STATEMENT OF JOHN HURLEY

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Preliminary

The following statement is submitted pursuant to the Direction dated the 2nd April 2015 issued by the Joint Committee of Inquiry into the Banking Crisis and in accordance with format (B) of the protocol in the letter from the Chairman dated the 2nd April 2015.

Introduction

I was appointed Governor of the Central Bank of Ireland on the 11th March 2002 for a seven-year term. I was reappointed for a second seven-year term from the 11th March 2009 but had previously indicated to the Minister for Finance that I would not serve more than a year due to serious health issues experienced near the end of my first term in 2008. I retired as Governor on the 25th September 2009.

Appropriateness of the regulatory regime (R1a)

The regulatory regime in Ireland changed significantly as a result of the Central Bank and Financial Services Authority of Ireland Act, 2003 ('the 2003 Act'). The 2003 Act amended the Central Bank Act, 1942 (referred to as 'the 'Principal Act') in a number of ways, including the insertion of new provisions. Under the 2003 Act there were three principal decision making bodies:

- the Governor for ESCB related functions;
- the Financial Regulator for the regulation and supervision of financial institutions;
- the Central Bank and Financial Services Authority of Ireland for other tasks.

The Central Bank and Financial Services Authority of Ireland (Central Bank) had as one of its objectives the task of contributing to financial stability. The Irish Financial Services Regulatory Authority was established as an autonomous entity within the Central Bank and was given responsibility for prudential regulation. Section 26 of the 2003 Act, inserted new Parts lllA and IIIB into the Principal Act. Part lllA, Chapter I provided for the Financial Regulator. The intention of the 2003 Act was to enable the Financial Regulator to operate with a high degree of autonomy from the Central Bank. The role of the Financial Regulator was the regulation and supervision of financial institutions and the relevant powers of the Central Bank were transferred to the Financial Regulator under Section 33C. The role of the Central Bank was stability analysis of the overall financial system. This division of responsibilities was reflected in the practice of the Bank and of the staff of the Financial Regulator. The Financial Regulator published a separate Annual Report, had its own accountability to the Oireachtas and direct communication with the Department of Finance. The Authority had a separate governing structure with a membership of ten directors, including its Chairman. Section 33C(11) provided that the Financial Regulator was required to perform the functions transferred from the Central Bank on the basis of its own opinion, belief or state of mind.

The Central Bank agreed the content of the Financial Stability Reports with the Financial Regulator. Joint meetings of the Board and the Regulatory Authority were held for this purpose. Regulation, comprising the choice and calibration of actions, was to be applied by the Financial Regulator in the light of the risks identified in the financial stability reports and its own assessments. Guidelines (as contemplated by Section 33D) relating to policies and principles, would only have arisen if the Financial Regulator did not accept that regulation was to take place in that context and as updated at the regular Board meetings. Such a situation never arose.

A Memorandum of Understanding set out the respective responsibilities and the principles for cooperation between the Central Bank and the Financial Regulator.

<u>Effectiveness and appropriateness of the supervision policy and powers and the effectiveness of the use of supervisory powers</u> (R1b, R2a)

The decision to divest the Central Bank of supervisory powers over financial institutions was opposed at the time by the Department of Finance and the Central Bank. An Appendix to the Report of the Implementation Advisory Group on the Establishment of a Single Regulatory Authority for the Financial Services Sector (1999) (the McDowell report) sets out an alternative approach locating the Financial Regulator within the Central Bank and subject to a single board but with significant autonomy within that context. I strongly supported this approach. During the financial crisis the Government reverted to an integrated structure with a single board.

The Regulatory Authority adopted a policy of 'principles based' supervision which was in accord with the philosophy of the time. Such an approach emphasised process and placed primary responsibility on the role of the Boards and managements of financial institutions. It also reflected a shift in emphasis in favour of market discipline. The supervisory framework was favourably assessed by the International Monetary Fund in its Financial Sector Assessment Program report 'Ireland: Financial System Stability Assessment Update' (August 2006, IMF Country Report No. 6/292. However, in the event, in Ireland and elsewhere 'principles based' supervision has not been effective. The crisis showed that the Basel I & II accords were seriously inadequate. They were the internationally regarded blueprints for regulation at the time. Among the main weaknesses were: both the quality and quantity of capital requirements were far too low and liquidity risk was largely ignored. These flaws are addressed in Basel III which includes (for the first time) the promotion of macro-prudential regulation.

<u>Appropriateness of macro-prudential policy</u> (R1c)

The prevailing orthodoxy of the pre-crisis period was that monetary policy, financial stability analysis and micro-prudential regulation constituted a sufficient framework to maintain overall financial stability. Macro-prudential policy was normally referred to as financial stability analysis at the time. It involved the elaboration of risks and vulnerabilities in the financial system and communicating these to a broad range of stakeholders. As was the practice adopted internationally, moral suasion was the main instrument employed.

The failure of the pre-crisis orthodoxy has resulted in a post crisis emphasis on macro-prudential regulation (as distinct from macro-prudential analysis) as an important component of overall policy and constituting a framework with three separate components: (i) monetary policy for price stability; (ii) macro-prudential policy for financial stability; (iii) micro-prudential regulation.

The Central Bank's performance should be assessed on the basis of the orthodoxy which applied at the time rather than on the new framework, which is still being developed and which places much more emphasis on macro-prudential regulation. There were also serious design flaws in EMU which were factors that complicated decision making in the course of the crisis.

Nature and effectiveness of operational implementation of the macro economic and prudential policy (R2b)

On the basis of the information available at the time, the Financial Stability Reports highlighted the risks and vulnerabilities in the Irish financial system. These included in particular:

(a) the high level and rate of credit growth;
(b) the high concentration of loan books to property related business;
(c) the high increases in property prices;
(d) the increasing funding gap.

The Central Bank emphasized that the likelihood of an external shock was growing and the systemic threats to the Irish economy were increasing.

Notwithstanding these warnings the Financial Stability Reports assessed the overall health of the banking system to be sound based on the internationally accepted yardsticks and notably capital adequacy. The Bank emphasized downside risks to the banking sector but it did not foresee the dramatic consequences that flowed from the interaction of the international financial crisis with our domestic vulnerabilities.

The reports from the Nyberg Commission and Regling and Watson suggested that there was a basis for taking some action by about the end of 2005. In hindsight I agree with this view and I consider now that the Central Bank should have escalated and reinforced its warnings on risks. However, at the time the Bank considered that its approach in the 2005 Financial Stability Report was the correct one.

The Central Bank was aware of plans to phase out tax incentives for property. In October 2004 because of the continuing growth in property prices and also the growth of the property sector in the Irish economy, it raised the issue in the Governor's pre-budget letter to the Minister for Finance. The Bank advised that no further extensions should be allowed to the termination date of mid-2006 for the range of tax driven incentives. In the event a review of tax incentives was announced in the Budget in December 2004. The review was completed in 2005 and the Budget in December 2005 announced their phased withdrawal.

The Central Bank was also very much aware that a slowdown in credit growth and property prices was dependent to a significant extent on future increases in interest rates. It was clear to the Central Bank that interest rates would not remain for long at their historic low levels and it made this known to all authorities, to the financial institutions and the general public. The start of a new interest rate cycle could have a strong psychological impact on investors and house buyers. In the Round Table discussion with financial institutions in December 2004 it pointed out that the equilibrium rate for retail mortgages was approximately 6%. While it could take time to reach that level it was twice the then prevailing level. In launching the Bank's Spring Bulletin in February 2005 the Chief Economist gave the same message at the Press Conference. A similar message was given in the Press Conference on the Summer Bulletin in May 2005 with one leading newspaper reporting that interest rates may double. Other media also carried coverage on impending increases. A further message to the same effect was given at the time of the Financial Stability Report in 2005 with again extensive coverage by the media. In the event interest rate rises were later than expected because of changed economic conditions in the Euro area but increased in December 2005 by 25 basis points with six other increases of the same amount in the period between December 2005 and March 2007. Arising from the importance of interest rate rises for credit growth the Central Bank's warnings on prospective rate increases were persistent and strong.

Towards the end of 2005 house prices eased considerably as part of an international trend. Regarding commercial property, as the Nyberg Commission shows (page 19, Fig.2.9) the real price was fairly flat since about 2000.

The Central Bank considered that increases in interest rates were the most effective way of cooling the property market and, with a lag, easing credit growth. In this regard, the exchange rate was also an important factor; the Euro appreciated by 35% and 12% against the dollar and sterling respectively, between 2000 and 2005. The decision of the Minister for Finance to phase out the tax incentives for property was also expected to play a major part. So too were the increases in capital ratios being considered by the Financial Regulator. The Bank considered that this range of measures should have been sufficient to reduce the growth in property prices and credit. In the event there was an unexpected strong reacceleration in house price growth and credit. It wasn't until about the middle of 2006 that evidence of a slowing in house price growth started to emerge. Later in the year, there were the first indications that growth in credit was beginning to ease. Many of the aggregates continued to moderate through 2007. It seemed that the expected soft landing had begun. The delayed response to the measures outlined earlier had significant consequences for the banking sector subsequently.

So far as macro-economic policies are concerned the main stabilization instrument available to the Government was fiscal policy which was governed by the Stability Growth Pact which did not prove effective. As Governor my input to the formulation of macro-economic policy including fiscal policy was made though the bulletins and reports of the Bank, pre-budget letters to the Minister and meetings with the Minister and Taoiseach. I considered utilizing these avenues to be the most effective way of communicating the Bank's views on the economy to the Government.

<u>Composition, skills, experience & number of resources at the Central Bank</u> (R1d)

Following the establishment of the Financial Regulator in 2003, the staff resources of the Bank were divided between the two entities, reflecting the very different functions and expertise requirements of each. A key focus of the Central Bank was financial stability, a function requiring economic expertise. The role of the Financial Regulator related to regulation and supervision requiring accountancy, corporate governance and legal expertise. The division of labour also reflected the fact that under the 2003 Act the Central Bank was neither a co-regulator nor co-supervisor of the financial sector.

When the Financial Regulator was established all staff with responsibility for regulation and supervision were transferred to it including all staff concerned with conducting inspections of financial institutions. No request for funding or resources from the Financial Regulator was ever refused. Virtually all the economists remained in the Central Bank in the Economic Services Department headed up by a Management Board Member who was also the Chief Economist.

The staff complement in the Economics Department in the pre-crisis period was around 90 of which two thirds were economists. During the same period the complement in the Financial Stability Unit varied from 10 to 14 of which 8/9 were economists. However, this significantly understates the resources devoted to financial stability. Economists in other Departments e.g. Economic Analyses, Research and Publications were also significantly involved, for example, in analysis relating to house prices and housing output, competitiveness and certain aspects of stress testing. The Payment and Securities Settlement Department was responsible for payment systems, a crucial aspect of financial stability. This significant involvement outside the Financial Stability Unit is evident from the signed articles published in the FSRs and Bulletins. The Bank continued it's previous approach during this period regarding the recruitment of high quality post-graduate economists with a strong emphasis on Masters and PHD degrees.

The services of the Economic Department were available as required to the Financial Regulator and the Memorandum of Understanding between the two entities so provided.

Adequacy of the assessment and communication of both solvency and liquidity risks in banking institutions and sector (R2c)

Liquidity

The creation of the Euro facilitated foreign borrowing by Irish banks in the newly integrated interbank money market of the Euro Area. This provided a new source of funding at low rates of interest and with no exchange risk. However, it enabled private sector indebtedness to increase markedly. Attempts to influence the flow of external funds into Ireland would have amounted to capital controls which would have been inconsistent with monetary union.

The prevailing view at the time was that such financial integration within the Euro Area was positive for financial stability. The risks associated with increased foreign borrowing by banks i.e. a sudden shock constraining the supply and/or price of such funding, was emphasized in a number of Financial Stability Reports. The benefits of financial integration was also recognised in international assessments of the Irish economy. For example, in its 2006 report "Ireland: Financial System Stability Assessment Update" the International Monetary Fund states at paragraph 27/page 17 under the sub-heading "Strengths and Vulnerabilities: Institutions and Markets" that 'offsetting to some extent the liquidity risks arising from relatively high reliance on wholesale funding by the Irish banking system, the funding has become increasingly geographically diversified. Also, Irish banks' funding needs are small relative to the size of the liquid Euro market (where much of the funding is raised) and any shocks that might occur would be more likely to result in some increase in funding costs rather than significantly reduced access. Finally, the maturity mismatch of funding and loans has not changed significantly over the last five years and Irish bank liquidity asset levels are good.'

The assessment of liquidity risk was a function of the Financial Regulator. When the liquidity crisis struck the Central Bank became involved because of its own responsibilities in relation European Central Bank liquidity.

Throughout the crisis arrangements were put in place to ensure that information on the liquidity position of each of the banks was readily available and circulated to members of the Domestic Standing Group.

Solvency

After the enactment of the 2003 Act the assessment of the solvency of individual financial institutions became a function of the Financial Regulator.

The Financial Stability Reports 2004 to 2007 set out the Central Bank's analysis of the risks and challenges facing the banking sector in Ireland. The overall assessment was that, despite a number of substantial risks, the health of the banking system appeared generally sound according to the standard indicators of financial health. The subsequent serious problems in the banks reflected the fact that - as with other central banks, international institutions and private sector economists, (both domestic and international) - the Bank expected some international slowdown but it did not expect the worst reversal since the 1930s. Neither did it expect that this would combine with our domestic vulnerabilities, including poor risk management practices, in the way it did to create such a critical situation for Ireland.

In a succession of reports, publications and public statements, the Bank had emphasized the vulnerabilities present in our economy, including the danger of an external shock. In the event these vulnerabilities turned out to have been underestimated in the face of the unprecedented world-wide crisis. In hindsight the response of the Central Bank and indeed all other agencies would have been more robust if it had foreseen the scale of events that were to unfold.

The Financial Stability Assessments were made in the context of very favorable domestic and international forecasts. The IMF, OECD, EU and the BIS and the leading central banks, including the European Central Bank and the Federal Reserve, were forecasting strong international growth at the time. Based on this international background, other key economic domestic forecasters, including the Department of Finance and the Economic and Social Research Institute, as well as the banks and stockbrokers, were predicting a continuation of strong economic growth here for a number of years to come.

In addition, the assessments made by the International Monetary Fund both in its Article IV reports and in its 2006 Financial System Stability Assessment Update on Ireland, were quite positive. The International Monetary Fund concluded in 2006, following its stress testing of Irish banks that the banks could cope with substantial falls in property prices.

At the time, Irish banks were among the top three countries in the EU whose banks were rated B or higher by Fitch. In 2006 an OECD report stated that although house prices had risen faster than in any other OECD country and might have overshot fundamentals to some extent, this did not imply that they would fall significantly. As late as 2008 they stated that the rise in property prices was largely driven by higher incomes and demographics and that the Irish banks were well capitalised and profitable and should have considerable shock absorption capacity. Given their cross-country perspectives and their experience of crises, the Central Bank regarded the views of the OECD as very important.

The dramatic drop in asset values which eventually gave rise to insolvency came much later.

Awareness and clarity of the roles and accountability amongst the regulatory and supervisory institutions of the state (R3a)

The roles and responsibilities of the Central Bank and the Financial Regulator were clearly prescribed in the 2003 Act and are set out above. Six members of the Regulatory Authority were also members of the board of the Central Bank and participated in consideration and discussion by the Board of all papers and reports on the domestic and international economic situation and outlook at the Boards monthly Meetings.

The Financial Stability Committee comprising representatives of the Central Bank and the Financial Regulator was the main forum at which financial stability issues were examined and draft financial stability reports finalised. The draft reports were subsequently considered by me at meetings with the personnel concerned before they were presented to joint meetings of both boards where they were discussed, usually over two meetings, and agreed. These arrangements were fully endorsed by both entities.

Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the banking institutions (R3b)

The relationship between the Central Bank and the individual banks changed fundamentally as a result of the 2003 Act. The main relationship shifted from the Central Bank to Financial Regulator. Contacts between the banks and the Central Bank subsequent to the enactment of the 2003 Act reduced dramatically and became confined mainly to ad hoc contacts on economic matters and round table discussions on Financial Stability Reports and also on operational matters. After the emergence of the liquidity crisis the Central Bank's decentralised role in ECB liquidity operations intensified and it had much more operational contact with the banks subsequently.

Effectiveness of the communication between the Central Bank and the Department of Finance (R3c)

The Bulletins and reports of the Central Bank including the Annual Reports and the Financial Stability Reports were an important means of communication by the Central Bank with the Department of Finance. These were augmented by (i) regular meetings between the Minister for Finance and the Governor and regular pre-budget letters (ii) the presence (ex officio) of the Secretary of the Department of Finance on the Board of the Central Bank (iii) contacts on day-to-day issues between officials of the Department and the Bank.

Dialogue with the Department of Finance at official level became more structured following the establishment of the Domestic Standing Group. Its role assumed increased importance from the beginning of 2008 as the international impact of the liquidity crisis began to take stronger hold. Contacts were not, however, confined to the DSG. Contact at the most senior levels was frequent and this increased as might be expected as the crisis developed post Lehmans.

The communication between the Bank and the Department of Finance was conducted on the basis of the assessment of risks by the Central Bank pre-crisis. It was based on its evaluation of information available and in the absence of the knowledge which subsequently emerged on the weak risk management practices in the individual financial institutions.

Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used (R4a)

When I returned to the Central Bank in mid-September 2008 I was informed that expert advice had been sought by the Department and the Financial Regulator in relation to a number of issues. An expert view was sought on the loan books of financial institutions. International expert advice was also sought in relation to actions that might be taken to help resolve the crisis for Irish banks.

In the circumstances the advice sought was necessary. Given the dramatic deterioration in the financial climate over August/September 2008 an outside assessment of the financial institutions was considered essential. A broad view of the handling of financial crises at that time by international experts was important for decision-making.

As regards the quality and effective ness of the advice received, the various reports did not foresee-in common with most others- the unprecedented decline in asset values that occurred over time and their implications for the banks. It was important to have the advice of experts with experience of crisis resolution in other countries. This was intended to ensure that all feasible options were identified. It should be acknowledged that the reports had to be completed at short notice in view of the speed of the crisis.

Analysis and consideration of the response to contrarian views (internal and external) (R4c)

The Nyberg Commission states that domestic doubters were few, late and usually low key. Most contrarians did not predict a sudden drop in prices. While they identified overvaluation most did not conclude that it would have major implications for the banking sector. However, they did point to potentially serious economic and fiscal fallout.

At any point in time there was a range of views on the likely evolution of the property market including the potential overvaluation of property. The Central Bank took account of all views and together with its own analysis came to a conclusion on the most likely outcome while at the same time setting out the risks that might make for a more negative result. In hindsight, the scale of the risks were immeasurably greater due to the range and extent of the international economic downturn and were not foreseen by any other domestic or international institution.

I was not aware of contrarian views within the Central Bank, which differed in substance from the Bank's overall assessment. Views, which set out a different risk assessment, were not made known to me or to the Board in my presence. Signed articles by various economists in the Bank in the Financial Stability Reports, Quarterly Bulletins etc. do not give any evidence of contrarian views. I was at all times open to the receipt and consideration of all views. As Governor I fostered and welcomed open discussion. In Board discussions, as is normal, there were varying views expressed from time to time. A clear consensus always emerged after careful consideration of issues.

Formulation and reaction to crisis simulation exercises (C1b)

Crisis simulation exercises were formulated on the basis of a crisis in a single financial institution in Ireland or a single European institution with some cross border links. The exercises either in Ireland or in Europe did not envisage the scale of the economic and financial shock which eventually occurred and in Ireland's case that the entire financial system would be threatened.

Despite this, the exercises were very useful in a number of respects. Examples included the following:

1. the importance of having up-to-date data on the liquidity position of financial institutions ;
2. the necessity to maximize the potential draw down of liquidity from the ECB through early organization of assets;
3. the importance of having all procedures in place to enable Emergency Liquidity Assistance to be provided including what collateral to accept and on what terms, legal documentation and solvency assessment by the Financial Regulator.

Appropriateness of the Bank Guarantee decision (C3b)

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I returned to the Central Bank shortly after the collapse of Lehmans on the 15th September. I had a telephone discussion with the Minister for Finance before my return regarding the worsening international financial situation and its impact on the Irish banking system. I was also briefed by staff in the Central Bank on the deteriorating liquidity situation. When I returned to the Bank, international financial markets were extremely turbulent and liquidity provision by the ECB was increasing significantly. One bank, Anglo, was very seriously affected while other banks were also experiencing increasing outflows. If outflows continued on the scale being experienced it would only be a matter of time before the Irish financial system was threatened.

Following discussions in the Department of Finance, the deposit guarantee limit was increased and a strong statement of support from the Minister of Finance was issued confirming the Government's commitment to the Irish financial system. Consideration was also given around this time to the desirability of guaranteeing the liabilities of the banks. While I did not support such a guarantee when it was first raised, I was conscious that if matters deteriorated significantly and the Irish banking system faced imminent collapse there would, in the absence of a European initiative, be no choice but to do so. This matter was discussed subsequently at joint meetings of the Boards of the Central Bank and Authority and it was accepted that such an approach could be necessary in the light of the liquidity pressures.

In meetings held during the weekend before the guarantee decision. it appeared likely that the financial institutions would have sufficient liquidity to get through the following week. The liquidity outlook changed quickly on the morning of the 29th September when it became clear that without assistance Anglo would not be able to open for business the following morning. As a result of contacts with the ECB, it was the view at the time that an overall European initiative of which Ireland might be part was remote and that any decisions in relation to Irish banks would fall to be made by the Irish authorities. The Government was expected to stand behind its banks and a Lehman-type situation was to be avoided.

When the Anglo situation arose the major concern was how to prevent contagion from Anglo spreading to the other banks, which were not then illiquid but had and were experiencing significant outflows. Arrangements for the provision of assistance to Anglo had already been made in the Central Bank and the necessary letter of comfort from the Minister for Finance was subsequently received. Emergency Liquidity Assistance (ELA) was extended to Anglo overnight to enable it to open for business on the morning of the 30th September. The bigger issue was how to avoid the risk to the entire banking system materialising with catastrophic consequences for the entire country. Without decisive intervention the risk of such an eventuality was very likely. I supported the guarantee in these circumstances.

The question of Emergency Liquidity Assistance (ELA), at national risk, for an Irish bank had been under consideration since the Northern Rock crisis in 2007. The granting of ELA to Northern Rock and its becoming public had undermined public confidence in the bank, increased panic and gave rise to a bank run that eventually required nationalization as well as guarantees by the U.K. Government. All the necessary arrangements, including the identification of the non-ECB eligible collateral in the banks and the legal arrangements for their transfer to the Central Bank had been made. The roles of the Minister for Finance and the ECB had been fully taken on board. The real concern in relation to ELA was the potentially serious effect it might have on a financial institution where market confidence had already been shaken and the risk of contagion to other financial institutions. The provision of ELA was not seen as a solution to the systemic crisis that had arisen.

The additional funding for Anglo agreed with AIB and the Bank of Ireland in the context of the guarantee decision was designed to mitigate the risk of negative market reaction with severe consequences for the credibility of the guarantee for the other banks if liquidity flows into Anglo did not materialise in sufficient quantity. At the time none of the other banks was illiquid and required ELA.

The option of nationalising Anglo together with issuing a guarantee for the remaining banks was considered on the night. Overall it was considered that the signal effect of nationalising Anglo would be more negative than positive and could raise market concerns about the systemic weakness of the Irish financial system and, as with ELA, threaten the credibility of the guarantee.

There was a strong view on the night that the Government had one opportunity to assuage the markets. If the decisions taken were considered inadequate and failed the consequences for the banking system would be devastating and lead to very serious economic and social fallout for the country as a whole. I supported the decision taken as being the one most likely to ensure that these consequences for the banking system and the country would be avoided.

John Hurley

April 23, 2015