Statement from Mr. Con Horan, Prudential Director, IFSRA

I have been directed by the Joint Committee to make a statement relating to items under the following headings:

- Regulatory, Supervisory and Government
- Banking, and
- Crisis Management

This statement is based on the facts as I saw them during my employment with the Irish Financial Services Regulatory Authority (IFSRA). I joined the IFSRA in 2003 as Head of the Banking Supervision Department and reported to Mr. Pat Neary who was the Prudential Director at the time. I became Prudential Director in February 2006.

The Prudential Director was not a member of the Authority. The CEO and Consumer Director were the only executive board members.

Regulatory, Supervisory and Government

A.1 Prudential Policy, Effectiveness of Powers, Communications and views of International Organisations

This statement looks at prudential policy from both a micro-prudential and macro-prudential perspective.

A.1. Micro-Prudential Supervision

The micro-prudential policy adopted by IFSRA comprised two key elements namely, the framework of international and domestic regulations governing credit institutions[1] (regulation) and the oversight of how those regulations were applied (supervision).

The core strategy of IFSRA was a 'principles-based' approach. It was a continuation of the approach to supervision, previously adopted by the Central Bank.

It is my understanding that the objectives and methodology were set out in a Central Bank Board paper, which was also considered by the Interim Board of IFSRA, in September 2002[2].

This approach was seen as the alternative to a 'rules-based' system where supervisory staff had a very detailed involvement with individual institutions involving lengthy on-site inspections as well as checking and testing compliance with prescriptive rules. It was the view of the Bank that a rules-based approach could be inefficient and placed responsibilities on the regulator that should properly be with the management of regulated entities.

[1] Meaning 'banks and building societies'

[2] Central Bank of Ireland Board paper, Supervisory Objectives and Methodology, 20 September 2002

A principles-based approach to supervision imposed general standards and principles on regulated institutions and essentially placed the onus of responsibility for compliance with such principles, and other requirements imposed, on the boards and senior management of the institutions.

The supervisory authority (the regulator) operated a fitness and probity regime to ensure that those in control of the organisation had a proper background and operated control systems that were consistent with the strategy of the bank.

The approach was consistent with that adopted by supervisory authorities in most of the main financial centres, including the United Kingdom.

Internationally, it was considered to be the most appropriate manner of supervision to address the growing complexity of banking, advances in risk management and for facilitating innovation in the industry; the latter being a factor which was considered to have increased the overall resilience of the financial system. Such innovation was identified as a key component in bringing about what had become known as the 'Great Moderation'. This phrase was coined by economists to describe the long-period of pre-crisis macro-economic calm, with stable growth, stable inflation and stable banks (Appendix: Section 1).

Speeches and corporate publications of IFSRA made regular references to the desire to foster innovation and competitiveness and, for the system to work properly, the need to trust those at the helm of financial institutions to act prudently. Given the international trends, a principles-based approach to supervision was also seen as important in developing Ireland as an international centre for financial services. Further, in accordance with the 'Better Regulation' agenda, the financial services industry in Ireland had been given significant influence over the approach to supervision in Ireland. The Financial Services Consultative Industry Panel ('FSICP'), which considered itself the 'lender of last resort' in a regulatory context for the financial services industry in its dealings with the regulator, was a strong supporter of the approach.[3]

Crucially, principles-based supervision was also promoted as best practice by the International Monetary Fund (IMF). In a paper entitled '*IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07,* the IMF identified that, pre-crisis, it had recommended to advanced countries to follow the 'light touch' U.S./U.K. approaches to the financial sector as a means to help them foster greater financial innovation.

Therefore, it is not surprising that another review of the crisis by the IMF *("The Making Of Good Supervision: Learning to Say "No")*, found that, internationally, there were "abundant" examples of supervision: (1) staying on the side lines and not intruding sufficiently into the affairs of regulated institutions; (2) being too deferential to bank management; (3) not being proactive in dealing with emerging risks and; (4) not being comprehensive in their scope.

However, no particular system of supervision fared well in the run-up to the crisis. The Spanish approach, which was initially lauded for its rules-based approach and intrusiveness (which involved the placing of large numbers of bank inspectors permanently on-site in the major banks), suffered similar problems to Ireland.

[3] Consultative Industry Panel Annual Report 2005

It is also clear that a number of the foreign controlled banks in Ireland that were subject to dual supervision[4] and in one case subjected to prudential oversight only by the home authority (as it operated on a branch basis)[5], suffered very heavy property related losses on their Irish loans.

However, with hindsight, it is obvious from what occurred that the approach adopted in Ireland was inadequate and failed to deliver a safe and sound system. This is a matter of deep regret. The system afforded far too much scope to the banks and placed too much faith in the boards and management and their control systems for risk management, internal audit and compliance.

In Ireland, as elsewhere, there is now a far more intrusive and challenging approach to micro-prudential oversight. This change in the approach to supervision has occurred in tandem with a complete overhaul of the system of international prudential regulation, which is universally accepted as having been grossly inadequate prior to the crisis (see section B.3 below).

Notwithstanding the international background, it is clear that the system of financial oversight in Ireland had the capacity, from the mid-1990s when excesses began to emerge, to intervene to curtail the market.

The capital measures taken in 2006 were, as Governor Honohan said in his report of May 2010, an example of what could have been done, albeit much earlier. Following the introduction of the capital increases for high loan-to- value loans in May 2006, growth rates for mortgage lending decreased consistently month-on-month[6]. ECB data shows that the rate of slowdown in Ireland for 'House Loans', between May 2006 and July 2007[7], was four times that of the Euro-area average. There was also a clear slowdown in lending for non-mortgage credit when the December 2006 measures were taken, as well as a shift in lending to non-residents, particularly in 2007 (Appendix: Section 2).

There were additional opportunities to enhance the system which could have strengthened effectiveness. In May 2005, I proposed to the Authority a corporate governance regime for banks and building societies[8]. This proposal was to impose a formal condition on the licences of all credit institutions, thereby laying a strong foundation for the taking of enforcement actions under the administrative sanction regime that was being developed at that time[9]. However, the proposal was not implemented as the belief was that the industry was overburdened with the changes brought about by the Financial Services Action Plan[10].

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[4] Ulster Bank, Bank of Scotland, ACC

[5] Danske Bank

[6] Central Bank Money and Banking Statistics

[7] ECB. www.euro-area-statistics.org. Ireland's rate of growth for 'House loans' decreased by 16.5% between May 2006 and July 2007, whereas the Euro area average was 4%

[8] Proposal on Corporate Governance Requirements for Credit Institutions. No 50 of 2005, 18 May 2005

[9] It is a matter of record, that at the time when administrative sanctions regime was being developed, I had also argued for the establishment of a new Investigations Unit in IFSRA to ensure that specialised skills were available to pursue breaches of requirements. See memorandum of 18 October 2004

[10] April 2005 speech entitled "The Future of Financial Regulation: Principles or Rules –Issues for the Irish Financial Services Sector", the IFSRA said " *Let me assure you that we will continue to ensure that practices and policies adopted reflect the unique nature of the Irish financial services sector. Finally, let me assure you that we, as Regulator, will not introduce or impose unnecessary regulatory burdens that will effect the continued competitiveness of our financial industry and will minimise the impact of such burdens coming from Europe*"

That proposal was important and was consistent with the features that have been introduced in many countries including Ireland after the crisis.

While there were missed opportunities to strengthen the system, there were areas where Ireland did take actions that were not taken elsewhere. For instance, new liquidity rules I proposed, which were introduced in July 2007, were broadly recognised at the time as averting the problems that were evident in US and, for instance, in the UK when Northern Rock was rescued in 2007.

A.2.Macro-Prudential Supervision

While micro-prudential supervision focusses on the safety and soundness of individual institutions, the objective of macro-prudential supervision is to contribute to safeguarding the stability of the financial system as a whole, by increasing its resilience and decreasing the build-up of systemic risks. It seeks to address the inherent pro-cyclicality of the financial system and the direct and indirect linkages between individual firms (Appendix: Section3).

Macro-prudential policy was a focus of the Central Bank and its financial stability experts. Given the importance and prominence of property-related lending to the Irish banking system, this issue was the subject of ongoing analysis, with numerous papers published over the years that addressed the drivers and implications of credit growth.

It is my understanding that the property market was also the key area of focus for the Board of the Central Bank. The main expectation of the Board was for a 'soft landing', driven by increases in interest rates. The IFSRA Board was, however, concerned about generating instability and the risks attaching to shrill warnings[11]. It also had concerns about the impact that regulatory intervention might have on the competitiveness of Irish banks[12].

Additionally, when my proposals for regulatory intervention were put forward in 2006, I was advised of significant concerns at Central Bank senior management levels, about the potential impact on the stability of the system. There was a desire to temper what was perceived as the appetite for heavy intervention[13].

Following the publication of Professor Morgan Kelly's *"Banking on very shaky foundations"*, in September 2007, the macro-prudential analysis[14] at that time was that:

- The outlook for the Irish economy was expected to remain fairly positive. Economic growth was expected to slow somewhat in 2008, although the rate of growth would still be quite high relative to other developed countries;
- Total non-performing loans for the domestic banking sector were low by historical and international comparison;
- The health of the commercial property market was considered to be robust;
- Loans outstanding to the construction and real estate sector for speculative property investment were lower than was suggested;

[11] Minutes of the Central Bank Board of 27 July 2006, 18 October 2007
[12] Minute of the Central Bank Board of 29 June 2006
[13] Email of 28 July 2006 from P Neary to C Horan and A. Mawdsley
[14] Note of September 11 2007 and attachments

- Estimates of foreign banks' exposures to the Irish banking system were also too large as they did not take account of Irish banks' significant levels of foreign assets with foreign banks;
- The article had not considered domestic banks' exposures to the construction and real estate sector in Ireland in the context of their global exposures. The larger domestic banks conducted significant business overseas and this was overlooked.

It is clear that the macro-prudential analysis did not raise the level of concerns to a point where any form of direct intervention was considered necessary by the relevant authorities. The domestic belief in the economic fundamentals of the Irish economy and the strength of the banking system was reinforced by the views of the main international organisations:

- In its review of its performance prior to the crisis, the IMF acknowledged that it "*provided few clear warnings about the risks and vulnerabilities associated with the impending crisis*".

- In relation to Ireland, it noted that, while there were risks arising from an exposure to an overheated property market, it had found that "*Still, as late as mid-2006, an FSAP Update for Ireland concluded that the outlook for the financial system is positive with financial institutions having sufficient cushions to cover a range of shocks and citing the diversification of wholesale funding sources as a strength" (Appendix: Section 4)*[15]

- In its 2006 Economic Survey of Ireland, the OECD states that: "*average prices have roughly tripled in real terms. Most of this increase is justified by the economic and demographic driving forces such as surging incomes, a rising population and changing living habits, with an additional fillip from low interest rates, but prices may have overshot to some extent*".

- In fulfilling its financial stability mandate the ECB systematically monitors cyclical and structural developments in the banking sectors of the euro area to identify any vulnerabilities and check the resilience of the financial system. The ECB did not express reservations about the system or a desire for macro-prudential action. In November 2007, the ECB Financial Stability Report was positive on the general state of the EU banking sector (Appendix: Section 4)

The messages from international macro-economic authorities endorsed a broadly shared perception about the economic fundamentals driving the economy and, in particular, property lending.

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[15] In its August 2006, Article IV Consultation, the IMF Staff Appraisal found "*The general approach of the Central Bank and the Financial Regulator is appropriate for the mature and sophisticated-but still relatively small- financial market.*

A.3. Resources and use of expert advice

The budget and resources applied to supervision was a function of the strategic approach. It was also an area where the FSICP had significant interest and influence. It is extensively recorded in internal records that the provision of appropriate IT services and staff recruitment was a source of considerable friction between the Central Bank and IFSRA.

When I joined the IFSRA Banking Supervision Department (BSD) in mid-2003, I identified a number of structural challenges to be addressed in order to enhance effectiveness and prepare for the most fundamental change in micro-prudential supervision in two decades, coming from the introduction of Basel II.

In the strategic plan for the Department, it is noted that *"The greatest challenge facing BSD over the next three years is the development of expertise in the supervision of credit institutions"*[16]. BSD had suffered in meeting the expanding responsibilities of IFSRA, as senior staff were deployed to other areas. The loss of senior staff was considered to be a major blow and one that impacted significantly on the quality of supervision of licensed banks.

A programme of recruitment and training was undertaken at that time. It was however, an on-going battle to attract and retain staff due to more attractive remuneration packages in the private sector.

IFSRA used external firms to carry out projects in credit institutions when specific problems were identified. These were usually drawn from the major accountancy firms and the costs were borne by the individual credit institution. The information derived from the exercises formed the basis for engagement with the boards and management of the institutions.

A.4. Contrarian Views

It is known within the Central Bank[17] (and recognised by the Commission of Investigation[18]), that I held views contrary to the group-think on property lending that existed in Central Bank & Financial Services Authority of Ireland, (CBFSAI) and was an advocate for direct regulatory intervention.

The formal proposals I made in August 2005, as Head of Banking Supervision, for higher capital charges for high loan-to-value mortgages were not accepted as they were not considered by senior management in the CBFSAI to be necessary. It was my understanding that part of the reasoning was a macro-prudential view that developments in the market could be explained by economic fundamentals.

This view was expressed in a paper published in the Financial Stability Report 2005 entitled 'The Growth in Mortgage Indebtedness in Ireland'. This had *"concluded tentatively that the ability of the*

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[16] Memo of 18 October 2004

[17] Please note the evidence of Professor Honohan on 15 January 2015 when he said "in fairness to some people who have been vilified in the media, they put in those measures". See also section 7.9 of "The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008"

[18] See Footnote 100 of the report of the Commission of Investigation

fundamental driving forces behind the mortgage loan market to account for the actual developments in the real stock of mortgages suggests that, to date, the market is not subject to substantial "excesses''".

In February 2006, in my first days as Prudential Director, I re-presented my proposals to the Authority seeking to introduce capital measures to address high loan-to-value lending; the first time in almost a decade of an exceptional property market that direct regulatory intervention was instigated.

I took these measures immediately on my appointment to signal to the banking industry that the approach to property based lending was changing under the new senior management regime. Taking such measures represented a significant move for IFSRA as it ran counter to principles based regulation. The measures were considered to be of such importance that the Cabinet was to be informed- an action that was unprecedented in the organisation.

It should also be noted that subsequently, the Executive Board of the International Monetary Fund commented on the measures, to the effect: *"The recent increase in the risk-weighting on high loan-to-value residential mortgages is an important signal of the need for banks to differentiate between higher- and lower-risk lending within an asset class"*[19]

The speed of introduction of the measures led to me being rebuked by the FSICP, which considered the lack of consultation as 'regrettable' and 'retrogressive'[20]. Its Chairman wrote directly me to express the concerns of the Panel.

Continuing the drive for change, I advised the industry on 4 May 2006 that IFSRA would consider its approach to residential and speculative commercial property when introducing the Capital Requirements Directive ('CRD').

After significant internal debate in 2006, higher capital charges were agreed for speculative commercial property lending. These measures were the most stringent in Europe. Other measures introduced in relation to buy-to-let mortgages were also considerably more conservative than those that applied elsewhere.

Additionally, in July 2007[21], revised prudential stress testing guidelines were issued to credit institutions on foot of concerns about underwriting standards. These required, inter alia, stress testing all residential mortgages for a 2 per cent rise in interest rates, interest-only mortgages being stress tested on the basis of repayment of interest plus principal and the incorporation of stress testing into bank's credit policy. These measures were important in curtailing further loosening of underwriting standards.

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[19] IMF Executive Board, 7 August 2006
[20] See Minute of the FSICP of 6 April 2006
[21] See letter of July 2007 issued to credit institutions

This fundamental change in approach, which commenced in 2006, was instrumental in slowing down the rate of property lending in a clear and consistent manner (See Appendix: Section 2). Had such actions been the catalyst for a collapse and financial instability, as many feared, it would have given rise to very serious consequences.

This is particularly the case bearing in mind that the public consultation undertaken on the introduction of the CRD, did not produce any material support for such measures. In fact, the responses were mainly critical, with the banks and their representative body expressing the belief that such action was unwarranted and raised the prospect of negative reactions from international investors, rating agencies and market analysts.

B. Banking

B.1 Lending Policy

It is clear from the massive losses incurred that the risk appetite and property-related lending strategies pursued by the Irish banks were inappropriate and that the boards and management had not acted in the manner envisaged by the principles- based regime at the time.

Property-based lending was a key feature of the business model of Irish banks from the mid-1990's with annual mortgages exceeding 20% for most of the decade from 1997.

In the period 1997 to 2001 the Central Bank issued warning letters to banks, at least annually, about the practices in the market. However, the impact of these letters is not evident as rates of credit growth remained high.

The market slowed somewhat in the early 2000 but growth resumed around 2002 and continued to grow at high levels until 2006. The net effect was that between mid-1990s and mid-2000s, Ireland experienced property price appreciation significantly outside international norms.

As Governor Honohan described: *'It was a world-beating property bubble, which took off on the eve of Euro area membership'*[22] [see Appendix- Section 5]

The reasons why the boards and management in banks pursued these strategies will be examined by the Joint Committee with the individuals/organisations involved.

One factor which drove the acceleration from 2003 onwards was the development of the Basel II Accord[23]. This Accord was the most fundamental change in prudential regulation in over two decades and was introduced into the EU by Directive 2006/48/EC (CRD).

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[22] Paragraph 2.4 of 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008'

[23] The capital reductions for property lending were signalled well before the finalisation of the Accord in 2004. The Accord was introduced in Ireland by means of Directive 2006/48/EC and is known as the Capital Requirements Directive.

Inter alia, it signalled a reduction in the amount of capital that banks were required to hold for residential mortgage lending by at least 30% and substantially more for banks that moved to a model based system of capital calculation.

It encouraged property-related lending strategies and led to banks in Ireland and elsewhere substantially increasing this line of business (see Appendix- Section 6). The changes were, for instance, widely considered to be a major contributor to the development of the sub-prime crisis in USA.

In terms of concentration risk, CRD allowed banks considerable scope in taking on large exposures, with banks permitted to have individual exposures up to 25% of their capital and up to eight times their capital in the aggregate value of all large exposures[24].

In terms of sectoral concentrations, the Directive required that banks deal with this in their Internal Capital Adequacy Assessment Process (ICAAP) and set aside appropriate capital to deal with risks arising.

Prior to the CRD, the issue of concentration risk was dealt with in the 1995 Licensing and Supervision Requirements and Standards for Credit Institutions. Within these arrangements banks such as Anglo, which was a property focussed bank from the 1990s, was considered to be diversified based on lending to different economic sectors and through geographical diversification. In early 2003, for instance, just before the establishment of IFSRA, a license was issued to a bank which concentrated exclusively on property based lending, where this approach was quoted as an example of what was acceptable from a supervisory perspective.

In October 2005, requirements were imposed on banks and building societies, as a condition on licenses, dealing with 'Impairment Provisions for Credit Exposures'. These requirements addressed provisioning, credit risk management policies and procedures. They imposed obligations on boards of directors and senior management as well as requiring that the independent functions in the institution (internal audit/risk management) review the credit processes and methodologies[25].

B.2 Funding

Growth and competition in property lending was only possible as long as banks were in a position to fund the liability side of the balance sheet and much has been written about the reasons access to funding was so readily available internationally e.g. accommodative monetary policy, global imbalances, savings glut etc.

Two key EU factors were instrumental in facilitating the growth within the Single Market. First was the introduction of the single currency, which removed the exchange rate risk from borrowing in euro area markets. However, a second crucial development was the programme of EU measures known as the Financial Services Action Plan ('FSAP').

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[24] Directive 2006/48/EC, Article 111 (3)

[25] Credit institutions and mortgage intermediaries were subject to conduct of business regulations. Inspections from 2003 did not produce evidence of widespread reckless lending.

This was the most comprehensive programme of EU reforms in the financial sector ever; it covering the period 1999 to 2007. The strategic objectives behind the FSAP were to bring about;

1. *A single EU wholesale market*
2: Open and secure retail markets
3: State-of-the–art prudential rules and supervision

Providing access to broader and deeper funding sources was a clear objective of the programme and this opportunity was clearly taken by the banks. The opportunity to avail of a wide variety of funding sources within the EU wholesale market was considered to be positive in terms of risk diversification. It was also considered positive in terms of the cost of funding and the rate at which lending could be provided. As mentioned, the IMF, in its Financial Sector Assessment Programme of Ireland in 2006, specifically cited the diversification of wholesale funding sources as a strength.

It is now accepted that the FSAP process and financial integration in Europe was a contributor to the problems experienced. It is recognised that free credit and other capital flows contributed to the build-up of imbalances in the euro area and helped fuel the boom-and-bust cycles observed in several Member States (see Appendix: Section 7).

B.3 Capital Structure and Loss Absorption Capacity

In addition to providing the access to deeper and more liquid markets, as mentioned above the FSAP had, as one of its three key objectives, the development of state-of-the-art prudential rules and supervision. The cornerstone for delivering this objective was the CRD which introduced the Basel II Accord into Europe. It is now broadly recognised that instead of delivering on its objectives, the Basel II Accord/CRD introduced a grossly deficient prudential regulatory system.

It delivered a legal regulatory framework in Ireland and elsewhere that seriously underestimated both the quality and quantity of capital that banks needed to hold and was inadequate to provide a safe banking system.

It failed to provide protection against systemic risk, was pro-cyclical, lowered the level of capital for property-related lending and permitted grossly excessive leverage. Aside from these direct effects, it simply omitted from the framework other areas of risk that materialised when the crisis hit, such as liquidity (see Appendix: Section 8).

In light of what was revealed by the crisis, it has been necessary to completely overhaul the system and to materially increase the level of capital that banks are required to hold. In effect, the equity that a bank is now required to hold is a multiple of what it was pre-crisis, or to put it the other way, the level of equity capital that banks were required to hold in 2007 is a fraction of what is considered prudent today.

At its most simple, the level of capital is now three times the pre-crisis level. However, when the full extent of changes is taken into consideration the difference is even greater. As Mark Carney, Chair of the Financial Stability Board said recently;

"Banks were woefully undercapitalised – many of the largest banks were levered 40 to 50 times. They are now much more resilient. As banking systems around the globe implement fully the new framework, a system that was built precariously on sand will stand more firmly on rock.......... They have more capital, more liquidity and are less susceptible to procyclical spirals. Capital requirements for banks are much higher, as are risk weights and the quality of bank capital. In all, new capital requirements are at least seven times the pre-crisis standards for most banks. For globally systemic banks, they are more than ten times. "[26].

It is absolutely clear that the level of taxpayer support to save the banking system would have been very significantly less had the pre-crisis levels of capital been set at the level that is required today.

The quality as well as the level of capital required was deficient prior to the crisis. New requirements have been set with respect to the types of instruments can now qualify as regulatory capital. This increased level of safety for day-to-day business, is further supplemented with new requirements for Minimum Requirements for Own Funds and Eligible Liabilities (MREL), a requirement for banks to hold certain liabilities that can be bailed-in to cover losses that may exceed a bank's equity.

Comparing the current higher levels of capital required, the higher quality capital needed and the requirement to hold debt to increase loss absorption capacity, with the statutory requirements pre-crisis, presents in stark contrast, the gross deficiency of the regulatory regime in 2007/2008.

C. Crisis Management System and Policy Response

C.1 Inter-departmental contact and the Memorandum of Understandings with other EU states on the issue of banking

Given the shared offices that existed and the nature of the relationship between the Central Bank and IFSRA there would have been a high level of contact between the two organisations, with less ongoing engagement with the Department of Finance.

However, as the crisis evolved, the degree of engagement between all the parties increased substantially, both in bi-lateral engagements and through the Domestic Standing Group (DSG). The DSG was also used as a vehicle for discussion with the corresponding authorities overseas, in particular in the UK, during the crisis. In parallel with such discussions, IFSRA would have had active engagement with supervisory bodies in a number of other jurisdictions throughout the crisis period.

C.2. Liquidity versus solvency debate

From a supervisory perspective these two issues are considered to be very closely related as liquidity issues in banks can quickly give rise to solvency problem and vice versa.

In 2007, when problems initially emerged in global debt markets, the problems centred on liquidity. While funding and rolling over of debt was challenging in Ireland and Europe, the most acute problems were arising in the United States.

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[26] Mark Carney, Governor of the Bank of England ,Chair of the Financial Stability Board, Monetary Authority of Singapore Lecture,17 November 2014

The Joint Committee will be aware that this continued into 2008 and alongside other challenges, created a very difficult systemic environment in banking as well as in many other areas of financial activity. There were improvements in the markets around May 2008 before the acceleration in the problems mid-year.

The solvency of credit institutions was an issue of concern throughout the crisis. It was vitally important to the management of the crisis and was, therefore, subject to ongoing consideration within the CBFSAI. The various audits and other forms of analysis undertaken at that time were suggesting that the banks were meeting their solvency obligations.

END

28 April 2015

Appendix

Section 1- 'The Great Moderation'

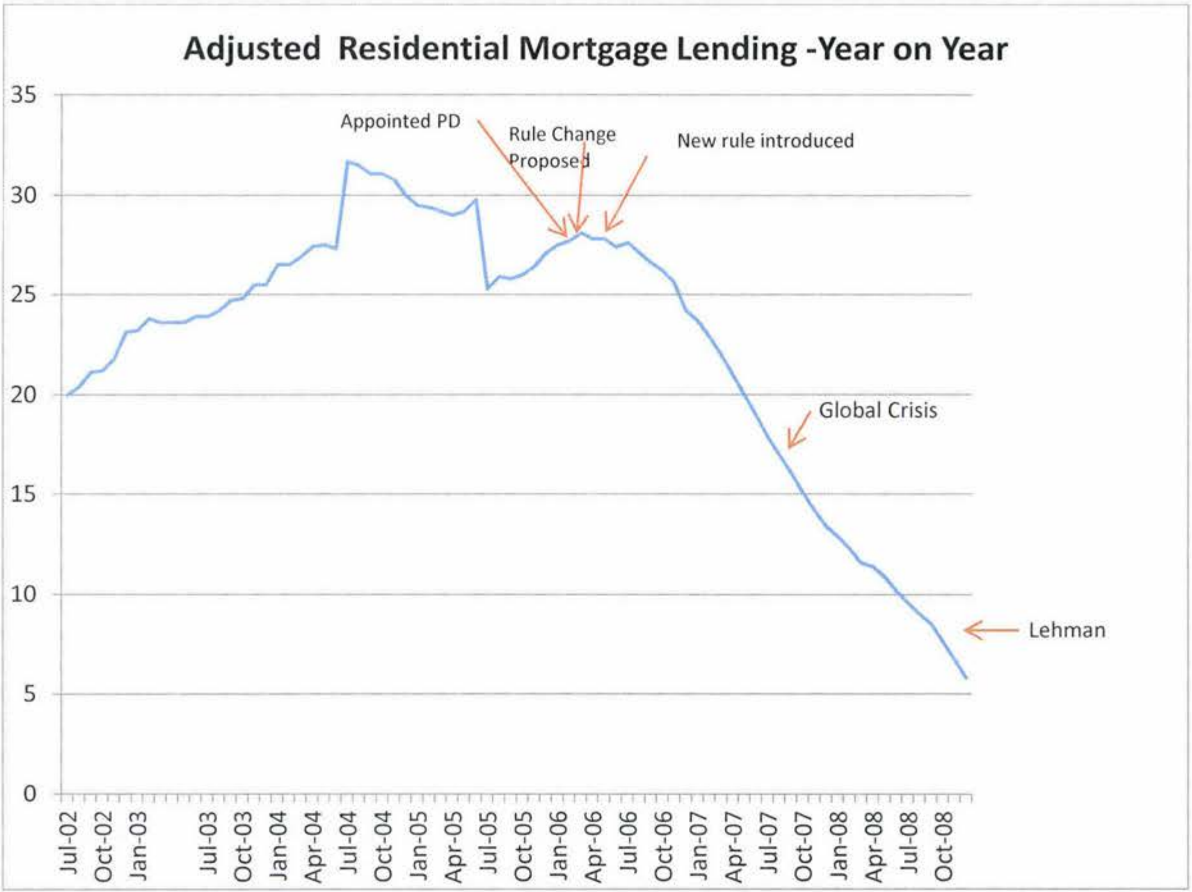
"13 September 2007 will be seen as a red letter day in financial history. It was the date news broke of Northern Rock seeking emergency liquidity from the Bank of England, prompting the first run on a UK bank in over a century. It also fired the starting gun on what subsequently became known as "The Great Recession". That very day, the Bank hosted a conference. In a painful irony, its theme was "The Great Moderation".

The Great Moderation described the long-period of pre-crisis macro-economic calm, with stable growth, stable inflation and stable banks. This view held that central banks, while not eliminating boom and bust, had moderated macro-economic undulations. It also held that financial innovation, while not eliminating risk, had scattered it to the four winds.

As Great Recession abruptly replaced Great Moderation, it was clear a grave analytical and policy error had been made. Economic and financial pride had come before a momentous fall. Nemesis had duly followed hubris. It was the coldest of comforts that this cognitive lapse was shared by the whole economic and policy-making profession"

Andrew Haldane, Chief Economist, Bank of England, Leadership: stress and hubris conference hosted by the Royal Society of Medicine, London 17 November 2014

Section 2- Effectiveness of Measures [From Central Bank: Money and Banking Statistics]



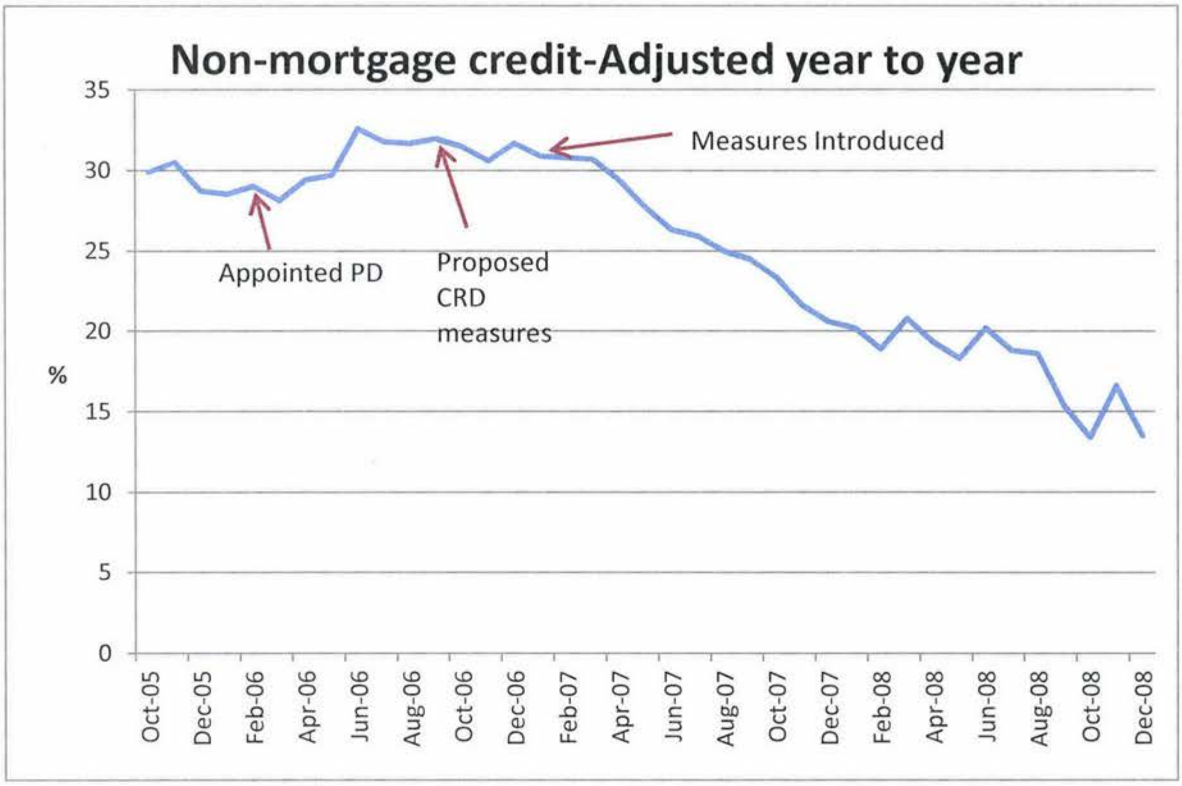
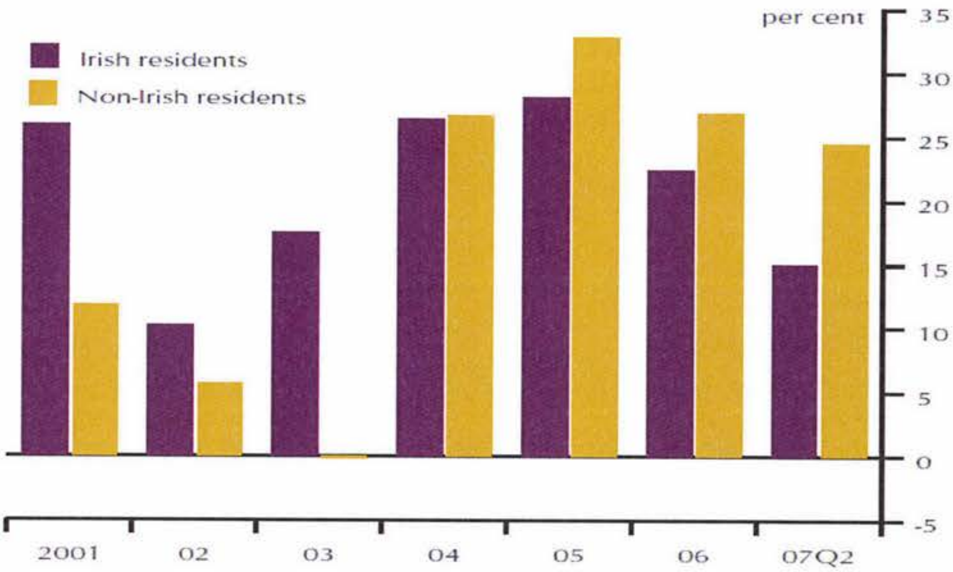


Chart 1: Growth of Irish and Non-Irish Assets



Source: CBFSAI

Section 3- Macro-prudential policy

> *"The objective of macro-prudential policy is to contribute to safeguarding the stability of the financial system as a whole, including by strengthening its resilience and decreasing the build-up of systemic risks, while ensuring a sustainable contribution of the financial sector to economic growth in the medium to long run. More specifically, macro-prudential policy seeks to address both the inherent procyclicality of the financial system (the time dimension of systemic risk) and the risks due to the direct and indirect linkages between financial firms and the distribution of risk (the cross-sectional dimension). This objective differs from that of other policy areas, such as monetary policy, and micro-prudential regulation and supervision. The latter is focused on institutions and ultimately aims at protecting depositors, investors and policy-holders; a distinction which warrants a separate legal mandate for macro-prudential policy."*
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> **'The macro-prudential mandate of national authorities', European Systemic Risk Board, March 2012**

Section 4- Views of International Organisations

"It finds that the IMF provided few clear warnings about the risks and vulnerabilities associated with the impending crisis before its outbreak. The banner message was one of continued optimism after more than a decade of benign economic conditions and low macroeconomic volatility. The IMF, in its bilateral surveillance of the United States and the United Kingdom, largely endorsed policies and financial practices that were seen as fostering rapid innovation and growth. The belief that financial markets were fundamentally sound and that large financial institutions could weather any likely problem lessened the sense of urgency to address risks or to worry about possible severe adverse outcomes."

IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07, 9 February 2011

"OVERALL ASSESSMENT

The further improvement of financial health within the EU banking sector in 2006 and in the first half of 2007 increased the capability of EU banks to withstand shocks relating to their different risk exposures. Nevertheless, banks' growing reliance on more volatile income sources could have made their earnings vulnerable to fluctuations in sources of non- interest income. In addition, the increasing role of non-deposit sources of funding has exposed some banks to liquidity risks that could impair their ability to manage their assets as effectively as they did over the past few of years. While the final impact of the recent re-pricing of credit risk will become evident only gradually, it cannot be excluded that the earnings, profits and funding liquidity of many EU banks will temporarily be negatively affected in the near term. However, solvency positions should remain robust. Beyond the short term, risk concerns focus on the outlook for the credit cycle – which will affect banks' expected losses and impairment charges – and the prospects for interest income from new and existing lending activities, which are related to the changes in interest rates at various maturities.

Pockets of vulnerability in the household and corporate sectors, including the highly leveraged borrowers and – in some Member States – exposure to foreign currency risk, need to be closely monitored. The final implementation of the Basel II Capital Accord this year will improve the banks' risk management practices. Nevertheless, recent events have underlined the importance of continuing attention to be paid on liquidity risk management including stress-testing and contingency funding planning."

ECB Banking Sector Stability Report, November 2007

"Good times are here for the euro area. The economic expansion is solid with GDP growing at an annual rate of 3% in the first quarter of this year and business and consumer confidence running high. Inflation has been stable at around 1.9% since November last year. It also looks like good times are here to stay for some time"

European Commission, Quarterly Report for the Euro Area (Volume 6 N° 2 (2007))

Figure III.1. Real house prices have generally been rising

Nominal price deflated by the overall consumer price index

Source: Table III.4 in the Appendix and OECD, *Main Economic Indicators*.

OECD Economic Outlook, Volume 2005 Issue 2, Recent House Price Development: The Role of Fundamentals

Section 6- Encouraging Property Lending

"When Basel II was published in 2004 banks were informed that the capital weight given to mortgages would fall from 50 per cent (under Basel I) to 35 per cent under the simplified Basel II, and to as little as 15- 20 per cent depending on whether and how a bank would use the sophisticated internal ratings-based (IRB) version. A lower capital weight raises the return on capital for a given mortgage asset, and the corollary of this is that greater concentration in low-capital-weighted mortgages improves the overall bank return"

The Current Financial Crisis: Causes and Policy Issues, OECD, 2008

"In many euro area countries, the growth of banks' mortgage exposures was driven in part by structural changes in mortgage markets – including greater mortgage product diversity – that improved borrowers' access to credit. Moreover, euro area LCBGs' preparations for the implementation of the new capital requirements under Pillar I of the Basel II accord could have provided additional impetus for banks to extend their activity in the mortgage market. For instance, banks may have been encouraged to shift assets in their lending portfolios from lower-rated corporate loans to higher-quality mortgage loans that carry lower capital requirements. Exposures also grew as banks in several Member States aggressively pursued market share."

ECB, Financial Stability Review December, 2006

Section 7- Financial Services Action Plan

"Financial integration in Europe had progressed significantly in the years prior to the crisis, in particular in wholesale markets. The adoption of the euro and, shortly afterwards, the Financial Services Action Plan were major milestones in the integration process. Financial integration brought significant benefits, contributing to the convergence and decline in financing costs and the opening up of investment and diversification opportunities across Europe.

However, the crisis has shown that financial integration - if not backed by the appropriate institutional framework and economic policy coordination - can also carry financial stability risks, especially in a single currency area. Free credit and other capital flows contributed to the build-up of imbalances in the euro area and helped fuel the boom-and-bust cycles observed in several Member States. Many cross-border capital flows turned out in hindsight to be excessive and ultimately unsustainable."

Economic Review of the Financial Regulation Agenda', European Commission Staff Working Document, SWD (2014) 158 final, Brussels 15.5.2014

Section 8- Deficiencies in the Supervisory and Regulatory Framework

- *"The crisis had a number of intertwined causes, which have been analysed in numerous studies. While other factors have played an important role, including global macro imbalances and accommodating monetary policy, the deficiencies in the financial system and shortcomings in the supervisory and regulatory framework are generally considered key contributors to the crisis. Many of these problems were global in nature, rather than specifically European"*

- *The regulatory framework had a number of other shortcomings, which are separately discussed in the subsequent sections. It was funding liquidity problems that triggered the crisis, but liquidity was largely left outside of the regulatory framework. Moreover, the risk weighting system turned out to fuel the natural procyclicality of banking, amplifying the boom and the bust when it eventually occurred. Also, its microprudential focus was ill-suited to take account of the increasing systemic risk*

- *In the run up to the global financial crisis, banks' balance sheets increased significantly, but on a very thin capital base*[1] *. The trend to expand balance sheets prior to the crisis was associated by an optimisation of risk models, suggesting low risks and consequently low required minimum regulatory_capital. The crisis demonstrated not only the insufficient capital to absorb losses, but also the inability of the regulatory ratios to provide timely recognition of emerging bank weakness so as to open the way to early corrective action by supervisors just before the crisis.*

- *Moreover, regulatory capital ratios reported by banks did not reflect their true capacity to absorb losses. The crisis made evident how several elements of what was considered (high-quality) capital to absorb losses did not work out as they were supposed to. For example, debt securities issued by banks that, in principle, should have been able to absorb losses (so called hybrid securities) did not perform as expected. Such securities were counted as capital, because they were meant to reinforce a bank's balance sheet by stopping cash flows from exiting the bank at times of distress. Unfortunately, the possibility to differ [sic] or cancel such payments during the crisis was not used. As a result, governments had to inject massive amounts of public money into banks and provide guarantees in order to maintain essential financial services for citizens and businesses".*

'Economic Review of the Financial Regulation Agenda', European Commission Staff Working Document, SWD (2014) 158 final, Brussels 15.5.2014

- *Unfortunately, as will be explained in the history of Basel II, the important but abstract general interest in effective and efficient banking regulation was subordinated at key moments in the negotiations by commercial and bureaucratic interests"*
- *"In fact, there is some basis for believing that safety and soundness motivation was eclipsed during the Basel II process by competitiveness equality motivation"*
- *"Key features of Basel II include reliance on the internal risk models of large banks to determine minimum capital requirements, the use of external credit-rating agencies to help set capital requirements for most banks, and an overall reduction in the risk weighting assigned to residential mortgages. The irony is inescapable, as the events of 2007 called into question the reliability of risk modelling, the usefulness of external ratings, and the benign view of residential mortgage riskiness"*

Extracts from the book "*Banking on Basel-The Future of International Financial Regulation*", *by* Daniel Tarullo, Member of the Board of Governors of the United States Federal Reserve Board