# Joint Committee of Inquiry into the Banking Crisis

## Statement by Patrick Neary

## 28 May 2015

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Good morning Chairman and Members of the Committee.

My name is Patrick Neary and I held the position of Prudential Director of the Irish Financial Services Regulatory Authority from 1 May 2003 until 31 January 2006 after which I was appointed to the position of its Chief Executive from 1 February 2006 until 31 January 2009. Before I begin my statement, I would like to say that, with hindsight, the supervisory measures taken by the Authority, which I will be outlining in this statement, were not sufficient to meet the challenges posed by the crisis and the recession that emerged and I am deeply sorry for that.

The Authority, from the date of its establishment on 1 May 2003, initially referred to itself as IFSRA, an acronym of its official name "The Irish Financial Services Regulatory Authority" but after the first two years of its operations rebranded itself as "The Financial Regulator". It used this name in its publications and public references. Despite the fact that it had its own Board and staff and was a constituent entity within the Central Bank, the use of its new name over time affected its standing with the public, as the impression was created, through the press and public representatives, that the Financial Regulator was an individual. I wish to correct this. The Financial Regulator was not an individual and any reference to an individual as the financial regulator is simply wrong.

The content of this statement addresses the fifteen themes and lines of inquiry to which the Committee has requested that I respond. It also describes the various regulatory actions and initiatives taken by the Authority over the period up to end 2008, such as higher capital requirements; new liquidity requirements; new requirements for impaired loans; new fitness and probity tests; new consumer protection requirements; better regulation policy; and oversight by the IMF and OECD. I will begin with the regime of prudential supervision.

**Prudential Supervision**

The Central Bank Act, 1971 first established the prudential supervision of banks in Ireland. The primary purpose of prudential supervision is to safeguard, as far as possible, depositors in banks. In fact, no prudential supervision of any entity involved in lending activities is required if that entity does not also take deposits.

The approach to supervision by the Authority derived from EU banking supervision legal requirements. The Authority's approach, in the same way as that of other country's banking supervisors, was subject to ongoing best practice review and external assessment by international bodies such as the IMF and OECD. These agencies benchmarked, in detail, the Authority against a framework of principles entitled "Basel Core Principles for Effective Banking Supervision". The conclusions of all these assessments by these independent expert bodies in relation to the Authority were very favourable, such as would indicate that the approach of the Authority was at least as good if not better than other authorities reviewed by those agencies.

The five key constituents of the Basel Core Principles which are fundamental to the prudential supervision of banks are referred to as the CAMEL principles—Capital adequacy; Asset quality; Management; Earnings ; Liquidity.

A bank's capital is the ultimate protector of depositors and there are international rules setting minimum requirements for all banks which have been enshrined into EU and Irish law. It provides the cushion to absorb losses that arise in the loans made by a bank. EU law requires that an EU bank must hold a level of capital to a value of at least 8 per cent of the value of its risk assets.

I would like to make the following observations here:

- All loans made by a bank have a risk weighting attached to them to determine its total risk assets;

- Loans to EU Governments attract a zero per cent weight, meaning, under EU law, a bank has to hold no capital whatsoever in respect of these loans; put differently, it is assumed by the law that these loans will not default—this practice continues today;
- Loans to other EU banks with a maturity of less than one year attract a 20 per cent weight, which may go some way to explaining the attraction to EU and international banks of funding the activities of Irish banks during the boom period.

Recognising that the EU legal requirements were minimum standards, the Authority required the Irish banks to hold capital within a range of 8.5 per cent to 11 per cent of risk weighted assets.

On 1 January 2007, the Capital Requirements Directive, commonly known as Basel 2, came into effect. This directive afforded supervisory authorities some discretion to tailor capital requirements to reflect national circumstances. Using this discretion, the Authority introduced a more stringent capital regime for property transactions to counter the growing exposure of Irish banks to the property sector. I am not aware of any other instance where an EU banking supervisor imposed tougher requirements on their banks than the basic minimum requirements of Basel 2.

At the requirement of the Authority, the Irish banks were subject to much higher capital requirements than the EU demanded, for instance:

- Basel 2 assigned a risk weighting of 35 per cent for residential mortgages irrespective of the loan–to-value of those mortgages; the Authority set a 75 per cent weighting for such loans by Irish banks having a loan to value ratio in excess of 75 per cent;
- For residential investment mortgages, Basel 2 also assigned a risk weighting of 35 per cent; the Authority made the entire loan subject to a weighting of 75 per cent;
- Basel 2 allowed a 50 per cent risk weighting for secured commercial real estate; the Authority required 100 per cent;

- Basel 2 applied a 100 per cent weighting to speculative real estate loans; the Authority demanded 150 per cent.

Staying with residential property, the Authority's decisions reflected the economic and growth forecasts from the Central Bank which it was obliged to follow. These predicted a soft landing and if that prediction had been fulfilled, there would not have been a banking crisis. In mid-2007, the Authority introduced a number of additional supervisory requirements on the banks as a response to the strong appetite for credit for residential property purchase:

- Stress-testing of individual mortgage applications to gauge repayment ability at a level 2.75 per cent above the ECB rate;
- Introducing the Consumer Protection Code with measures to address aggressive lending including suitability;
- A ban on pre-approved credit; and
- Obligations to engage early with customers in arrears.

Eleven separate press campaigns were carried out in relation to debt as well as numerous interviews and published articles. I have to stress that these were the minimum standards expected of banks. The Authority did not run the banks and these minimum standards did not excuse the Boards from their duties to set appropriate policies.

In July 2005, well before the crisis in financial markets began to take hold, the Authority imposed new conditions on the licences of the Irish banks in relation to credit risk management policies and procedures which required each bank to have specified arrangements in place to monitor and control credit risk, with particular focus on impairments and provisions. Each bank was obliged to comply with International Financial Reporting Standards and was obliged to advise the Authority of deterioration in the credit quality of its loans. These reports formed part of the quarterly statutory returns submitted by each bank to the Authority and never indicated deterioration in loan quality. It is worth mentioning in this context that it is an offence to submit a false return to the Authority.

In line with Basel supervisory best practice and corporate governance codes, the Authority required that all appointments to the Board of a bank and any of its subsidiaries should be subject to its approval. This was to ensure that all directors of a bank, both executive and non-executive, and later, Heads of all business critical functions, should be fit and proper persons with the necessary competence and experience in banking to contribute to the proper running of the bank. A final framework was introduced by the Authority in January 2007 and applied to all new appointments from that date. Existing persons were "grandfathered" under the new arrangements.

In January 2007, the Authority imposed new liquidity rules by way of conditions on the licences of the Irish banks. This made Ireland a leader in Europe in introducing a forward looking system of liquidity management. Ireland was the only EU country to have updated its liquidity requirements in advance of the liquidity crisis. The reporting frequency was increased from monthly to weekly reporting in August 2007 to coincide with the onset of the international liquidity crunch.

In relation to all of the foregoing, I should mention that the OECD in its "Economic Survey of Ireland 2008", commented that the Authority had introduced the new consumer code to limit the scope for predatory lending practices and introduced a forward looking liquidity regime just before the international financial market turmoil struck.

**Regulatory Strategy**

The Authority adopted a "principles led" approach to supervision from its inception in 2003, which essentially placed Boards and Management of banks at the centre of responsibility for the prudent conduct of business. The Authority was legally obliged, at least 3 months before the beginning of each year, to prepare a strategic plan and submit this plan to the Minister of Finance. The plan had to specify the objectives of the Authority for the financial year concerned, the nature and scope of the activities to be undertaken and the strategies for achieving these objectives. As soon as possible after receiving this plan, the Minister had to arrange for it to be laid before both Houses of the Oireachtas. When this had been done, the Authority was required to publish the plan and take all reasonable steps to implement it. So, to reiterate, the process was Authority, Minister, Houses of the Oireachtas. The principles-led approach was thus not the sole decision of the Authority. This approach to supervision was followed by all EU countries. The USA is the main proponent of rules-based regulation but this did not protect it from issues with Bear Stearns, Lehman Brothers, AIG, Wachovia and others.

The strategy also set down the objectives of the Authority. One of its objectives was that its regulatory approach would facilitate innovation and competitiveness. It is clear that both of these elements played an important part in the increased availability of credit in Ireland in the years before the crisis, through a combination of more banks entering the market and more innovative types of lending products being developed.

To have taken measures to stifle these developments would have conflicted a fundamental strategic objective of the Authority as mandated by the Minister and the Oireachtas.

In January 2004, a white paper entitled "Regulating Better" was issued by Government to improve national competitiveness. The paper called for wider consultation and more regulatory impact assessment on any new regulations. This illustrates the context in which all supervisory initiatives of the Authority required extensive consultation with a wide range of what were termed "stakeholders"-

-Govt. depts., representative bodies, the Industry and Consumer Panels, banking schools in the Universities. Detailed regulatory impact analysis was extensive. In fact, the Authority also put in place an arrangement with industry called the "Stakeholder Protocol" with enshrined time commitments by the Authority to respond to industry requests for regulatory approvals, issuance of the findings of inspection reports etc. I can understand that initiatives such as this formed a perception of the Authority as a "can do" entity, willing to prioritise industry demands rather than appearing more detached and discerning. This is something which I believe, in hindsight, the Authority got wrong.

In September 2006, the Government published a review of the future of the financial services industry in Ireland entitled "Building on Success". I want to bring two items from the report to your attention:

i. The paper asserted a growing awareness in both Ireland and Europe that poor quality or unnecessary regulation could be a barrier to competitiveness and growth and such regulation could alienate citizens and enterprises through imposing disproportionate compliance costs.

ii. The paper did not propose any increased prudential supervision or suggest a tougher, more burdensome regulatory regime.

The growth in private sector credit arose mainly from the appetite for property acquisition and associated construction activity. This expansion in these areas was due to a number of factors including strong economic growth, an increase in the level of household formation, very low interest rates, lower personal tax rates, a vast range of tax incentives for property investment, the desire of Irish people for property ownership, a "feel-good-element" generated by increasing property values which quickly seasoned loan-to-value ratios, and all supported by readily available bank loans. A further and extremely important factor was the consistent pattern of very positive economic commentary in relation to the performance and prospects for the economy and the property market from the Economic and Social Research Institute, the Central Bank and the Department of Finance.

In formulating its strategy, the Authority always took full account of the output of these authoritative sources, which predicted that the Irish economy would continue to show growth above the EU average and that the property market would experience a soft landing. The Authority relied on the Central Bank which maintained an economic services division with 86 staff, including a dedicated Financial Stability Department, to monitor and assess the overall health of the financial system; there were no economists in Banking Supervision Department. Had these predictions held, there would not have been a bailout.

I do not think, even with the benefit of hindsight, that the Authority, in the context of the time, would have assumed a different approach to supervision. I have come to this conclusion bearing in mind the following:

- The capital requirements in Ireland were higher than the EU demanded;
- The absence of any strong views from the financial stability perspective that a more draconian regime of supervision was warranted;
- The fact that the introduction of a tougher supervisory regime in Ireland compared to other jurisdictions would have conflicted with Government policy to promote the strength and profitability of the financial services industry in Ireland and its attractiveness as an international financial services location.

**Powers of the Authority**

The Central Bank Act, 1971 introduced a limited range of statutory powers for the prudential supervision of banks and the 2003 Act gave the Authority the power to impose administrative sanctions for breaches of specified regulatory requirements.The Authority approved the introduction of the new regime from 1 July 2005 and began to codify the new arrangements. In the case of Banking Supervision Department, priority was given to codify elements related to breaches of requirements enshrined in law and elements relating to the conditions on banking licences such as capital ratios, liquidity and impaired loans. A substantial part of the project-to codify governance and professional behavioural items- made little progress as scarce resources were deployed to meet legally bound commitments such as the implementation of Basel 2. While there never was any reluctance to press ahead with this work, comfort was taken that the well- established prudential regulatory relationships would be effective as an interim measure in managing these governance and professional behavioural items.

**Resources**

Questions have been rightly asked in relation to the number, skill set and experience of resources devoted to the supervision of banks. As mentioned in the Honohan Report, staff numbers in the banking supervision department increased marginally from 44 at end 2005 to 48 at end 2008, and were allocated in teams to supervise portfolios of banks. Apart from considerable day-to-day contact with their respective banks, staff in banking supervision carried out over 50 inspections of banks between 2003 and 2008.

The Authority had approved higher staff; however, the HR Department of the Central Bank, which performed recruitment activities on behalf of the Authority, experienced difficulty in attracting persons with banking experience to the department. This reflected constraints on salary levels available to public servants and very strong salary competition for such persons in a market operating at a high level of economic activity. I agree with the conclusion in the Honohan Report that the Authority did not have the mix of skills necessary for a more intrusive style of supervision. The difficulty in attracting new staff with good experience in banking and the rapid pace of evolution of the new regulatory directives which had to be implemented, stretched existing staff to the limit to both engage in ongoing supervision work while at the same time having to maintain training programs for newer staff transferring in from other departments in the Authority. There is little doubt that staff were stretched very thinly in banking supervision and thus the capacity to react to the unfolding crisis was made more difficult.

I would like to take the opportunity to note the dedication displayed by the staff of the banking supervision department and the long hours worked during the period before, during and after the crisis.

Notwithstanding the above, it would be overly simplistic to single out the level of penetration of banking supervision staff into systems, practices and governance arrangements of the banks as a single major element in the banking collapse. The contact between supervision staff and their bank counterparties had been in place for many years and was useful in sourcing data and solving issues as they arose. I believe this remains the approach taken by the Central Bank today. Let us not lose sight of the fact that the primary responsibility resided with the banks themselves who were best placed of all to assess their own risks and business models, to strike the right balance between their risk and reward and have skilled, responsible people in place.

Again, by way of hindsight, I would accept the view that the Authority, as well as focussing acutely on the key prudential supervisory fundamentals I set out earlier in this statement, could have had more regard to the systemic risk that was accumulating in the banking sector and whether it was being adequately quantified and assessed. Within the Authority, and consistent with its mandate, there was the belief that the discharge of its obligation to contribute to financial stability would be achieved by adherence to the prudential fundamentals. The Authority relied on the Central Bank's work on financial stability to identify, monitor and assess risks and to be proactive in providing a choice of possible remedies which would be implemented by both the Central Bank and the Authority to mitigate these risks.

In hindsight, this approach was flawed and I believe now, that a clearer, more direct and specific allocation of responsibility for the oversight of financial stability within the organisational structure of the Central Bank would have been more appropriate.

A stricter, well defined allocation of such responsibility may have facilitated a move away from a supervisory approach grounded on point-in-time facts towards an approach grounded on an assessment of the future. Instead, the main sources of data for the Authority were the quarterly prudential returns and weekly liquidity reports provided directly by the banks as well as the ongoing regulatory engagement by the banking supervision staff. It is clear now that this was not sufficient.

It is important to note that whilst these data submissions and the more regular touchpoints between senior executives of the banks and the Central Bank and the Authority pointed to concerns about access to liquidity, there was, at no stage, any indication of difficulties with solvency.

Moreover, major work by Authority staff on the internal arrangements in banks for risk assessment mandated by preparations for the implementation of Basel 2, revealed no matters of concern in relation to asset quality. As you are aware, these are demanding global standards, yet, to reiterate, they revealed no matters of concern in relation to asset quality.

It is also worth noting that the annual loan reviews required to be carried out by senior bank management in advance of the publication of their accounts and their presentation to shareholders and ratings agencies and which in turn were subject to audit oversight did not bring to light any significant pattern of impairment across the loan portfolios of the banks. Regular stress testing carried out both by the Central Bank and the banks themselves, using a range of shock scenarios and adverse economic assumptions, did not identify concerns relating to solvency but rather went some way to confirming the robust nature of the banking system.

**Relationship with Department of Finance**

The relationship between staff of the Authority and officials of the Department of Finance, while cordial, was highly professional with both sides being highly conscious of their duty always to act in the public interest. Engagement took the form of regular meetings of the Domestic Standing Group as well as frequent and ad-hoc meetings and correspondence to do with regulatory strategy, funding and implementation of the EU financial services action plan. No request for a meeting or assistance by the Department was ever declined. At senior level, the Chairman of the Authority held periodic meetings with the Minister—on average twice a year – while the Governor had more regular engagement with him. The Secretary-General of the Department was an ex-officio member of the Board of the Central Bank and in that capacity had access to all economic and supervisory information available within the overall organisation.

**Professional Advice**

The Authority obtained professional advice and analysis from PWC in relation to the financial condition of each of the banks at the time of the guarantee, which work enabled the joint confirmation by the Governor of the Central Bank and the Chairman of the Authority on 18 November 2008 that each bank was in excess of its minimum solvency requirement as of 30 September 2008. I am unable to comment on the degree to which this assessment remained valid, and to what extent, into 2009 and beyond as my retirement as Chief Executive of the Authority had taken place by that time.

**Statutory Auditors**

In relation to information and reporting from statutory auditors, all banks received unqualified audit reports throughout each of the years before the crisis and I am not aware of any instances where supervisory issues uncovered by the Auditors were escalated to the Authority.

**Domestic Standing Group**

In July 2007, an MOU was put in place between the Central Bank, the Authority and the Department of Finance to establish a committee, called the Domestic Standing Group to help in the management of financial stability issues and to prepare to handle a financial crisis. Frequent and regular meetings of the group were held and a number of workstreams emerged, dealing with emergency liquidity, deposit protection, draft legislation for nationalisation/transfer of ownership of banks as well as the updating of a manual to be used in the event of a crisis. As the crisis deepened the Department of Finance retained consultants to assist in preparations to nationalise a bank/building society and work to determine to what extent there may have been a need for further capital injections to meet market expectations. I see no reason to call the adequacy of the DSG process into question. Its operations meant that that many issues that could arise in a crisis were identified and examined and several initiatives relating to emergency liquidity arrangements, draft bank resolution legislation and capitalisation of banks were undertaken.

**The Bank Guarantee Decision**

At around 5.30pm in the evening of 29 September 2008, I accompanied the Chairman of the Authority to the Department of An Taoiseach. We joined a meeting which had already commenced and which was attended by An Taoiseach, the Minister for Finance, the Secretaries-General of both the Department of An Taoiseach and the Department of Finance, The Deputy Secretary-General of the Department of Finance as well as a senior partner from Arthur Cox, Solicitors. The Governor and the Director-General of the Central Bank were also in attendance. The meeting seemed to have only recently begun when we arrived and was in the process of discussing the serious liquidity position of Anglo and what facilities could be made available to it to help it survive until the weekend. Mention was also made of the fact that the two larger banks had sought a guarantee for their deposit holders from the Government earlier that afternoon.

The Chairman and I were asked to advise the meeting in relation to the solvency position of each bank from the point of view of the Authority. We advised the meeting that on the basis of the information available to the Authority, all banks were in compliance with their required capital ratios, were in a position to meet their obligations on a going concern basis, but liquidity was becoming a critical issue for them, especially Anglo.

Both the Chairman and I left this meeting after about an hour and were asked by the Secretary-General of the Department of Finance to remain on in the offices of the Department in case our presence was required later. We rejoined the meeting some hours later, possibly around 11pm. On our way back to the meeting room, we were met by the Governor of the Central Bank who indicated that the discussions that had occurred since we had left the meeting had narrowed things down to two options, either nationalisation of Anglo coupled with a guarantee of the five remaining banks or a guarantee of all the banks. He suggested to us that our view was likely to be sought in relation to these options.

Following a brief discussion with the Governor, who indicated that he had no difficulty with the proposed response to these options which the Chairman and I discussed with him, we rejoined the meeting which now included the Attorney-General. In relation to the options to which the Governor had alerted us earlier, the Chairman and I raised a concern about whether there would be confusion in the minds of the market practitioners the following morning as to who was or was not guaranteed and that making a distinction between nationalised banks and guaranteed banks ran the risk of being very confusing. (Some two weeks earlier, confusion had arisen in relation to the increase in the deposit guarantee limit to €100,000, especially as regards whose deposits it covered and the eligibility criteria.) Both the Chairman and I raised the concern that this would neither encourage the inflow of liquidity that would be expected to occur, nor would it stem outflows of deposits; questions would undoubtedly arise whether the nationalised bank was stronger or weaker than the guaranteed bank and in that situation all banks would risk being adversely affected. The Chairman and I expressed the view that if a guarantee was going to be put in place, we would be inclined to favour it being extended to cover the depositors in all banks concerned in the same manner.

Following this discussion, we left the meeting and remained on in a nearby waiting room. I was advised by the Chairman after some time that he had learned of the decision to guarantee the deposit holders in all the banks.

I returned to my office in Dame Street around 3am on the morning of the 30th September 2008 and as requested by the Deputy Director-General of the Department of Finance, I made phonecalls to representatives of Irish Life and Permanent, EBS Building Society and Irish Nationwide Building Society to advise them of the Government decision. I tried but was unable to make contact with representatives of Anglo Irish Bank.

The effects of the guarantee were evident immediately. The daily liquidity reports being submitted by the banks to the Central Bank showed inflows of both market and retail resources and an end to the pattern of outflows which had been occurring prior to the guarantee. The guarantee was viewed positively by market commentators and was seen as addressing satisfactorily the concerns of depositors and thus the funding and liquidity difficulties that had been affecting the banks.

**Summary and Conclusion**

This statement has addressed the menu of headings requested by the Inquiry and has focussed heavily on the supervisory approach of the Authority. I have set out for you the Authority's approach to the prudential supervision of banks as well as the various initiatives taken by it to strengthen its oversight of banks, such as the higher capital requirements, liquidity, impaired loans, fitness and probity, consumer code and the influence of the white papers on regulatory policy.

I also acknowledge, with the benefit of hindsight, that the supervisory measures introduced by the Authority were not sufficient to meet the challenges posed by the crisis and the recession that emerged.

I regret that very deeply.

Thank you Chairman and Members of the Committee for your attention.