

**Statement of Mr John Beggs**

**in response to Professor John Fitzgerald's testimony to the Joint Committee of Inquiry into the Banking Crisis of 11 February 2015 and his follow up correspondence with the Joint Committee on 16 February 2015**

I refer to the transcript of Professor John Fitzgerald's testimony to the Joint Committee of Inquiry into the Banking Crisis of 11 February 2015 and his follow up correspondence with the Joint Committee on 16 February 2015 in which he identified me as a senior economist from AIB with whom he had a meeting in October 2005.

I wish to make the following comments:

1. I did meet with Professor Fitzgerald in relation to stress testing. I do not recall the exact date but am happy to accept, from his records, that it was in October 2005 as stated by Professor Fitzgerald as we met only once on this issue.
2. Professor John Fitzgerald himself in his email of 16 February 2015 to the Joint Committee accepts the possibility that his recollection of the content of the meeting was faulty. Professor Fitzgerald's recollections on the content and nature of the meeting are, in many key respects, very different from mine. My recollection is that I initiated the meeting, making direct contact with him as we have been acquainted since working together in the Department of Finance in the 1970's and 1980's.
3. Specifically, I recall and am certain that I expressed no concerns on the part of the AIB Board about stress testing. The Board never authorised, or was aware of, the meeting. I did not report back to the Board on the outcome of the meeting.
4. It was an exploratory technical meeting between economists to ascertain whether the ESRI's model could be used to enhance the scene setting of base and stressed economic scenarios by providing more variables than contained in regulatory exercises at that time. Only very limited macro data were provided in the 2004 and 2006 CBFSAI stress tests.<sup>1</sup>
5. It was never the intention to ask the ESRI to carry out stress tests independently of required regulatory ones and it was certainly never envisaged that the ESRI would apply macro scenarios to the bank's internal data. I never asked Professor Fitzgerald to carry out stress testing on behalf of AIB. I sought to explore whether prescribed regulatory economic stress data could be run through the model to generate a more graphic picture of the stressed outcomes.
6. The meeting failed to produce any results as Professor Fitzgerald indicated that the ESRI would not undertake private work, there were some limitations as to what the model could do but he was prepared to make data from the

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<sup>1</sup> See The Irish Banking Crisis. Regulatory and Financial Stability Policy 2003-2008. A report to the Minister for Finance by the Governor of the Central Bank, 31 May 2010, Table 6.2, page 86 for details.

forthcoming Medium Term Review available to us. It was an inconclusive meeting and in so far as I am aware, my unit never followed it up. If Professor Fitzgerald did any other work for AIB or other banks on stress testing I'm not aware of it.

7. The impression created by Professor Fitzgerald's testimony is that the AIB Board was concerned about the lack of severity of the stress test exercises as far back as late 2005, which may imply a broader level of concern. I have no knowledge of the Board's opinion on this matter. I never received any negative feedback or reports from the Board or Risk Committees on stress testing. As a result, I had no reason to believe that the AIB Board had any misgivings about regulatory stress testing. It was not my practice in AIB to attribute comments or opinions to other businesses or committees, least of all the Board.
8. I think that it is important to clarify that I was employed in AIB as Chief Economist AIB Treasury from 1992 to 2011. I headed up a research unit Economic Research Unit (ERU) within the Wholesale Treasury business, which was one of several business units making up Global Treasury. Global Treasury, in turn, was one of the main business units that made up the Capital Markets Division of AIB.
9. The primary role of my unit, the ERU, was to provide commentary and forecasts on economic and financial market development to the Bank's internal and external customers. A significant part of the work involved the assessment of interest rate and exchange rate trends and forecasts, primarily to the Bank's Irish corporate and commercial customers.
10. Though a function of the Wholesale Treasury business, the ERU was also a resource available to the rest of the AIB Group. One of the services provided by the ERU was its involvement with the Stress Testing Steering Group (STSG), which was part of the central Group Risk management framework. The architecture of this risk management framework, which culminates in the authority of the AIB Board, has been outlined in the Group's Annual Reports.<sup>2</sup>
11. The role of the Stress Testing Steering Group is to ensure a comprehensive stress testing programme is embedded in risk management and to ensure that an effective framework is in place to enable stress testing across the Group.
12. I attended meetings of the STSG when a stress test exercise had to be carried out at the request of Irish, UK, Polish or other international regulatory authorities. My role was to communicate the evolution of the scenarios from base case to stressed scenarios to the STSG and onward to divisional risk management and business units as appropriate. I was not involved in the application of the economic variable to the bank's internal data. This was carried out by analysts within the divisional risk and credit units as well as the Group risk unit.

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<sup>2</sup> See pages 31-36 of the AIB Group Annual Report and Accounts, 2007 for a presentation of the Group risk management framework.

13. My experience of dealing with the Stress Testing Steering Group was that the regulatory stress tests were carried out in a very professional manner, with full commitment on the part of the Committee and the other units within the Group responsible for assessing the impact of the shock economic scenarios on the Group's capital and other key metrics. The Executive Risk Committee examined the output of these stress tests before sign off at AIB Board level. I was never involved in any discussions that took place once the STSG had signed off on the report to "go up the line."
14. From an early stage, probably prior to 2005, I felt that the regulatory stress testing exercise could become too procedural. Banks were provided with stress scenarios, the work was carried out with great care and attention to detail, signed off by banks' boards and reported on by the Central Banks in various reports. I also felt that the stresses were too mild, though not on every occasion.
15. I was also concerned that the moderate nature of the stresses was not conducive to maximising management buy-in of the risks involved. This was my personal opinion and had much to do with the view that people performing the stress tests in various business units needed to understand the broader economic and financial implications of a given shock to a base case scenario.
16. To do this, one needed a model and the ESRI had one. A model would provide more outputs for consideration, a wider context to the changed economic environment and given the likelihood of a growing stress testing framework, a more consistent approach to the exercise over time. I raised these issues with the STSG and suggested that I talk to John Fitzgerald in the ESRI to see what could be done. I stated that this would have some cost implications.
17. I quote Professor Fitzgerald from his testimony to the Committee:

*"We did macro-economic scenarios. The difference compared to what the Central Bank and so on was doing was that we used a model, so it was consistent. One did not get a housing price crash and no change in unemployment; one got a housing price crash, unemployment going through the roof and Government revenue collapsing, all coming together which is the way to do it. That was my concern. It was not just the Central Bank. It was interesting doing something similar with a British owned bank. The Bank of England and the Financial Services Authority, FSA, had a similar inappropriate approach to stress testing."*

*"If one just asks what happens if house prices fall by 30%, one will get an effect. It becomes much worse if unemployment goes through the roof and Government revenue collapses with the Government then having to tax the hell out of the economy. That is a far worse scenario. What they were doing was just picking a housing crisis and unemployment independently, the reason being they did not have a model. To do the scenario properly in a way that is internally consistent, one needs a model of the economy. The only people with a model of the economy*

were in the ESRI.”<sup>3</sup>

18. I also felt that the amount of data and scenario scene setting between the base case and stress case scenarios was too limited. This applied to both Irish and UK regulatory tests. I wanted to bring more information to bear on the process of assessing the risks to the business from the economic deterioration under consideration in the stress. In fairness to the regulators, the process by which different macro scenarios were used to calculate the impact on banks’ capital requirements and other key metrics relied on a limited number of economic variables particularly changes in real GDP and in the rate of unemployment.
19. I carried out most of the work on the macroeconomic inputs for stress testing in AIB. From year to year, I endeavoured to be consistent in how I interpreted the shocks and in producing additional information for the divisional risk and business teams, particularly the changes in employment (which were not specified in the macro aggregates in the base or stress scenarios) which had to be estimated from the changes in real GDP and unemployment rates supplied for the exercise.
20. As regards the point made at the hearing that AIB, in approaching the ESRI, was attempting to use an alternative source to the Central Bank for stress testing, I can confirm that I regularly raised technical points with the Central Bank about the implementation of the stresses. Our primary relationship was always with the CBFSAI. There was never any intention of duplication by approaching the ESRI.
21. In his testimony, Professor Fitzgerald stated on several occasions that his recollection of the meeting in October 2005 may be inaccurate. In his letter to the Committee of 16 February 2015, Professor Fitzgerald states  
*“However, as my recollection of the timing of the meeting was faulty there is always the possibility that my recollection of the content of the meeting was also faulty.”*
22. Much emphasis has been placed on the importance of this meeting between the ESRI and AIB in October 2005 at the Committee hearing on 11 February 2015, but it did not have the imprimatur of the AIB Board.

27 March 2015

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<sup>3</sup> In a footnote (112) on page 87 of the Central Bank Governor’s Report to the Minister for Finance (May 2010) the Governor notes:

*“There is the question as to whether the scenarios that were chosen were sufficiently severe. Any given external shock to the economy would lead to knock-on effects through the worsening of overall financial weaknesses, depressed private demand and fiscal difficulties, leading to further downward pressure on the property market. How banks’ behavior might react to such an environment and the consequent further macroeconomic and financial impact, is not captured. Moreover, macroeconomic models are generally built on the basis of log-linear relationships; for example, doubling the size of a shock will generate a proportionate increase in its effect. In reality, however, in a situation of considerable stress, the effect might well increase more than proportionately.”*