought it over the line. This is something that we do not have full information about.

Deputy Pearse Doherty: I know the Bundestag carried out its own investigation.

Professor Patrick Honohan: Yes. I do not dispute the fact -----

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Deputy Pearse Doherty: There are views that the opposite was the case - that DEPFA took out Hypo.

Professor Patrick Honohan: I think those views are wrong.

Deputy Pearse Doherty: The professor is entitled to his view.

One of the things that the banking inquiry is looking at, which is the nexus, is the relationships between the State, between banks and between being regulatory, development and so on. The reason I asked about DEPFA is that on the weekend of the decision of the guarantee Professor Honohan has said that the minds of the authorities were concentrated by the issue of DEPFA.

A director in DEPFA was second assistant general in the Department of Finance. He was the professor's predecessor because he was Governor of the Central Bank. He was also a director in one of the biggest banks that went bust in this State. What does that relationship mean in terms of the overall problems in the banking crisis? Professor Honohan mentioned, in his sub-note No. 12, the view in which bankers were held by politicians and so on. I ask him to elaborate on the issue.

Professor Patrick Honohan: We want to be a little bit careful about who was director of DEPFA at what time. I am surprised to hear the Deputy say that person was the director at that time but perhaps the Deputy is right.

From what I understand about the DEPFA story at that time, and the interactions, there were approaches from DEPFA, which is no longer a licensed bank, to the Central Bank for emergency liquidity. The Irish authorities, in consultation with the Department of Finance, although I am not sure if it was in consultation with the Department or the Minister, the Central Bank decided not to accede to this emergency liquidity assistance, ELA, request and left the problem for the German authorities to solve. That was a sensible decision.

Deputy Pearse Doherty: Professor Honohan has picked me up wrong. I never said that Mr. O'Connell was director at the time when DEPFA went bust.

Professor Patrick Honohan: Yes, it was before that.

Deputy Pearse Doherty: He was director up to 2007 until Hypo Real Estate bought DEPFA out. As Professor Honohan has acknowledged, the damage was done in the period leading up to 2007.

My point was about the relationship. For example, it has been reported extensively that DEPFA Bank - the German bank at that time - in 2001 lobbied the Government in terms of the Asset Covered Securities Act which was introduced in 2002.

Professor Patrick Honohan: Yes.

Deputy Pearse Doherty: The bank then reconstituted itself as an Irish bank as the Act was passed. It was the first to involve itself in that type of issuance.

Professor Patrick Honohan: Yes.

Deputy Pearse Doherty: It was followed by the Bank of Ireland and the Anglo Irish Bank. That move allowed for cheap credit to enter the market and allowed triple-A banking in banks

that were not triple-A rated. My question is on that nexus. I refer to the relationship where somebody is a director of a bank but was one of the most senior people in the Department of Finance, was the Governor of the Central Bank, was an ECB board member and was a director of the European Investment Bank. When such a situation arises do people challenge it? Do they self-censor themselves because of the positions that were formerly held by individuals like the one I mentioned?

Professor Patrick Honohan: I do not dispute that this sort of thinking could happen. In the particular instance given, I doubt if DEPFA needed to play that card. I doubt if it needed to say to anybody “By the way, do you know who is on our board?” or anything like that. Getting a big bank, a credible bank, a formerly State-owned bank like DEPFA into the IFSC would have been seen as a great plus for the development of the Irish financial services industry. The IFSC would have wondered what it needed and thought yes, that sounds safe enough so let us go ahead. I agree that those effects are possible but I do not think I would like to suggest that they were relevant. I have no idea but I doubt that they were relevant.

Deputy Pearse Doherty: Does Professor Honohan believe it was the Government’s view there should be a non-intrusive environment in terms of regulation in the IFSC?

Professor Patrick Honohan: The Government’s position would have been that we should be seen as a welcoming and accommodating regulatory environment in order to encourage banks to come in. Banks do not mind having intrusiveness. A good solid bank does not mind having the trees shaken.

Deputy Pearse Doherty: I asked about the Government’s policy. Does Professor Honohan believe that it was Government policy to have a non-intrusive environment in terms of the IFSC and its promotion?

Professor Patrick Honohan: I would have to say no. The Government would have been in favour of having an accommodating, efficient and welcoming environment that did not put in unnecessary restrictions, which is different. One can be intrusive without causing problems. Big banks like to have the tyres kicked because it helps them.

Deputy Pearse Doherty: Professor, on page 109 of your report you write that “A non-intrusive regulatory environment conducive to promoting the IFSC was considered important by Government”. How do you make that-----

Professor Patrick Honohan: Okay. All right. I am sorry. You have caught me out. You did better than Deputy O’Donnell.

Deputy Pearse Doherty: It is not, with respect Professor Honohan, about catching you out. I am asking why because in your report there seem to be contradictions.

Professor Patrick Honohan: There are not really. I do not think there are. I will tell you why I did not answer your question. In regard to the IFSC, I do not know ---

Deputy Pearse Doherty: The question is this and maybe Professor Honohan could clarify-----

Chairman: We are running out of time now, Deputy.

Deputy Pearse Doherty: Which is the accurate version? Was it Government policy to have a non-intrusive regulatory environment? This is important. It is mentioned in your report

and in other reports that the regulation that was applied to the IFSC had to be applied to other banks. So, for example, as I mentioned, the DEPFA Bill as it is colloquially called, or the Asset Covered Securities Act, which was amended in 2007, had to be applied to all other banks even though it was not envisaged for all other banks originally. Was it Government policy to have non-intrusive regulation?

Professor Patrick Honohan: I am sorry to get hung up on this word and I would have an easier life if I said “yeah, yeah” but I do not want to be populist and I am trying to avoid certain language. I acknowledge that I did use that language there, with “intrusive”. I am not sure that the Government ever said - oh, I think you are right Deputy. I do not know why I got hung up on “intrusive”. I think I will agree with what you said, that the Government - not just the Government but the whole regime - did not want to interfere. I would also say that big banks - banks as big as DEPFA - should not and do not mind having a regulator that is asking all the questions. They do mind having their business model messed with. They did mind, for example, when we introduced in 2011 a requirement that they have independent directors. They said, “What do you mean by independent directors? Can we not send somebody from head office?”. We said, “No, they need to be independent”. They did not like that at all because it interfered with their business model.

Chairman: Can you conclude now Deputy?

Deputy Pearse Doherty: The last point I want to make is about moral suasion. You mention on page 97 of your report that the Financial Regulator had access to increasing capital requirements and moral suasion. I would like you to talk to us about what you mean by moral suasion. What do you mean in regard to appealing to the morality of Irish banks? I want you to answer that in the context of what we know happened in the banking system in previous years. Simon Carswell’s book, *Something Rotten: Irish Banking Scandals*, lists the Irish Trust Bank, merchant banking, PMPA, the Irish Insurance Corporation of Ireland, Ansbacher, National Irish Bank, DIRT, off-shore tax evasion, clearing debts for VIP customers, AIB in foreign exchange transactions and AIB in the Faldor scandal. These are a number of what Carswell calls the “banking scandals”. Appealing to moral suasion is something that you have repeated at this committee but how does that stack up, given the fact that we know what has happened in the past, and is that the principles-based or moral suasion that we should be following in the future?

Professor Patrick Honohan: No, moral suasion is useful but it is not enough if the regulated entity will not heed the indication. Moral suasion has nothing to do with morality. It has to do with non-legally binding requests whereby one says, “Please stop doing this, please stop doing that” and if the banks know what is good for them, they say, “Okay, yes, let’s behave differently”. However, if they do not respond, it has to be followed up with enforcement, strict directives and rules. It is not principles versus rules but principles and rules. If you only have rules, you are going to have big problems like the Americans because banks say, “All we have to do is abide by the rules”. Now we are seeing a lot of lawyers and a lot of financial engineers finding ways of getting around the rules. They have to be supplemented by principles. Principles does not mean “Now, be good”. It starts with that and if they will not change their behaviour, that has to be followed up with directives such as, “Since you would not behave in the qualitative improvement way, we will tell you to do this, this and this”. That is what you have to do. You have to try to do that in such a way that it does not prevent the services that the economy needs from banks from being provided.

Deputy Pearse Doherty: One of the elements missing, apart from increasing capital requirements and applying moral suasion, which was not working, is credit controls. The Chair-

man mentioned this earlier. Applying the credit control rules - which you acknowledge existed but which were completely avoided - would have had a major impact in terms of commercial property lending and house lending. Why was that not highlighted in terms of the options you had?

Professor Patrick Honohan: These are quantitative credit controls whereby we say “You cannot increase credit by more than X per cent this year” or “You cannot increase it to this sector by more than X per cent this year”. Why were they not applied? Nothing much was applied. How effective would they have been? I think they would have been less effective than measures on the loan-to-value ratios, for example. Why? People may dispute this but the experience of the 1970s and early 1980s showed how easy it was for financial systems to get around those old-fashioned regimes of credit ceilings. They said, “Okay, I am not able to give you a loan here but look, here’s the form for our Isle of Man branch” and so forth. There were all sorts of ways of getting out of them; well tried and trusted ways. All of these measures can be got around. Probably the reason ---

Deputy Pearse Doherty: Can I just ask one more question? I appreciate that those measures can be got around, as you have said in terms of the 1970s and 1980s, but if we look at Anglo Irish Bank, for example, its lending was in commercial property. There was a massive concentration on commercial property. If we had applied the rules on credit limits would it not have been next to impossible to get around those rules, given the over-concentration on commercial lending?

Professor Patrick Honohan: Yes, it could have been reined in with measures like that. It was a question of choosing what measures. The measures that were chosen were very light.

Chairman: Before I bring in anyone else, I want to round this off. We have been around the room this morning with you, Professor Honohan and it would be unfair not to get this ironed out before we move on. You talked about the rules in the 1980s and the 1990s. In 1995, the Central Bank, in its winter bulletin, set out very clear advice with regard to concentration limits in the sector. This is referenced in the report by Peter Nyberg, who was before us recently and I think it is even referenced in your report.

Professor Patrick Honohan: Yes, it is.

Chairman: Something happened between 1995 and 2005 and to use your term, this bulletin became a “dead letter”. A more appropriate term might be that what was set out in that bulletin was “abandoned”. What happened?

Professor Patrick Honohan: I do not know.

Chairman: You said earlier this morning that the regulation was the same. Something happened. Sectoral credit limits were there, set out clearly. No new letter came from the Central Bank; there was no waiver issued on paper but something happened and the banks started changing how they operated. How did that happen?

Professor Patrick Honohan: I do not know. I suppose - but it is only a supposition - that when the regulations were brought out, they had not thought through them and had not realised that they were going to be so far away from what the banks were likely to want to do. They just felt it was on the books but it was a mistake. I imagine that was probably the way they thought.

Chairman: Yes, but the Irish financial environment changed quite significantly from 1995

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on. We did not have the IFSC operating at that time to the extent that it was in the 2000s. I am asking you if it was as a result of lobbying or something else that the bulletin that was issued in 1995 became a “dead letter”, as you describe it?

Professor Patrick Honohan: I would be surprised if there was not lobbying, with the banks saying “we can’t stick to that. Do you want this and that?” I am sure there was that kind of thing going on but I do not know because it was before my time.

Chairman: Would it have been coming from a particular sector? Would it have been coming from the pillar bank sector or from the financial services sector?

Professor Patrick Honohan: I do not know the answer. Presumably it came not from the IFSC as much as from the local banks. This is normal in the context of regulation. It is normal but not good. I am trying to make distinctions here, not always successfully. It is right and proper in a changing financial environment for firms to say, “Look at this regulation - it is not working, you can’t make it work. It is going to be a disaster”. People do that all of the time. They have done it for my latest consultation on loan-to-value ratios.

Chairman: We had a banking model in this country, going back for decades if not a hundred years, that did not face the crisis that we faced in the 2000s. Certain rules applied and sectoral concentration limits were very much a part of that - in the same way a pension fund would operate, you do not invest all your money in one horse.

Professor Patrick Honohan: That is right.

Chairman: What we had was an over-concentration in property by banks in this country.

Professor Patrick Honohan: Absolutely. Of course, in those days, the entities that lent for house building were building societies, not banks.

Chairman: I want to flag this. In 1995, when that bulletin was written, we were mainly talking about high street banks in this country. The topography of the Irish economic landscape changed and we had the major development of the Irish financial centre. As Deputy Doherty alluded to, there was an environment to develop that and everything else. Part of developing that was the creation in the Irish Financial Services Centre of the Clearing House Group. The Department of the Taoiseach was there, the Central Bank was there, the Department of Finance was there and the other sectoral interests were there as well. Can Professor Honohan tell us what was the Central Bank’s role in the Clearing House Group? What was the purpose of the Clearing House Group?

Professor Patrick Honohan: I did not explore this an awful lot but, from what I know, and I think the Clearing House Group still continues, it was a forum for communicating from the financial services industry to the Government and regulator what regulations and what facilitation of one sort or another would help the growth of the financial services industry. The role of the Central Bank there would be to fulfil part of its mandate, which was to develop the financial services industry.

Chairman: On any occasion, did the Central Bank raise concerns in that forum on how financial institutions were operating, particularly with regard to concentration limits, or were any concerns brought to the attention of the group by either the bank or its members? Did this issue arise there? Something happened in the Central Bank which meant it stopped examining this. I am trying to figure out what the motivation was for stopping examination of the sectoral

concentration limits. Is there a possibility it may have come out of the IFSC or the Clearing House Group in particular?

Professor Patrick Honohan: I doubt it. I would say that matter would have been directly between the banks and the Central Bank. I am not sure it would be the IFSC banks as I think it is the local banks that were more affected by this. The IFSC banks are doing other kinds of business. By the way, though, all over the developed world, the banks have become increasingly concentrated in property. Other types of financial firms do other things. It is a problem that has developed all over.

Chairman: Before I bring in Senator D’Arcy, I will make a final comment. Like most industries, they want to grow. Would it be a fair assessment of that time that the only area in which growth could actually happen at the speed and the rate at which it was seen to required was in the area of property?

Professor Patrick Honohan: Yes, if they wanted to grow that fast, but they should not have wanted to grow that fast.

Chairman: But they were all growing that fast, as we know now from looking back at the records.

Professor Patrick Honohan: Yes, but they should not have been growing that fast.

Chairman: There was exponential growth but the only growth that was happening-----

Professor Patrick Honohan: Or internationally. The Iceland banks went international.

Chairman: -----was in the area of property. What we had was massive growth in property yet we had a Central Bank position with regard to sectoral concentration which was completely out of kilter with what was actually happening in the industry. Would that be correct?

Professor Patrick Honohan: The concentration rules were just abandoned because they were irrelevant in that context. It was not a question of: “Can we exceed it by 1% or 2%?” They were saying: “This is so far away from where this is going.” It just was not regulated.

Chairman: Professor Honohan is saying that letter was a dead letter.

Professor Patrick Honohan: Yes, I do not know from what date but certainly by the time my report starts in 2003.

Chairman: Thank you. I call Senator D’Arcy.

Senator Michael D’Arcy: I thank the Governor for attending. I will start with his position that Anglo should have been allowed to fail at the end of September 2008. That is his view now. Was it his view at that stage also?

Professor Patrick Honohan: No, I did not know anything about the extent of the situation. My critique of the guarantee was limited to the points I have raised several times about subordinated debt. What I am saying is that that should have been on the table and discussed with colleagues. That might not have been the best end result but it should have been a realistic threat point to encourage a co-operative solution.

Senator Michael D’Arcy: So, with the benefit of hindsight, that is Professor Honohan’s view.

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Professor Patrick Honohan: Absolutely. Nobody in the room at that stage knew or had any concept, so we should not blame the people in the room taking that decision.

Senator Michael D’Arcy: Eventually, Professor Honohan’s report states, there was a broad consensus that the guarantee scheme for all institutions was the best approach - that is what his report states.

Professor Patrick Honohan: Yes.

Senator Michael D’Arcy: In terms of dissenting voices, was the Minister, Mr. Lenihan, not a dissenting voice?

Professor Patrick Honohan: No, I do not think so. What I know from conversations, as far as I understand it, is that he agreed with the idea of an overall guarantee but he also thought that INBS and Anglo should be nationalised there and then. Just to be complete on it, he also argued strongly not to go down to cover the subordinated debt. That is what he told me.

Senator Michael D’Arcy: Professor Honohan is saying that Mr. Lenihan’s view was that Anglo and INBS should have been nationalised.

Professor Patrick Honohan: Yes.

Senator Michael D’Arcy: In the piece Professor Honohan provided for the Brian Lenihan book, he stated: “As he told me himself, Brian argued strongly for the immediate nationalisation of both Anglo and INBS - but ... he was overruled on the night.”

Professor Patrick Honohan: Yes.

Senator Michael D’Arcy: Who overruled him?

Professor Patrick Honohan: We are not meant to talk about individuals but we know who was there. He was not the senior politician. It was probably the weight of advice around him as well. There was a practical issue. This was a Monday night so what are you going to do? Have you got all the tools ready? Sort of, but it is going to be messy. I think he backed down from that with the expectation that: “We will struggle to the end of the week and then we can nationalise them”. That was where he thought things would go but the guarantee was such a miraculous generator of inflows of funds that it was off the agenda - problem solved. So it was not done then; it was not done until three months later.

It was not obvious. What do you do when you have to nationalise a bank? Anglo Irish Bank caused us a lot of problems for several more years even though it was nationalised from the middle of January and INBS from a slightly later date.

Senator Michael D’Arcy: What the Governor is saying is that Mr. Lenihan was overruled on the night, although we are not naming anybody. Who has the authority to overrule the Minister for Finance?

Professor Patrick Honohan: I am not playing political points here. A proposal was brought to the Government. The Minister for Finance did not, in the end, insist on an alternative approach. He is in the room. All the people around him are saying: “I do not think we should nationalise”.

Senator Michael D’Arcy: But Professor Honohan said he was overruled.

Professor Patrick Honohan: Yes. I keep on getting caught on little words like this but I think the point is obvious. I do not want to be on television naming people. That is what the Chairman said in the first place.

Senator Michael D’Arcy: I have not asked Professor Honohan to name them. I have asked who has the authority, which body has the authority, to overrule the Minister for Finance.

Chairman: The Governor can best answer-----

Professor Patrick Honohan: The Taoiseach and the Attorney General were present. They are the only other political people who were present on the day.

Chairman: That is a question we may be asking more specifically and directly to the individuals who may be able to answer it more accurately than Professor Honohan later on in this inquiry.

Senator Michael D’Arcy: I have a question in regard to DEPFA. On the weekend prior to the State guarantee there were difficulties in terms of its liquidity, and funds were presented into that particular bank. In the professor’s piece in the same book, he made the point that, here, the Irish authorities stood firm, resisting foreign pressures to provide Government or Central Bank support towards the bank that was based in Ireland but in the ownership of another, internationally regulated entity. To his knowledge, who was applying that pressure on the Irish authorities to provide funds?

Professor Patrick Honohan: I think the answer is, first, the bank itself, DEPFA, was looking for the funds and, then, the persons in the German system, who are both public and private people, were concerned with the rescue of DEPFA. They were anxious that the Central Bank should provide the assistance in the form of ELA.

Senator Michael D’Arcy: And they are standing firm. Did Professor Honohan get the impression that potentially there was a payback when they did not supply telephones?

Professor Patrick Honohan: No, I do not think so. I think the failure of Hypo and DEPFA added to the dissatisfaction in general with the performance of the Irish authorities in subsequent months in terms of saying to them, “Look you’ve messed up here, not only for your own banks but for DEPFA”. There was an atmosphere of that around.

Senator Michael D’Arcy: In previous evidence from Mr. Nyberg when he came before the committee before Christmas he made the point that the special resolution legislation was being considered in 2007 but that because of our Constitution, there could have been difficulty in passing that legislation. We subsequently passed it a number of years later, and there was not a difficulty with the Constitution. If that legislation had been on our books, that legislative tool would have been available on the night of the banking guarantee.

Professor Patrick Honohan: Yes.

Senator Michael D’Arcy: The evidence presented by Mr. Nyberg was that the Central Bank and the Financial Regulator were not in favour of proceeding with that legislation. Is that Professor Honohan’s understanding?

Professor Patrick Honohan: Actually, it is not. I am surprised that the Nyberg report said that because my understanding is that the Central Bank was in favour of introducing resolution legislation and that this was discussed earlier in 2008, and indeed that all of the policy people

in the Department of Finance and the Regulator were in favour of this at the time it could be unconstitutional because the issue of property rights came up. That is not an empty - I am not saying it is fatal. I do not think it was just used as an excuse. Resolution legislation was introduced but not as drastic as some resolution legislation which would actually remove property rights in a more aggressive manner. Although we do have resolution legislation, it is not as dramatic as it might be. The British authorities brought in a very complicated piece of legislation in January 2009. They started in September, or whatever it was of 2007 and they got it enacted in January 2009. It is not as if we could have lifted something off the British statute book, tried it out on the Constitution and had it ready before September 2008. It would have been better if it had been there. There was a sense, certainly from Brian Lenihan, that we do not really need that because we nationalise. The thinking was never how do we impose losses on creditors of banks, it was how do we protect the banks from stopping functioning? His idea of nationalisation and that then confidence will return was taken without sufficient regard to the possibility that perhaps we would want to separate part of the liabilities of this bank into an entity which would be one down and losses would go where they had to go.

Senator Michael D’Arcy: I suppose-----

Professor Patrick Honohan: In terms of the particular difficulty in the Irish legislation, the senior bonds and depositors were treated *pari passu*. In terms of how to split that, legislation was definitely needed. I know that during 2009 and 2010 from talking to Brian Lenihan about this and asking when we would introduce a resolution, he said that if we start to bring that in we will cause another panic.

Senator Michael D’Arcy: Between his report and his piece for the Lenihan book, Professor Honohan seemed to pour scorn on some of the advice, and even today he speaks about experts within the elite international investment banks. An example I would give him is that Merrill Lynch said that Anglo Irish Bank was financially sound 11 days before it was nationalised. Merrill Lynch got a fee of €11 million for that.

In the overall context of the period Professor Honohan’s report examines, how would he rate the advice given by, to use his own term, the elite international investment banks?

Professor Patrick Honohan: I had some experience in trying to get external advice. In the stress tests of 2010 when NAMA was buying banks some people asked me why I would not get some top investment bankers or consultants in to do it and I said we had a string of them and none of them came up with the right answer. Maybe that was a mistake because it was a tough thing to do and we did not get it right in the beginning of 2010. We did subsequently under pressure from the troika. We got some people in who were pretty smart and who helped us until 2011. It is a mixed bag. You would say, “We’ll get Merrill Lynch”. Are you going to get the thousands of people who work for Merrill Lynch? No. You are going to get a team of four or five people and you could be lucky or you might not be lucky. We have got some very good advice from people in my time. I have seen some very good advice and I have seen some bad advice which I did not take. That is the way it is, and it is very expensive. Why do we pay for it? The reason I would be prepared to pay for it is more for the reputation - do not trust me, trust-----

Chairman: What Senator D’Arcy is asking you, in fairness, Professor, is whether we got €11 million worth of advice.

Professor Patrick Honohan: In that case, obviously not. They put the effort in but you do

not always get what you pay for.

Senator Michael D’Arcy: I am sorry, but 11 days later they were nationalised.

Professor Patrick Honohan: Yes, because they were running out of cash then again. It was still not a perception that they were insolvent in the balance sheet sense. They were running out of cash.

Senator Michael D’Arcy: But Merrill Lynch said that they were financially sound.

Professor Patrick Honohan: I am not here to defend that. Absolutely not.

Senator Michael D’Arcy: No.

Deputy Joe Higgins: I have a general question first for the Governor. Some people would feel that in terms of a new report and indeed in other reports, in trying to get to this mystery of why there was not an intervention to stop the property bubble from being blown up, there is too much tiptoeing through the tulips and that we can get to a very fundamental reason. Is it the case that the property bubble was blown to extremes by this scramble for super profits by banks, developers and bondholders, that this is what the capitalist financial markets are all about, that this ideology is shared by Government, the majority of the Legislature in this State and by much of the media, and also that the regulatory authorities, most of whom came through that system, share that and that the prevailing spirit is, “Don’t separate the lion from its prey. That is what they do. Let them at it”?

Professor Patrick Honohan: That is right. That is what I read.

Deputy Joe Higgins: The Governor agrees.

Professor Patrick Honohan: It is a sort of dramatic way of doing it. I am pleased the Deputy has not given me one word that I am to get hung up on, “like intrusive” which-----

Deputy Joe Higgins: Okay. Let us-----

Professor Patrick Honohan: In broad terms, it is the Deputy’s way of putting a situation which is-----

Deputy Joe Higgins: Let us move on, then. I have to say we are making excellent progress so far. In page 109 of his report the Governor states, to paraphrase him, that the Financial Regulator and the Central Bank were mandated by legislation to pursue two goals: financial stability on the one hand and then on the other promotion of the financial sector-----

Professor Patrick Honohan: Yes.

Deputy Joe Higgins: -----which you say may well have been in conflict.

Professor Patrick Honohan: Yes.

Deputy Joe Higgins: He stated that while the stability goal was given explicit priority, the potential conflict between the two goals complicated choices. Let us be concrete about that. The promotion of the financial sector must mean inviting banks in and encouraging existing banks to flourish. The banks’ *raison d’être* is the maximisation of profit. The property bubble was the site for making the quickest profits, therefore, blowing the bubble bigger was in their interest. Is there an irreconcilable conflict between promoting this on the one hand, which the

Financial Regulator was tasked to do, and on the other hand strong regulation that would restrict such profiteering?

Professor Patrick Honohan: As we saw in the end, it was very bad for the shareholders of Anglo Irish Bank and so forth. Some people benefited from it - I do not dispute that - but it was very bad for them in the end. Unrestrained use of depositors' funds for pumping up the property market is not a good thing and is not part of a well-functioning capitalist society. That is why they are regulated, why they are supposed to be regulated.

Was there a conflict? Yes. There is a conflict, and that was supposed to have been resolved in favour of stability. What the legislation said is that you can only attend to promotion of the financial sector - or whatever it is called - as long as you have got the prudential or financial stability under control. However, that is a difficult thing to match, which is why I pressed very hard to ensure that promotion of the financial services sector was taken out of the legislation.

Deputy Joe Higgins: Professor Honohan says on page 109 that the Financial Regulator was in a difficult position, as the possible adverse effects of discouraging inward investment in the Irish financial services sector were more immediate and real than the perceived distant concerns about financial stability. Is he saying there that proper effective regulation would discourage investment in the IFSC?

Professor Patrick Honohan: It would limit it to what would be regarded as prudent. For example, when some bankers come into me and say, "We are thinking of coming into the IFSC" or "we have a unit in the IFSC and we just thought we would come and see" and ask about the regulatory situation or say they are happy or unhappy with it, I say, "What we provide here in the Central Bank is a service to customers of the financial services industry to have proper regulation. You will be regulated to the top international standards. That is what you can expect". Most of the credible firms say, "That is exactly what we want". It is only the people who are sailing close to the wind who are discouraged by that.

Deputy Joe Higgins: To return to the professor's non-intrusive regulatory environment, conducive to promoting the IFSC as considered important by the Government, the Department of the Taoiseach took a lead role. The professor referred to the clearing house group and for people who do not know, that body that was set up in 1987. It provides incredible access to all the leading financial institutions, big banks, etc., to the highest political offices in this land. Is that correct?

Professor Patrick Honohan: In fairness, I do not think there are political people at the clearing house group. I think it is all officials.

Deputy Joe Higgins: Yes, but they are officials who are the key advisers to the Taoiseach and the Minister for Finance.

Chairman: Department of the Taoiseach officials are there.

Professor Patrick Honohan: The Department of the Taoiseach attends, but it is the officials.

Deputy Joe Higgins: Was participation of these officials in that type of industry-heavy grouping not a restraining factor on the Regulator, who was also a part of that structure?

Professor Patrick Honohan: Of course, it was part and parcel of being in charge of the

development of the financial services centre. However, nowadays, I would want to have somebody there watching what is going on, but not contributing to any weakening of regulation. I would not like to have those meetings happening without sufficient sight of what was being talked about.

Deputy Joe Higgins: The Governor says on page 109, “The Chair and CEO of the FR participated in several roadshows to promote the IFSC”, and the Financial Regulator approach was characterised as being user friendly and presentations were aimed at expanding the export financial services sector.

Professor Patrick Honohan: “User friendly” is the sort of term I was trying to get at - not so much “non-intrusive” as “user friendly”.

Deputy Joe Higgins: In presenting roadshows to the big bankers, the bondholders and those who wanted to make a killing in the Irish property bubble, would a reasonable person not think that the Office of the Financial Regulator is hopelessly compromised as regulator through having this approach?

Professor Patrick Honohan: Yes. I will not do that stuff. I do not do it. I am not saying they were wrong to do it, but I will not do it. It conveys a wrong impression - that it is more important to get you in than regulate you. I think that is the message that must come out of that.

Deputy Joe Higgins: It is much more than a wrong impression is it not? Does it not fatally compromise the regulator as being part of the whole thing that is dominated by profit maximisation?

Professor Patrick Honohan: In fairness to them, I think that if we asked them they would say, “Oh no, we always said that we would regulate them properly” and so forth. They would have believed they were actually doing that.

Deputy Joe Higgins: On page 16, Professor Honohan says, “One additional element deserving of consideration is the suggestion by some commentators that the fact that some banking personages were politically well connected might have been a key factor in discouraging aggressive supervisory intervention”. What is his view on that?

Professor Patrick Honohan: I worked hard on the wording of that and the footnote associated with it because it is potentially a delicate issue. I have no evidence of any corrupt transactions and I said that in the report. I still have no evidence of that. It is a different matter to say whether people were well liked or known and so on but it is a leap that I am not prepared to make - from the fact that people were well liked and well known, to the fact that anything wrong was decided on the basis of that.

Deputy Joe Higgins: I am not talking about corruption necessarily but what did the people Professor Honohan spoke to in the establishment say in regard to this?

Professor Patrick Honohan: I asked them, “Did you not think that so and so was politically well connected? Would that have influenced you?” They all said, “No, we were not influenced by that consideration”.

Deputy Joe Higgins: In regard to saying “Of course it did not influence us”, Professor Honohan is talking about leading members of the establishment. The simple wisdom of the late Mandy Rice-Davies is “They would say that, wouldn’t they?” They are not going to come out

and say: “Yes, in fact we were influenced”.

Professor Patrick Honohan: I think that somebody, in the interval - either then or in the past five years - would have said, “Look here Patrick, cop yourself on here. Don’t you know X, Y and Z?” Nobody has said that to me. Maybe we will hear that sometime, but I have not heard it. I would have told the Deputy if I had heard it.

Deputy Joe Higgins: Is it not inevitable that the close relationship between-----

Professor Patrick Honohan: Yes, it may affect attitudes and that and the framing of the way you think about things. That is certainly the case, but that is different.

Deputy Joe Higgins: Particularly because they all share the same ideology, as I mentioned earlier.

Chairman: I will give the Deputy just another few minutes.

Deputy Joe Higgins: To sum up, I have been asking about the Irish Financial Services Centre and the push for profit maximisation, which pushes against effective regulation. The associate professor in the school of business at Trinity College, William Kingston, cited Professor Honohan and Regling and Watson in an article. He pointed out that from the mass of evidence they provide, it emerges beyond doubt that the International Financial Services Centre, which came to life under the Haughey regime which took office in 1987, has been an important element in the self-destruction that took place - referring to the excesses of the property bubble - and that tax havens, of which the IFSC is one, are in competition to offer as little regulation as possible. Does Professor Honohan agree with his interpretation?

Professor Patrick Honohan: I do not altogether believe it. If the IFSC had not been there, if for example it had been outlawed by EU rules or something else, I think we would still have had the problem with our domestic banks, which is what we are really talking about here. I think the international regulatory environment, which moved very much in the direction of laxity during the 2000s, certainly spilled over into attitudes here as well. People thought they were behaving like the general trend. There was definitely a move towards lighter regulation globally from the mid-1980s on and that certainly influenced the environment.

However, whether the channel was through the IFSC, I would not see it like that. I do not dispute the fact that regulation was a relevant factor and that encouraging an open door policy was relevant for influencing regulations that affected the IFSC, but it was not as if the regulations were brought in to ease the way of IFSC banks and were seized on by local banks. I do not think that was the mechanism, if that is what is implied by the discussion here.

Deputy Joe Higgins: Professor Honohan mentioned earlier that banking should be ethical in its conduct. In all the interviews he conducted with the leading players concerning the blowing up of the bubble, did he find any concern for the victims of the bubble - the young generation of working people trying to purchase a home? From 1996 to 2006, the price of a home rose by the equivalent of the average industrial wage each year. Their mortgages went from 20 years to 40 years, shackling them to this millstone of debt. If nothing else might have prompted intervention, did Professor Honohan find any concern for the plight of this generation, which was almost destroyed by this profiteering?

Professor Patrick Honohan: For this report I interviewed only a small number of the bankers because I was focusing on the regulators.

Deputy Joe Higgins: Should the regulators not have been thinking of these unfortunate young working people?

Professor Patrick Honohan: Yes, they should.

Deputy Joe Higgins: Not the speculators.

Professor Patrick Honohan: I am not speaking about the bankers, in regard to whom I do not have much visibility. Many of them are shattered. They feel something has gone badly wrong but they are not quite sure why and they are not sure what they could have done differently. Given the effects on people, nobody is going around breezily saying these things happen.

Deputy Joe Higgins: I remember this period distinctly.

Chairman: This is the Deputy's last question

Deputy Joe Higgins: I was in the Dáil at the time. I was virtually a lone voice in trying to challenge the massive rise in house prices, the level of profits and the speculation that was happening. This massive burden was being put on a young generation. They can agonise now but between, say, 2002 and 2006, they knew about this. Even on that basis nobody said it should have been halted.

Professor Patrick Honohan: I absolutely agree. At the same time, however, to understand why that happened one has to have regard for the huge tax revenues coming in to the Government which allowed it to lower tax rates and hire more people, and the boom in construction. There were positive sides. I agree that it was not good and that it ended up in a very bad situation but at the time there were actual short-term benefits to which more attention was paid than the vague idea that everything would go wrong.

Deputy Joe Higgins: Mainly to the super profits of the banks and the bondholders.

Professor Patrick Honohan: If I may niggle on the poor old bondholders, I hold no great lobby for them but by and large they only got their money back. Irish banks had such a high standing that bondholders preferred to invest in them rather than British Government securities because they could get more. They were not in speculator mode but I agree with the Deputy in regard to shareholders and other participants.

Senator Susan O'Keeffe: Did Professor Honohan interview or speak to former staff members who had left the Central Bank by the time he carried out his investigations?

Professor Patrick Honohan: Yes.

Senator Susan O'Keeffe: Did he speak to anybody at the ECB or on the council of the ECB?

Professor Patrick Honohan: I did not do so specifically while preparing for the report but I have spoken with individuals there about these matters subsequently.

Senator Susan O'Keeffe: Why was that?

Professor Patrick Honohan: As they were not involved in the regulation thing, I did not regard them as a high priority. As the Senator will be aware, the report was prepared very speedily. I do not see that as a gap. I think the ECB should have been more closely involved with the problems of specific countries. I was quoted - presumably I said this - at a commit-

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tee meeting several months ago as saying it is not caring about or focusing on Ireland. The ECB has tended to focus on the euro system as a whole. In the period in question, prior to the guarantee, I understand that rather than raise the problem of a particular country, one would ask about the effect on the euro area as a whole. It was not knowledgeable about or interfering with the Irish regulatory structure.

Senator Susan O’Keeffe: If he was to use a word to describe the relationship between the Department of Finance and the Central Bank over the years, would he say “close” was a reasonable one to use? I mean close in all its senses.

Professor Patrick Honohan: I hope so. All public authorities need to work closely together but with a sense of independence. I work closely with senior officials in the Department of Finance. We can call each other on our mobile phones and we offer frank advice. Sometimes they do what I would like them to do and other times I will not do what they would like me to do. That is normal. We could stand on ceremony and pretend otherwise. It is somewhat different in respect of regulated entities. I am not at all close to senior officials in the regulated entities.

Senator Susan O’Keeffe: How is it that in his own report there was little discussion or examination of the role of the Department of Finance?

Professor Patrick Honohan: That was for Wright to do. There were three preliminary reports.

Senator Susan O’Keeffe: I know about Wright. In the interests of the public and all of that, Professor Honohan is saying that was not part of his remit.

Professor Patrick Honohan: Absolutely, because it would have been wrong to say, “I know you are interested in the Central Bank but I am going to tell you what everybody else did wrong.”

Senator Susan O’Keeffe: It seems odd, given the close relationship that would have existed, that through the whole report I get the sense that it is just about where the building of the Central Bank ended. It does not feel like a joined up piece of thinking. That seemed odd to me when I read it.

Professor Patrick Honohan: It was deliberate to focus on what we were asked to do.

Senator Susan O’Keeffe: Between 2004 and 2006, which Professor Honohan regards as the crunch time when things started to unravel, if regulation had occurred at that stage perhaps things might have changed. It seems to me that at the very time when banks became more aggressive in selling loans and credit became cheaper and more plentiful, regulation became less efficient and there was less interference or involvement. It is an odd coincidence that at the very time when banks were ramping up their activities, the regulatory side started to fail. Why did it happen at that point?

Professor Patrick Honohan: I am not sure I recognise that. I think it was not all that effective running through. It is just that between 2004 and 2006, the scale of the problem in the banks was getting bigger. There was the same sort of reaction, in other words, very little reaction.

Senator Susan O’Keeffe: In other words, we had a failing regulatory system for quite

some time.

Professor Patrick Honohan: Yes. For example, one case which went on for many years began well before the time covered by the report in terms of the failings of the firm in question.

Senator Susan O’Keeffe: It is repeatedly stated that nobody saw that it was a solvency crisis. That cannot be because everyone was stupid or not paying attention. What role did the banks and their advisers play in concealing their own solvency problems? How did that contribute?

Chairman: That question is somewhat leading. I ask the Senator to refrain from asking it.

Senator Susan O’Keeffe: Nobody saw the solvency crisis. That is extraordinary. What role might the banks have played in that?

Professor Patrick Honohan: I think the banks were taken by surprise. This was largely because when they examined big loans they thought, for example, that a loan-to-value ratio of 80% would be all right. They felt they had the personal security and failed to look beyond that. What happened when this loan-to-value ratio was on a property for which the price fell by 40% to today’s prices? The ratio became completely different. They had not thought through this. They were in a different world, whereby they were effectively participating in property speculation. They were not doing old fashioned banking, according to which they would take no risks, hold onto security beyond the value of the loan and charge a nice premium for doing so. That is the old style of banking but they had moved into a different sphere completely without changing their thinking. I think they were surprised. We know from the various Anglo Irish Bank tapes and so on that the bank knew it was running out of cash. Everyone knew that the cash was running out. During the summer they were probably starting to think that the market did not believe in their business model. They were hawking it around and nobody believed in them. They were starting to have doubts as to the long-term future of the bank. In respect to whether they knew they would burn through €40 billion or €45 billion of their shareholders’ capital, there was no evidence that they did. In fairness, however, I have not spoken to any of the Anglo Irish Bank people.

Senator Susan O’Keeffe: Page 7 of the report states that it would have been known in the Financial Regulator’s office that intrusive demands from line staff could be and were set aside after direct representations were made to senior regulators. That is a very serious statement. Were those representations in the form of what we would describe as posh dinners, golf outings and brown envelopes, followed up by the capacity to make a phone call? What does Professor Honohan mean by those representations? It is a very serious statement.

Professor Patrick Honohan: I think direct phone calls.

Senator Susan O’Keeffe: What would the phone calls be on foot of? One does not call somebody to make a representation unless there is already a relationship, which may have been forged somewhere else in the social arena.

Professor Patrick Honohan: Let us be careful about this.

Senator Susan O’Keeffe: Yes, indeed.

Professor Patrick Honohan: A junior staff decision is not the final thing. Somebody will think, “Oh, look it was overruled.” Yes, because that is why bosses are there - to make the final

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decisions. The problem I see is that the final decisions may not have been made and probably in some cases were not made on the basis of a good judgment of prudence versus development. In some cases - this is why it was mentioned here - without really saying, "Okay, I have a representation. Let me find out what the staff think, let's think it through, let's see the arguments on both sides". It was more this will be sorted on the seventh floor.

Senator Susan O'Keeffe: To which people would say-----

Professor Patrick Honohan: And the message goes down that it would be rescinded.

Senator Susan O'Keeffe: The public would say that was the sort of cosy club arrangement.

Professor Patrick Honohan: It would not have to be a cosy club. It is separate from a cosy club. Even without a cosy club, the Governor or the Financial Regulator may get a call from a firm saying, "I do not know why I am getting messages like this and what are you going to do about it". Hopefully, in a well-run organisation, the Financial Regulator will say, "That is the first I have heard about it and let me review the situation."

Senator Susan O'Keeffe: Page 8 of the report refers to the management of the big banks tolerating a change in the "lending standards, including decisions to authorise [a] numerous exceptions to stated policies". I would suggest it was not that the management of the big banks tolerated that-----

Professor Patrick Honohan: They encouraged it.

Senator Susan O'Keeffe: Yes, they encouraged it. Did they not incentivise their own staff with financial rewards for the larger loans they put out?

Professor Patrick Honohan: This is an important point. I do not have good visibility into the incentive structures. The banks themselves say it was not very important. I am not so sure. They say it is all history now which they do not have much of a grip on. Of course, exceptions to policy happen. It is okay that they happen but it is a warning sign. If it is an exception to a policy, you should have a very good reason for that exception. That is where the exceptions became the real driver for it in some cases.

Senator Susan O'Keeffe: Finally, you said earlier that no one in the room on the night of the bank guarantee quite knew how bad the banks were, particularly Anglo Irish Bank. However, you might not have been aware of back channels of communication between the individuals concerned, as well as private documentation and knowledge. Is it reasonable or correct to say that no one in the room knew? It is an extraordinary claim which I would challenge.

Professor Patrick Honohan: Of course they could be lying to me. There were not very many people in the room. I know them all. They could be lying. They could say, "I did know but I did not choose to tell anybody". In another note prepared by a senior official in the Department of Finance about a meeting of officials in September - maybe the Minister was there - he states Anglo Irish Bank might be €8.5 billion after capital. I asked the person involved if that was what he thought. He replied, "No, that was wrong". Maybe he meant €8.5 billion inclusive of capital, meaning the shareholder would have covered it all. That is the only evidence that I found written or oral. No one said to me, "You know so-and-so, he was saying that".

This is a wider point but it is useful to say it here. A number of directors of the Central Bank and the Financial Regulator said to me in evidence that they had put out warning signs. Indeed,

others said, “You know so-and-so, he was always warning and you will find it in the minutes”. But, of course, the minutes were very summary and, to their frustration, these people’s warnings - these Cassandras - are not noted in the minutes. There were people warning but it is a long way away from warning to saying on the night you are going to be hit for tens of billions for this thing.

Chairman: This is very much in direct contradiction to what Peter Nyberg told the committee. He said warnings of stability risks appear to have been sidestepped internally or were made public, especially in the financial stability reports, but toned down in policy conclusions. Also, when material warning about risk was provided, he said there were clear indications that little attention was paid to such material or that it was only included after toning down or redrafting.

Professor Patrick Honohan: I fully agree with that. I am talking about the particular position of certain directors who feel their views were not in the minutes. My predecessor got caught in framing the following question which one should never ask in public, namely, “Are we all right?” The financial stability report asked if we were all right. If the answer was “No, we are not all right”, then you have to do something about it before you publish it.

Chairman: So you agree with Peter Nyberg?

Professor Patrick Honohan: I absolutely agree with Nyberg.

Chairman: Do you agree with Peter Nyberg that toning down did take place in the financial stability reports?

Professor Patrick Honohan: Absolutely.

Chairman: My understanding is that the financial stability committee deals with the financial stability reports. Is that where the toning down took place?

Professor Patrick Honohan: No, my understanding is not only there.

Chairman: Did your examination find examples of toning down taking place at the financial stability committee?

Professor Patrick Honohan: Yes, I think so but the final decisions on those would have been taken at the higher level of the financial stability committee.

Chairman: Thank you. I call Senator MacSharry.

Senator Marc MacSharry: I welcome Professor Patrick Honohan and thank him for being with us morning.

It has already been asked by the first questioner as to how much the guarantee actually cost. Professor Patrick Honohan ventured that it came to €40 billion. On re-questioning from others, he said he was happy to clarify that the cost of the guarantee was not €40 billion but the cost of rescuing the banks may be €40 billion, which includes a wide variety of other measures, including the European Central Bank’s position of not allowing bondholders not to be burned. Is that correct?

Professor Patrick Honohan: No, that is right. The €40 billion was sitting in there waiting to cause trouble-----

Senator Marc MacSharry: It was not the cost of the guarantee, however.

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Professor Patrick Honohan: If there had not been the guarantee, it would have been something else and a lot of it would have been incurred.

Senator Marc MacSharry: Absolutely. And if we were able to burn the bondholders, it would have been substantially less, albeit €5 billion or €10 billion or €15 billion.

Professor Patrick Honohan: Relatively speaking only a little bit less but not the whole lot.

Senator Marc MacSharry: That was an opinion earlier as opposed to a fact.

Professor Patrick Honohan: I am afraid I deal in opinions as well as facts.

Senator Marc MacSharry: It might have been €20 billion or €15 billion.

Professor Patrick Honohan: Yes, it is a question of how much would you have got away with.

Senator Marc MacSharry: It is important.

Professor Patrick Honohan: It is very complicated to calculate these sums. There is the promissory note, the re-financing and the long-term considerations. It is very complicated.

Senator Marc MacSharry: Absolutely. For the guarantee itself, it would be incorrect to say it cost €40 billion.

Professor Patrick Honohan: That is correct. If there had not been the guarantee, there would have been something else.

Senator Marc MacSharry: It would not have been €40 billion. Is that not correct?

Professor Patrick Honohan: It could hardly-----

Senator Marc MacSharry: It could hardly have been €40 billion. That is good as it is important.

Professor Patrick Honohan: It could have been worse.

Senator Marc MacSharry: It could have been better.

Professor Patrick Honohan: Yes, it could have been better.

Senator Marc MacSharry: Yes, absolutely because there were other matters such as the burning of the bondholders and all of that stuff that came right up to 2011 and beyond.

Professor Patrick Honohan: Yes.

Senator Marc MacSharry: That is good and it is important. As we are speaking today, news agencies are reporting the cost was €40 billion. I am pleased to hear Professor Patrick Honohan put it on the record that the figure is incorrect.

Using ELA, emergency liquidity assistance, between the Tuesday and Sunday in question, why does Professor Patrick Honohan believe the European authorities, with negotiations, would have made an intervention to the extent that the price for the overall cost of the crisis to the people would have been less?

Professor Patrick Honohan: I am not saying it would have been. I am saying it was worth trying. On Tuesday night, in the middle of the night, what are you going to do? Do we have to guarantee? No, you did not have to guarantee. You could easily have got through to the end of the week and there was time to talk because everything was very fluid and moving in Europe with all sorts of banks falling left, right and centre.

Senator Marc MacSharry: That is Professor Patrick Honohan's opinion at the time. He has not changed it in advance. If, as the Governor of the Central Bank, Professor Honohan was presented with the same option today, would he opt for emergency liquidity assistance as a kind of a gamble, just to see how the political negotiations go between now and the weekend or, given what he now knows, as a member of the Governing Council of the European Central Bank, would he be concerned that the magnitude of the Spanish and Italian contagion would have been such that Ireland would have been pushed out to deal with the issue on its own?

Professor Patrick Honohan: I definitely would have been on the ELA side. The world has changed since about 2012 and the concept of bail-in of bondholders is now accepted. It was accepted in the professional literature for years and the Americans, who had a different legal system, kept on bailing in people. However, it went away for a while and now it is back. If the same thing happened today, we would be in a different world *vis-à-vis* our European partners. Not only would they permit us to restructure banks with losses to bondholders, they would require it.

Senator Marc MacSharry: In his role as a member of the Governing Council of the ECB, does Professor Honohan have fiduciary duties?

Professor Patrick Honohan: My role as a member of the Governing Council of the ECB is that I am there in my personal capacity and not as a representative of the Irish Government.

Senator Marc MacSharry: I am asking whether Professor Honohan has a fiduciary duty when he attends the bi-monthly meetings in Frankfurt?

Professor Patrick Honohan: I am not sure what I should understand by that.

Senator Marc MacSharry: Fiduciary duty means that one must represent the interest of the principal. I presume the principal in this instance would be the European Central Bank.

Professor Patrick Honohan: Yes, I have a fiduciary responsibility to the institution.

Senator Marc MacSharry: Does it supersede Professor Honohan's responsibility, in his role as Governor of the Central Bank of Ireland, to the Oireachtas and Government?

Chairman: I will give the Senator plenty of time but I need him to clarify a matter for the committee. We are dealing with the time of the report. If the question is in regard to the lead-in to the bailout programme, he may make an argument as to whether there was a conflict of interest.

Senator Marc MacSharry: If the issue I raise was related to that, I would have said that.

Chairman: I ask the Senator to take the discussion to where he wants it to be.

Senator Marc MacSharry: I want it to be exactly where I have it. Let me rephrase if that makes people a little more comfortable. If the Governor of the Central Bank has a fiduciary duty in his role as a member of the Governing Council of the ECB, where does the hierarchy

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come in? In other words, which of his responsibilities supersedes the other? Is the person who was previously-----

Chairman: The then Governor of the Central Bank.

Professor Patrick Honohan: I will give you the following answer. I will not give you a legal answer as some lawyer will-----

Senator Marc MacSharry: It is one of two responsibilities.

Professor Patrick Honohan: I will give a practical answer. The way I think about it-----

Senator Marc MacSharry: It is the responsibility to the Irish Government or the ECB.

Professor Patrick Honohan: I want to give the Senator a good and comprehensive answer on this. The ECB and the eurosystem are a creation of the governments of Europe. It is not accidental that I am plucked out of nowhere. I am plucked out of Ireland. I am designated by the President on the advice of the Taoiseach to be the Governor of the Central Bank. That means something, in particular that if there are discussions coming up in the ECB that involve Ireland specifically, I had better make the Irish point of view and interest known and express them in the strongest possible terms and most comprehensive and convincing way because nobody else has that responsibility. Therefore, it is very important that I am there as myself. That means, however, that I am an Irish person and I am very knowledgeable, aware and conscious of the issues. This has never caused a problem for me.

Senator Marc MacSharry: I understand it has not caused a problem for Professor Honohan. To my mind, Professor Honohan's responsibility when he goes to Europe is the same as that of a European Commissioner in that he leaves the jersey at the door and brings the Irish information to the ECB on an ECB basis. Let us say the Governor of the day had information related to the position in Ireland and set out this position in the Governing Council and the other 24 people around the table felt this information was useful in protecting the other euro countries and broader euro area. Would his responsibility not be to the ECB rather than the Irish people or Government?

Professor Patrick Honohan: It is in that general territory that I am saying that even a few days of ELA would give time for such matters to be explored, not just at the ECB but probably at intergovernmental level.

Senator Marc MacSharry: That is a bit worrying in any case. What is Professor Honohan's personal view on the ECB's refusal heretofore to co-operate with this inquiry?

Professor Patrick Honohan: Does the Chairman want me to say something about that very quickly?

Chairman: Yes, if Professor Honohan can keep me safe while doing so.

Senator Marc MacSharry: It is perfectly relevant.

Professor Patrick Honohan: There are a few things that really are important to the ECB, one of which is its independence and another is that it has to be accountable. Who is the ECB accountable to? It is accountable to the European Parliament. It does not want to put itself in the position of appearing to be accountable to national parliaments as opposed to the European Parliament. That is the constraint it feels. It is a sort of legal thing. You may think it is a bit

precious or something but the ECB feels this very strongly. It is not in any way resistant to sharing its views in a way that would be readily accessible to the committee. I have been talking to several of the people involved and I think there may be some possibilities to communicate the information and an understanding of the ECB's position in some way, as distinct from my own attempts to communicate them, which I will do.

Chairman: That reflects very much the position of the committee, which has continued to correspond with the ECB and awaits a response from it further to our most recent correspondence.

Senator Marc MacSharry: We will see on that one. Professor Honohan made much of the need for expertise in the banks. He believes the banks are ultimately responsible and that we need the highest standards of ethics. I may be ruled out of order on this issue but I do not believe I am straying too far. Since the report was published, has the Central Bank refused many directors or qualified financial advisers on the basis that they were not qualified or appropriate to-----

Professor Patrick Honohan: In that period.

Senator Marc MacSharry: Since the report.

Professor Patrick Honohan: Quite a lot of people are refused. Other people are told they must send us this or that information and they kind of know they are not going to get it. Actually, the figure is not zero as people get discouraged. There was a whole process after the collapse where there was a reassessment of the directors who remained from that period. There are precious few of them left.

Senator Marc MacSharry: Senator O'Keeffe mentioned the closeness of the Central Bank to the Department. My information is that no one has been formally refused and banks obtain an opinion first on an individual and then take a decision.

Professor Patrick Honohan: I am being trapped into this. I have some briefing on this matter but it is not just specifically on banks. That is the point.

Chairman: Senator MacSharry should ask a question rather than making a statement as to what he believes.

Senator Marc MacSharry: If the Chairman wishes to rewind he will see that a question was asked.

Professor Patrick Honohan: I have here figures on withdrawn by applicant and rejected/insufficient information. I have some numbers on rejected/insufficient information as opposed to rejected outright. These people have gone away and are not directors. They started the process and they have not got through. This is not a process that has no teeth. You can see that from the fact that their applications have been rejected on the basis of insufficient information. They could have brought more information forward but did not do so.

Senator Marc MacSharry: This is a little like the banks' announcements on lending figures which do not feature details of applications that have not been fully processed. Is that it?

Another question arises in terms of the Central Bank's investigations. Property investment syndicates were not regulated in the relevant period. From speaking to people, did Professor Honohan believe this issue should be addressed? Real estate investment trusts, REITs, for

example, are now regulated. The unregulated syndicates were able to borrow money from all sorts of people and this played a part in causing the crisis. Did Professor Honohan, in doing his report, believe there was a need to regulate property investment syndicates? At the risk of being out of order for this meeting, can the Governor outline whether there is an intention to bring forward regulation? I happened to note that as of today, there is none.

Professor Patrick Honohan: The whole area of shadow banking, shadow financial institutions and unregulated entities is something we have been looking at for some time. While one could have the ambition to regulate everything, one will not actually achieve it. Therefore it is quite a good idea to draw a line where one thinks one can regulate, if people who are outside that line are not exposing the system or individual depositors to risk. As for firms that are collecting money from wholesale sources and lending it on, this is an area in which we actually have promulgated a proposed set of regulations for these firms or funds that initiate bank loans. These are tough regulations we have proposed to introduce and we had a discussion paper about it earlier this year. That is very much in that territory but we move cautiously, because we do not wish to give the seal of approval to firms about which we have no way of discovering what they are doing. It is a tricky area.

Senator Marc MacSharry: In my last question-----

Chairman: Briefly.

Senator Marc MacSharry: Yes. This was partly covered by others earlier but in his report, Professor Honohan mentioned the unfortunate benign commentary by some international bodies such as the IMF and others.

Professor Patrick Honohan: Yes.

Senator Marc MacSharry: At this point, is the Governor content that the situation could not happen again or would it be equally likely to be benign? Have there been changes to how these things now are being communicated?

Professor Patrick Honohan: On the international side?

Senator Marc MacSharry: Yes.

Professor Patrick Honohan: We are constantly having reviews and there is a statutory requirement to have a review every four years of what we do. We had a team, organised by the IMF and coming from different international regulators, which was looking at our insurance sector. I had a general first meeting with them, at which they said they noted how in my report, I had stated the 2006 financial sector assessment program, FSAP, review of the Irish financial sector was unhelpful because it made no criticisms. As they said they were hoping to be helpful this time, I am anticipating several criticisms from that. There is heightened awareness. A lot of what we are talking about here has happened all over the world. There is heightened awareness of the need to be more intrusive. We are doing it, everybody else is doing it and some of those old models are being discarded. It is very important for the nation for us not to have some concept that as a nation, we have been uniquely stupid in this environment. We obviously have made big mistakes and have been badly hit but we have done so by doing things that have happened in more or less the same way in a dozen other countries, just not on the same scale. Why was this on a big scale here? It was the momentum from our success in the Celtic tiger and the momentum of our entry into the European monetary union with cheap finance. That is what gave us that launch from which to make the whole thing so big that we could not cope with it.

If one went down to the other countries, one would find similar criticisms being made of what they did. We will not do it the next time. The next time, there will be some other problem.

Chairman: I will move toward the wrap-up and will invite Deputies O'Donnell and Michael McGrath, as lead questioners with five minutes each, followed by one minute of questioning from each of the other members. To wrap this up, I refer to one thing that did not come up this morning but which has come up in the other sessions. The Governor mentioned the domestic standing group in his report. Can he tell the committee what was the domestic standing group, what was its purpose, what was it set up to do and whether it actually did it?

Professor Patrick Honohan: The domestic standing group was set up in response to a European Union-wide initiative - back in 2005 or 2006 or some time fairly early before the crisis - so that every country should have co-ordination between its central bank, treasury authority, that is, the Department of Finance and its financial regulator. Sometimes, these are in different entities.

Chairman: Who were the parties in the domestic standing group?

Professor Patrick Honohan: The Central Bank, the Financial Regulator part of the Central Bank and the Department of Finance. Generally speaking, it met two levels below the Governor. Actually, today we still meet and now are joined by the NTMA. We meet on a monthly basis and nowadays, I go along and attend meetings and so forth.

Chairman: Going back to then, what was it to do and did it do it?

Professor Patrick Honohan: Going back to that period, it was mostly at that two levels down and then it got escalated to one level from the top or even to the top person. As to what it did, the group talked about a lot of these things like whether we should have a resolution scheme, how is liquidity going in the banks, what needs to be done, what if there is a catastrophe, should there not be a paper prepared on that or what about legislation for a nationalisation. The group did all of that preparation. Basically, it was a meeting of the principals to see that preparation for financial stability events would be developed.

Chairman: I suppose the question I am asking of the Professor is whether the group realised the purpose of its creation.

Professor Patrick Honohan: Yes, it did. It did a lot of preparation work but when it came to the crunch, they realised the preparation had not been brought to conclusion, had not been drilled down into details like whether we should do subordinated debt or what happens if it happens in the middle of the week and we need emergency liquidity assistance, ELA.

Chairman: I thank the professor.

Senator Susan O'Keeffe: May I seek clarification?

Chairman: Yes.

Senator Susan O'Keeffe: Was the Department of the Taoiseach represented on the-----

Professor Patrick Honohan: No, just the Department of Finance.

Deputy Kieran O'Donnell: I wish to touch on two quick points. First, I refer to the time of the night of the guarantee. On page 118 of his report, the Governor makes reference to this

point when he stated:

While considerable effort was thus devoted to preparing for a liquidity crisis, this period was also noteworthy for the unravelling of the Quinn-Anglo CFD affair, which was not ultimately resolved in a satisfactory manner. This appears to have represented a major preoccupation for the Authority at a crucial time.

The Governor touched on the point earlier that he currently is getting a review on the insurance industry.

Professor Patrick Honohan: Yes.

Deputy Kieran O'Donnell: There was a situation in which the Financial Regulator was regulating both Anglo and Quinn Insurance. Was there a question regarding the decision and the views taken at the time, in terms of how they dealt with Anglo? In the Governor's investigations, did it form part of the deliberations that there might be contagion with the Quinn Group in respect of how they would deal with Anglo?

Professor Patrick Honohan: The Deputy means that in September, because of the previous linkages with Quinn-----

Deputy Kieran O'Donnell: Well, the existing linkages; the linkages were there.

Professor Patrick Honohan: There still were some linkages with Quinn.

Deputy Kieran O'Donnell: Quinn still had significant loans from Anglo in respect of the purchase of Anglo shares.

Professor Patrick Honohan: Yes. I do not think so. While Quinn and the financial situation of the Quinn Group and Quinn Insurance continued to be a preoccupation thereafter, I do not think, have not seen in any of the documentation and never have heard anybody say "of course, the worst thing would have been if something had happened to Anglo, as then there would have been a Quinn knock-on". I never heard that and do not see it in the evidence. No, I did not hear it.

Deputy Kieran O'Donnell: Even though the regulator was regulating both.

Professor Patrick Honohan: Yes, it had been preoccupied earlier in the summer, running up to June or July, as to what it was going to do about the Quinn contracts for difference, CFDs, which had to be taken off the pitch and all that stuff we know about from the court case.

Deputy Kieran O'Donnell: Can I then go back to the European Central Bank, ECB?

Professor Patrick Honohan: Yes.

Deputy Kieran O'Donnell: The Professor's role is Governor of the Central Bank of Ireland and he is our representative on the ECB. Is it fair of me to state the Governor is the representative of the ECB in Ireland?

Professor Patrick Honohan: I have resisted that description. I do not think I am. I must represent-----

Deputy Kieran O'Donnell: Is the ECB aware of that?

Professor Patrick Honohan: I must represent the ECB and will represent the ECB's position and will explain and provide all the justifications I can for the various policy stances of the ECB in respect of parliamentary hearings here. So in that respect, but I do not regard myself as an ambassador of the ECB. It is much more than that.

Deputy Kieran O'Donnell: In a final point, would the Governor encourage the ECB, in his role as the Irish representative?

Chairman: There are communications going on between this committee and-----

Professor Patrick Honohan: I do not want to get involved too much in that.

Deputy Kieran O'Donnell: I will phrase it in another way. Does the Governor anticipate that the ECB will look favourably on the inquiry and will appear before the committee?

Professor Patrick Honohan: I think the ECB does not wish to disrespect in any way this inquiry.

Deputy Kieran O'Donnell: I thank the Governor.

Deputy Michael McGrath: In the Governor's comments today, he is advocating that at the end of September 2008, Anglo should have been liquidated. He acknowledges that this is with the benefit of hindsight, because that is not in his original report as a recommendation.

Professor Patrick Honohan: Yes.

Deputy Michael McGrath: In such a scenario, what would have happened to the €52 billion-worth of deposits it had on its books at that time?

Professor Patrick Honohan: That is exactly why the question is, on the Tuesday how could one have coped with that? One would have needed to take some time because there was no plan. One would have had to have worked out that thing. Now we know the European resolution framework, which distinguishes not just between guaranteed and-----

Deputy Michael McGrath: It was not there then.

Professor Patrick Honohan: It was not there then. Could one have made this up in a matter of days? No. Even the clever people who were there could not have done it very easily. It would have been very complex to do it. It was just that if one had put that on the table, one could have enlisted the help of people who are our friends.

Deputy Michael McGrath: It is not clear in that scenario under the circumstances of that time-----

Professor Patrick Honohan: No. It is not clear what would have happened and how much we would have got away with.

Deputy Michael McGrath: We cannot be sure what would have happened to the €52 billion of deposits. Given that it was acknowledged that Anglo Irish Bank was about to go under the following day without any intervention and that the bank had a balance sheet of €100 billion at the end of September 2008, does it strike Professor Honohan as odd that at that time a call was not made to the ECB to say there is a major problem, that we thought it was a short-term liquidity issue but it could be much more, that it is far too big for us and to ask what advice it could give on what we should do and whether it was willing to get involved? Does he find it

odd or normal that such a call was not made?

Professor Patrick Honohan: I can only say that when similar situations emerged in the course of 2010 I made it my business to give as much advance notice as possible of where things were going and what things might happen months in advance - "This is where we will be at the end of September and it is not looking good and so forth".

Deputy Michael McGrath: On the issue of senior bonds and deposits being ranked equally in law, *pari passu* to use the term used earlier, how much of a complicating factor would that have been at the time, if one were trying to separate good banks and bad banks and to separate deposits from bondholders? This issue was put forward during the course of 2009 and 2010 as being a problem.

Professor Patrick Honohan: This is what one might have been able to have ready if there had been resolution legislation in place. Then one could have said that in a failure the first people to be hit after the subordinated debt holders would be the senior bondholders, or some such category of creditor, and then afterwards the depositors. There is nothing holy about depositors relative to bondholders. Some of these banks had deposits of hundreds of millions of euro from international entities, so a distinction between depositors and bondholders was not clear precisely because they were *pari passu* in law. Somebody could say they would take a bond or that they would put it as a deposit. It did not make much difference to them. That is why I was saying that we should not demonise the bondholders. In that environment they are *pari passu*.

Deputy Michael McGrath: I wish to clarify one issue regarding the net cost of the banking crisis in terms of direct State support. Professor Honohan gives a figure of €40 billion for it, which is quite different from what the Government is indicating. The indications are that all of the moneys put into the surviving banks will eventually be recouped, which would leave a bill of between €30 billion and €35 billion for Anglo Irish Bank and INBS. Can the witness account for his figure of €40 billion?

Professor Patrick Honohan: The Minister published an article on that recently. He is hoping for improved prices as the banks recover and that he will get more from selling the shares and so forth than is actually priced into the valuations. That is the main source of difference. Also, to do these calculations one must bring them back to a certain date and one must be very careful about adding and subtracting interest. There can be double counting. The main difference-----

Deputy Michael McGrath: It is about assumptions.

Professor Patrick Honohan: It is about assumptions about the future return to increased share valuation of AIB.

Deputy Michael McGrath: Professor Honohan's report paints a picture of the time. On page 119, Professor Honohan lists the dividends that were paid by the main banks in the first nine months of 2008, amounting to €1.25 billion. It includes dividends of €270 million on 26 September 2008. Four days before the guarantee was put in place they were paying out €270 million. Does Professor Honohan have any comment or observation on that?

Professor Patrick Honohan: I will make two observations. One is that many of those dividends were going to Irish middle class people. Second, if it had been proposed to block dividends in the early part of the crisis, I am sure the argument that would have been made is that it would worsen the situation and that if banks stopped paying dividends it would cast a

doubt over the banks. That argument would have been made but this is all part of not realising and not dealing with the situation, which was much more grave.

Can I say one thing? I know the committee is in an awful rush but I am looking at the list of things that I hoped would arise.

Chairman: I will give you some time at the end, if you do not mind.

Professor Patrick Honohan: Yes.

Chairman: The next questioner is Senator Barrett, who has one minute. There is one minute each for every questioner after that.

Senator Sean D. Barrett: On page 151 of the report Professor Honohan examined what happened to the bottom half of the income distribution because of the guarantee. He says that the guarantee protects the less well-off, not directly by covering their bank deposits, if any, but by underpinning the functioning of the economy to provide employment and generate the tax revenue needed to pay for public services, and relatively little of the guarantee goes to protect the bank deposits of the more prosperous members of society. Is that something he would revise now? We have evidence, certainly in Leinster House, of the misery that the last number of years have brought for low income people, with increased unemployment and emigration, the emergence of a two-tier wage structure, discrimination against young people entering the labour market, social welfare reductions and reduced public services. Is it now the case that the income distribution consequences of the guarantee could be seen to be more regressive than anticipated at the time?

Professor Patrick Honohan: The guarantee is very specific. Guarantees do not protect poor people relative to rich people because rich people have more money. However, the attempt to stabilise the economy is an attempt which could help reduce the adverse distribution effects of a collapse in economic activity. Some crashes have affected the rich worse than the poor. This one in Ireland has affected the poor worse than the rich, although the distribution effects are not just relative to the rich and the poor but to different income groups and different classes of society. I do not dispute the fact that this has been very bad for the poor. Also, the poor do not have the ability to weather a loss of income, even if it was a proportional effect. Definitely, this has been very bad for the poor.

Deputy John Paul Phelan: I have a two-pronged question. In reply to Deputy Doherty earlier, Professor Honohan said he had just one meeting with the Minister prior to the guarantee, in which he was not asked about banking directly. Was he surprised that he was not asked? Second, and I do not mean this in a bad way, Professor Honohan does not strike me as the type of man who would be slow to give his view. As that was his opportunity to give it, why did he not give his view on the banking situation?

Professor Patrick Honohan: I did not hold back. I had no information that there were €40 billion of losses sitting in Anglo Irish Bank. We talked about different things. I remember we talked about what he was reading at the time and so forth, but we were focused on the fiscal thing. Should I have said anything? If I had had anything useful to say that had not already been published, maybe.

Deputy John Paul Phelan: On page 7 of his report Professor Honohan says that the major responsibility lay with the institutions themselves during the banking collapse. Does he think the institutions had enough skilled people in senior management positions or on their boards to

be able to deal with the potential crisis?

Professor Patrick Honohan: In the banks?

Deputy John Paul Phelan: Yes. On page 7 Professor Honohan says the major responsibility lies with them.

Chairman: That was dealt with already.

Professor Patrick Honohan: From my limited knowledge, the members of the boards were people with a lot of experience and were highly considered. Boards are a big issue, as well as non-executive directors of boards. This is a point I was going to deal with. This is a problem. If there is a complex situation, it is not very easy for non-executive members of boards to get to grips with what is happening. In the case of my board, I feel very sorry for people who meet once a month, or very often twice a month with committees. There are masses of information to be digested and if something goes wrong I would be sorry to think that people would blame the non-executive directors. They can only perform a very limited oversight role. I feel the legislation of the Central Bank - and this is the point I wanted to make - is a little bit unfair to the commission members, and the non-executive directors as it puts all the responsibility on them. They delegate responsibility but all the powers and responsibilities are with the commission. The same was true of the previous board. They cannot be on top of everything. The responsibility should lie with the senior executives and the commission members should be there as a supervisory board with the responsibility to check what is going on but not the primary responsibility.

Deputy Eoghan Murphy: I have a question on the financial stability reports and want to get an idea of who was in charge of that process. The Governor talks in his report about some of the warnings being toned down in those reports and of important data on overvaluing in the property sector being left out and a focus instead on criticising Morgan Kelly. What was happening there in the drafting of those reports?

Professor Patrick Honohan: The financial stability committee is an internal committee composed of senior staff members and chaired at that time by the Director General of the bank. I suppose it was that person who, with the Governor, would have brought the reports to the board for approval. I cannot quite recall whether anyone used the words “toning down” at the board. I think the toning down was done in the committee and perhaps between the committee and it being brought to the board of the Central Bank for approval.

Deputy Eoghan Murphy: The Central Bank was driving through that process.

Professor Patrick Honohan: It was just the Central Bank. The financial regulator part of the organisation contributed to those reports, but it was the Central Bank side that was in charge of that.

Deputy Eoghan Murphy: I think the Governor indicated that, perhaps, the financial regulator side was not contributing in a helpful way.

Professor Patrick Honohan: They were probably not really engaged in it as it was really an overall economic matter. They were thinking “Oh, that is economics, but what we are interested in is that banks have good governance structures. While I am dealing with AIB, you are talking about the economy”. They are different worlds which were not meeting.

Deputy Eoghan Murphy: Decisions on redrafting and on leaving out what might be important information while including other information was all happening within the Central Bank and it left the board of the bank and was published.

Professor Patrick Honohan: Yes. I think it was joint. For the financial stability report, they met as a joint board - the board of the regulator and the board of the bank - in a joint session to approve those reports.

Deputy Pearse Doherty: With others, the Governor has taken up the issue of my question in terms of being hooked on one issue. I am sure Professor Honohan understands that is very important the information he gives to the committee is evidence and the question I had and what he gave earlier on was that there was no policy of non-intrusive regulation. He has retracted that, which I welcome, but it is not about getting hung up. It is very important that we have evidence that we can rely on to make findings if we so wish at a later stage. I just wanted to make that point.

Professor Patrick Honohan: Can I respond?

Deputy Pearse Doherty: Yes, when I am finished with the question. There are two things I want to bring up. One is in relation to the phone calls with the ECB. Can the Governor elaborate on that and the Trichet phone call in particular? Was there a phone call between Trichet and the Minister, Brian Lenihan, as the latter said publicly in the RTE documentary, where he left a voicemail on Saturday the 27th, which he heard on the 28th, and which said, "You must save your banks at all costs". Does the Governor believe that came and was it verified to him?

The Governor went into an area which is of crucial importance to the committee. In relation to the guarantee and the question of whether there was a suspicion that there would have been losses, he mentioned minutes of a meeting. David Doyle is the person who was noted in that meeting. I have it in front of me and it is already in the public domain. It states that David Doyle noted that Government would need a good idea of the potential loss exposures within Anglo and Irish Nationwide Building Society and that on some assumptions INBS could be €2 billion after capital and Anglo could be €8.5 billion after capital. Again, I note that this is evidence we rely on. The Governor mentioned that Mr. Doyle said that was not what he meant, that it could have been with capital and, therefore, the capital could be absorbed within Anglo. The Governor did not make any reference to Irish Nationwide Building Society. However, even if they did have that capital, there would still be a need to be recapitalised, would there not?

Professor Patrick Honohan: Yes.

Deputy Pearse Doherty: Therefore, there would be a cost to the State. If the Governor is suggesting that what David Doyle has said is that this is with capital, it is not a suggestion for the first time that this was not a simple liquidity crisis, but was rather an issue of capital. It was a recognition on 26 September that there was a need for capital injections in the banks.

Professor Patrick Honohan: Absolutely, and that is why I mentioned it. This is a document that the Deputy has a transcript of, which I think is accurate. I also recall seeing this in a handwritten note. In the handwritten note, it looks sketchier. It looks like somebody wondering what he is saying. I am not totally convinced this is the properly considered position because he says he had no concept of it. The committee may, presumably, talk to him and ask him what he thought. Unless, I have misunderstood him----

Deputy Pearse Doherty: If memory serves me, the Governor says that when he spoke to

Mr. Doyle, his concept was that it was with capital, not after capital.

Professor Patrick Honohan: He said he had no concept that there was a loss. I am suggesting that those could be reconciled if the €8.5 billion figure was inclusive of capital as, around the same time, the Merrill Lynch document was talking about approximately €7.5 billion. As that definitely included the capital, why would he - out of the blue and when nobody else was saying there was a problem - say that, in particular when he himself says he did not think it was insolvent. It is a little bit of incompatibility with the written document, which is a meeting minute, and what he thought. The committee can find out from him what he thought. I wanted to be completely clear that there is that little bit of evidence, but it is the only one.

Deputy Pearse Doherty: Quite a large number of people attended that meeting including those from the NTMA, the Department of Finance, Merrill Lynch, the financial regulator's office, and the Central Bank. Were any of those people spoken to in relation to Mr. Doyle's suggestion that the minute of that meeting was inaccurate and that he did not suggest there were losses of that nature in either of the banks?

Professor Patrick Honohan: This minute came to light quite late in the process, but I think I probably spoke to people. We can check with Kevin Cardiff, who was the author of the minute and from whom I would have understood that he too had not really adverted to this. He felt that nobody thought there was a loss. It is worth further exploration.

Deputy Pearse Doherty: What about the ECB phone call and voicemail?

Professor Patrick Honohan: I do not have clear visibility into this. It was very late in the day when I started hearing this idea that Trichet had said the Minister must save the Irish banks. I think it is an extrapolation from what I heard which was that there was no European network and the Minister would have to look after our own banks, which is different.

Deputy Pearse Doherty: Has the Governor asked Trichet, with whom he served on the ECB?

Professor Patrick Honohan: Yes. He said he spoke to the Irish the same as he spoke to everyone to the effect that there was no system and they had responsibility for their own banks.

Deputy Pearse Doherty: Just to be clear, this is in an RTE documentary where Mr. Lenihan says there was a voicemail.

Chairman: Was it the drama or the documentary?

Deputy Pearse Doherty: It was the documentary. Did the Governor ask him about the voicemail specifically?

Professor Patrick Honohan: No, I did not ask him about voicemail specifically.

Chairman: It was a TV3 drama.

Professor Patrick Honohan: That is his recollection and there is no way he said there was to be a guarantee. Nobody is saying that. "Look after your own banks" is what was said.

Deputy Pearse Doherty: It was the late Brian Lenihan himself who said in the documentary that Jean Claude Trichet left a message on his phone on Saturday the 27th, which he received when he picked up the voicemail the following Sunday, and it said "You must save your banks

at all costs”. Is that not a case of “We are giving you a blank cheque to do whatever you wish”?

Professor Patrick Honohan: That would be to say for example “I do not want Anglo Irish Bank to close on Wednesday, so do something about that”. What could that be? It could be ELA. He did not say “Do not worry, you have a blank cheque”. No, no, no.

Chairman: I need to move on.

Professor Patrick Honohan: Can I just respond to Deputy Doherty’s other point. I certainly did not want to pick him up on focusing on a word. It was myself I was blaming for focusing on this word and whether it was “intrusive” or not. I regret not having given the Deputy a more categorical answer in the first place. It is a fair question. I hate getting caught on particular words that are not of my own choosing but in this case it was one of my choosing, but five years ago.

Senator Michael D’Arcy: Is there any particular reason the Central Bank financial stability reports ceased reporting on the extent to which property was over-valued after 2006?

Professor Patrick Honohan: To cut a long story short, I think this is probably an example of toning down. We have in an annex to that report a research paper which still shows some numbers but that, somehow, is not in the main text. The gap, the over-valuation, modest though it proved relative to what subsequently happened, is starting to become a little big so let us not frighten the horses, is, I think, what is going on there. That is consistent with the evidence. This was pursued by the team that were working with me and they could not quite get to the bottom of who took that out at that point.

Senator Michael D’Arcy: Professor Honohan used the term “let us not frighten the horses”, which, from what I am told, appears to have been the intention. Was that not contrary to the oversight role of the Central Bank and Financial Regulator? Was the role of the Central Bank and Financial Regulator not exclusively to ensure that if the horses needed to be scared they would be scared?

Professor Patrick Honohan: The role is to ensure there is nothing for horses to be frightened about. It does happen that people can get into a situation, which they did, of causing more damage by suddenly revealing a situation that was not imagined. That is something that is very difficult to manage. As a central banker one must at all costs avoid creating particular situations. For example, the Senator might recall the old days when we had fixed exchange rates and the famous occasion when the then Minister for Finance when asked if he was going to hold onto the exchange rate or if there was going to be a devaluation, said, if my memory serves me right, “We’ll hold it until the end of the week”. One cannot allow oneself to get into a situation where one creates an uncertainty and panic which causes people to damage the rest of the economy.

Senator Michael D’Arcy: It is important that on occasion that occurs.

Professor Patrick Honohan: Yes, but one has to frighten not the horses but the handlers of the horses. You have to tell them, “Stop doing this or else you’ll get into trouble” but that has to happen much earlier.

Deputy Joe Higgins: The Governor refers on page 107 of his report to measures that could have been taken to stop the bubble. Militating against more decisive and aggressive intervention was as stated by Professor Honohan to be seen to contribute to market disorder. Does it

not speak volumes that the financial markets, which were at the centre of this, based on private profit maximisation essentially can hold society to ransom-----

Professor Patrick Honohan: Yes.

Deputy Joe Higgins: -----and blackmail society by threatening to take their money elsewhere if they are not allowed to profit at will?

Professor Patrick Honohan: Exactly.

Deputy Joe Higgins: The Governor then goes on in his report to refer to looking into the future and learning from the mistakes of the past. We are experiencing a terrible housing crisis. Many people cannot afford to buy a home and there is also a shortage of houses. How can the human right to a home ever be vindicated if there is an economic dictatorship dictated by bankers, lenders and large developers? Apparently, the political establishment is enthralled to them and they rule the roost. The Governor will probably be aware that it is 41 years since, not a raving revolutionary but a High Court judge, Mr. Justice Kenny, in a famous report said that speculation in building, land and housing should be outlawed. Why does the Governor never consider these measures rather than just the general kind of regulation which is not having a real affect for ordinary people?

Professor Patrick Honohan: We could get into a lengthy discussion but I want to focus on one thing which I think is important. The banking system is a fragile animal. It generates a lot of potentially good resources for investment in housing and other things but it creates risks. It has to be managed carefully so that the investors who can do terrific damage to the economy by pulling out their money fast will not want to pull out their money. It is a delicate balance. That is why it becomes such a huge issue and why we have elaborate central banks and regulations and so on. The Deputy is right in saying that banks are vulnerable to sudden withdrawals of funds. Therefore, they have to be managed in such a way that the funds will never want to go away. This means that what the Deputy describes as excessive profit seeking, but I would call excessive risk-taking, is reined in and the banks can work in a calm way to provide the financing needs and payments mechanisms demanded by the economy.

Deputy Joe Higgins: There is an economic dictatorship by the financial markets.

Professor Patrick Honohan: No, it is needed by the people. A well-functioning financial system is one - and only one - of the elements that gives us growth in employment and good wages for the people whom I know the Deputy is very concerned about. I am not saying it works perfectly, of course, it does not. Without a financial system that is choosing investments prudently and carefully and sourcing savings, we would be in a much less well-housed and much less well-employed society. That is not a defence of a particular system. All kinds of political systems can be consistent with this but the banking system is a fragile entity and one which generates good over the long run, on average. We have had a very bad experience in the past ten years.

Senator Susan O’Keeffe: Did anyone, either inside or outside the Central Bank, attempt or succeed in toning down the Governor’s report?

Professor Patrick Honohan: This report?

Senator Susan O’Keeffe: Yes.

Professor Patrick Honohan: No.

Senator Susan O’Keeffe: The Governor states on page 10 of his report that in the 2007 FSR there was internal evidence available to the contrary. The Governor says there was internal evidence that was evidently not put into that. Is that internal evidence, which the Governor has obviously seen, still available?

Professor Patrick Honohan: I am sure it is.

Senator Susan O’Keeffe: What the Governor said is quite serious. We have talked about toning down in the broader sense but the Governor specifically states in the report that there was internal evidence that said X while the FSR said Y, meaning they were poles apart.

Professor Patrick Honohan: It is all a question of tone and what one decides to include or not. There are always matters of judgment. Obviously, I would not endorse the judgment. Hunting down some particular research paper that said something pessimistic is not a good way of going about these things. Fortunately in my organisation there are many people, researchers and analysts, with different views. We have vigorous arguments and they are encouraged to challenge senior staff members. We have those debates. The people who are too optimistic or too pessimistic who do not get their way may 20 years on say that when a particular fellow was in charge he would not allow anything to happen or was too liberal on something but that he or she wrote a paper on it. That does not mean they were right, although they might have been. We have to be careful about implying that just because somebody in the Central Bank said something it was right.

Senator Susan O’Keeffe: Given all the failings of the Central Bank and Financial Regulator, the lack of prudence and lack of management and oversight, no one has resigned and no one was asked to resign. What does the Governor think about that?

Professor Patrick Honohan: Members will be aware of the environment in which we work on these things. I have some figures. Of the 12 most senior staff members in the bank, none were at that grade in 2008 and only five were in the organisation in 2008. There has been extensive change and many retirements. A lot of people are not in previous roles and a lot of people have learned lessons. My goal in organising the organisation is to achieve a functioning organisation that delivers what the Oireachtas and the people of Ireland want.

Senator Susan O’Keeffe: There is a difference between learning lessons and being held accountable. That is what we are here for. If we do not hold people to account across the board - I do not mean in one particular place - then we are failing.

Professor Patrick Honohan: I am not sure I should express a view on it. I have organised my organisation to be effective and functional. I do not think the other thing is really my role.

Chairman: Senator MacSharry.

Senator Marc MacSharry: I am good.

Chairman: The Governor has indicated a couple of areas he wants to follow up in order to be as conclusive as he can this morning. In doing so, there is one question that has to be asked, whether the sum is €40 billion, €64 billion or €30 billion. Where did it go? How was it spent?

Professor Patrick Honohan: Ah, yes, and this will be the afternoon session. I think I gave a partial answer to that one earlier. The way to frame the question is to take your thinking back

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to the beginning of the century, 2000. Supposing the banking system had been restrained and was just like a normal banking system, what would have happened to the economy and how does that compare with what we have now? The €40 billion, or whatever it is, is only a part of that component, and we find that in the early years the economy would have been doing less well, wages would have been lower, employment would have been lower, and house completions would have been lower in the more steady path. However, since the crisis, although there would have been a dip following Lehman's, there would have been a higher level of output, employment would not have slumped as much, unemployment would be lower. In addition, and there is where some of the €40 billion went, there is the distributional effect. The bondholders did not make any difference one way or the other. They would not have invested in Irish banks because the Irish banks would not have wanted the money because they would not have been able to lend, so the foreign bondholders would have said: "Oh, okay, no takers in Ireland, I think I will invest in France."

Chairman: Professor, every Christmas in my local credit union, as they did around the country, people in previous years went down to pick up their interest rebate and their dividend at Christmas and there was a couple of hundred euros, just like a Christmas bonus for credit union members. Since the crash that has gone. I do not know if that is connected or not to the bigger programme.

Professor Patrick Honohan: It is connected.

Chairman: So where did the money go? It did not disappear into the ether; it has a physical existence. So where did it go to?

Professor Patrick Honohan: It went on buildings that nobody wants to live in, that is part of it. It went on paying wages for the builders of those buildings. Some of the money, I would say a much bigger sum, went from borrowers - including the borrowers the credit unions are struggling to pay back and therefore there is nothing left over - to the sellers of property and good times. That is a part that is often not focused on but it is a factor. I know you cannot identify this class of people because other things would have happened to them. Where did the money go up in smoke? It went up in smoke on property that was not worth anything and is no use to anybody.

Deputy Joe Higgins: Land speculators got a huge amount, surely?

Professor Patrick Honohan: Oh yes, sellers of property at high prices did very well, not all land speculators because some of them ploughed the money back in and then---- Deputy Higgins is absolutely right, but it was not just land speculators, it was also perfectly ordinary people who just happened for whatever reason to sell the property they had at high prices.

Deputy Kieran O'Donnell: Physically when the money went in, the €64 billion, physically----

Professor Patrick Honohan: Yes - "oh, where is he gone?"

Deputy Kieran O'Donnell: Where did that go?

Professor Patrick Honohan: Well, we borrowed it. We, the Irish----

Deputy Kieran O'Donnell: That is what the person out there who has gone through six years of extreme difficulties wants to know. Where did that go?

Professor Patrick Honohan: First of all, the extreme difficulties that were suffered by those people are mainly paying for the rebalancing of the fiscal accounts and not paying for this amount. This amount of €40 billion or whatever it is was formerly borrowed by the banks from bondholders - the bondholders have been repaid and now it is borrowed by the State from the----

Deputy Kieran O'Donnell: So it went to bondholders.

Professor Patrick Honohan: I am sorry, Deputy, but I have spent the last ten minutes trying to say that is one framing which is very bizarre, because if we say it is the bondholders, we say, well, under what circumstances? If we had not had a boom and bust - and you have to take the boom part - those bondholders would have just got their money somewhere else. The money----

Deputy Kieran O'Donnell: When the banks came knocking at the door in terms of ELA funding and funding from the Irish State, why were they doing it and who were they looking to get the money to use?

Professor Patrick Honohan: All of their creditors, bondholders and depositors, and all of the Irish depositors who took out their money in 2010 when they thought things were not going alright. Those people were paid also with money borrowed by the Government.

Chairman: There are a few additional points the Governor wants to add, and then I will wrap up.

Professor Patrick Honohan: I will not hold you any longer. I managed to bring in the points that I had in mind in response to other questions so thank you very much.

Chairman: As always Professor Honohan has provided a full morning, as he has in any meeting I have ever chaired with him, or a full afternoon. I thank him for his participation. It has been a very informative and valuable meeting which has added to our understanding of the factors leading to the banking crisis. We look forward to engaging further with the professor again later in the inquiry as we move to the next phase.

Sitting suspended at 1.45 p.m.

The joint committee resumed in private session at 1.52 p.m. and adjourned at 2.12 p.m. until 9.30 a.m. on Wednesday, 21 January 2015.