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Eurosystem

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Ciarán Lynch T.D
Chairman
Joint Committee of Inquiry into the Banking Crisis
Leinster House
Dublin 2

12 February 2015

Dear Deputy Lynch,

I am writing to follow up on a few points that arise out of my evidence to the Banking Inquiry on January 15.

1. Powers of Governor in period up to 2008

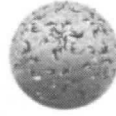
I undertook to provide a considered response to the legal question: “Did the Governor have the power to issue specific directions relating to a wide range of micro-prudential policies, including credit concentration limits, during the time prior to the guarantee?”

Two legislative provisions are relevant. Section 23 of the Central Bank Act 1971 provides that the Bank has a general power to require banks or a particular bank to maintain specific ratios; this power could conceivably have been used to impose a wide range of limits, including minimum capital and liquidity requirement etc. (Note that Section 23 of the 1971 Act was not a designated enactment until 2010 and breaches of Section 23 would not have been liable to administrative sanctions until then). As with most of these long-standing powers, this power has long been delegated to the Governor.

Another provision, specifically Section 33D of the 1942 Central Bank Act, gave the Governor (having regard to his ESCB tasks) or the Board of the Bank (in relation to its objectives and most appropriately the objective of contributing to financial stability (at 6A (2) of the 1942 Act) power to issue guidelines to the IFSRA as to policies and principles it was required to implement in performing functions, or exercising powers, of the Bank. (Reference to this provision was made in Paragraph 3.8 of my 2010 Report.)

Accordingly it was open to the Board of the Bank to issue guidelines for the exercise of functions and powers of the Authority, including:

- in relation to the statutory power of the Authority to impose conditions on licences of banks for the orderly and proper regulation of banking (e.g., financial stability grounds) under Section 10 of the 1971 Act, including minimum liquidity requirements, or



- in relation to the power of the Authority to issue requirements on any bank under Section 23A of the 1971 Act as to the composition of its assets and its liabilities, including liquidity buffers, sectoral limits etc.

In addition, it may be relevant to add that the Governor was empowered, under Section 17A of the Central Bank Act 1971, to authorise a suitably qualified person to investigate the business of the holder of a licence or of a related body.

While these powers existed, it is only right to add that the normal operation of the Central Bank and Financial Services Authority at the time did not entail the Central Bank's board or the Governor intervening to second-guess the Regulatory Authority or its Chief Executive, who had numerous specific powers.

2. Best options at end-September 2008

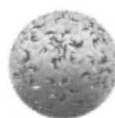
In light of the discussions during my evidence at the Inquiry on January 15, I have been asked whether my views on what should have been done with Anglo Irish Bank in September 2008 have changed since completion of the 2010 Report. It is possible to speak more plainly about these matters now than five years ago, but I do not think that there has been much evolution in my thinking on this. However, reading the official record, I can see that a different impression might have been conveyed.

In evaluating decisions taken at end-September 2008 it is especially important to distinguish between a hindsight scenario and the actual information available to Government decision-makers at that time. The discussion at my session with the Inquiry moved between these two scenarios in a manner that may not have been altogether clear (especially pp. 113-4). So let me rephrase my views as follows.

Scenario 1 (Hindsight): Suppose the consultants from international investment banks had advised the Government in September 2008 that a blanket guarantee of Anglo and INBS would cost the Government €35 billion in the long run. (Of course they did not so advise).

Government's best available response given this information: Had it been known, a €35 billion cost would, in my opinion, have made guaranteeing these two banks too expensive relative to the reputation and confidence damage that would have been caused to Ireland by a liquidation involving bail-in. Therefore although Anglo was clearly a systemically important bank at that time (despite the modest role it played in the Irish credit and payments system), had it had that information, the Government would have done better by not including those two banks in a guarantee. Instead, it could have advised the ECB and European Commission that it intended to liquidate these banks protecting only insured depositors.¹ (At the same time it would have been wise to guarantee new senior liabilities of the other banks.) On hearing the Government's intentions, European officials would have been shocked; they might possibly have agreed to some risk-sharing arrangement to induce the Government to

¹ A variant, under which uninsured personal and small business depositors would have been protected, while other creditors lose, is an option available under the subsequently enacted BRRD, but not evidently available in 2008.



refrain from bail-in given its destabilizing confidence effect beyond Ireland. Absent such a risk-sharing agreement, and notwithstanding the associated significant reputational damage, on balance some bail-in should have been applied. [This option was adumbrated in the 2010 report, footnote 162]

Scenario 2 (Actual): In reality, the investment bank consultants' advice was that the market had no confidence in the business model of Anglo and INBS, and that that explained the liquidity crisis. They advised that loan losses could eat into bank capital but their central estimates did not suggest that the banks had significant negative equity.

Government's best available response, given their limited information: Given this information, the two failed banks should, in my opinion, have been intervened by the public authorities, replacing top management, likely through nationalization (this corresponds to Minister Lenihan's stated preference). ELA should have been provided to allow time for consultation with European officials (including on the potential for risk-sharing). A more limited systemic guarantee should have been provided (no old – i.e. existing – bonds, no sub debt). [Cf. my answer to Deputy McGrath at the Inquiry on January 15, and the 2010 report: paragraphs 8.39, 8.40 and 8.46]

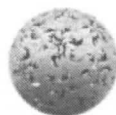
Actual response: These two responses are to be contrasted with the steps actually taken by Government. Existing top management was left in place for several months, creating a potential risk (though in practice there has been no evidence of management looting of the two failed banks). There was no prior consultation with European partners, resulting in annoyance on their part and no risk-sharing. The blanket guarantee included old debt and sub debt, increasing net fiscal costs. The guarantee also implied accelerated payments in case of an event of liquidation; this inhibited steps to effect a more extensive corporate restructuring of the failed banks for two years because of the Government's inability to meet the large cash call that would have been triggered such action.

In this context and throughout the discussion, it is useful to bear in mind that the terms failure, liquidation, intervention, nationalization, all have specific meanings and none of them necessarily implies anything about whether the Government will make payments to bank creditors.

As I have often remarked, none of the courses of action available at the end of September 2008 would have relieved the State of *all* of the costs that resulted from the bank failures.

3. Meeting note from Document 6

I would like also to refer to the discussion between myself and Senator Susan O'Keeffe (page 148) and later with Deputy Pearse Doherty (pages 161-2) about the contemporaneous note made, I think, by Kevin Cardiff in September 2008 of a meeting in which David Doyle is reported to have referenced a possible sum of €8.5 bn in relation to Anglo Irish Bank. (It is Document 6 in a set of documents on the website of the Public Accounts Committee



<http://www.oireachtas.ie/documents/committees30thdail/pac/reports/documentsregruarantee/document6.pdf>).

Examining the record, my evidence to the Inquiry has likely created a misleading impression here in regard to one point, which I would like to correct. I do not believe that I have spoken to Mr. Doyle specifically about that note. I probably did speak to Mr. Cardiff about it. My understanding of Mr. Doyle's perceptions of the state of Anglo Irish Bank in September 2008 is based on other, previous, conversations.

4. The Official Record 15 January 2015

I have not attempted to correct inaccuracies or clarify ambiguities in the official record of what was certainly a very complex and fast-moving conversation. I hope that nevertheless, my testimony is fully intelligible if taken in conjunction with the video record.

Yours sincerely,

Peter Hall