**Statement of Tony Grimes**

**This statement has been proofed by the Oireachtas legal team in accordance with section 33AK Central Bank Act 1942 (as inserted by section 26 of the Central Bank and Financial Services Authority of Ireland Act 2003 and as amended by section 1 of the Central Bank (Amendment) Act 2015). Where necessary parts of the statement have been deleted or a summary or aggregate of those parts has been created and inserted in compliance with the Act. Where the statement has been so amended or modified this is marked in red.**

## Introduction

The following statement is submitted pursuant to the Direction dated the 9th 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 Clerk of the Joint Committee of Inquiry into the Banking Crisis dated the 9" April 2015.

I was appointed Director General of the Central Bank of Ireland in August 2007 and served in that capacity (and that of Deputy Governor which was equivalent) until my retirement in July 2011.

## Assessment and communication of solvency risk

Reflecting the division of labour arising from the establishment of the Financial Regulator in 2003, the Central Bank, having neither the mandate, the skills nor relevant information, had no role in assessing the risk of insolvency in individual banking institutions. For example, it did not collect information on the consolidated balance sheets of individual banks on which calculations of capital were based using the prudential framework. Also, the Central Bank did not examine the quality of bank assets; this was the role of the Financial Regulator.

The Central Bank's role in respect of the banking sector as a whole was carried out, inter alia, in the context of its annual Financial Stability Reports (FSRs) which were first published in 2000. These reports had the aim of setting out the key risks and challenges facing the banking system in Ireland. The intention was that risks identified in the FSRs would be taken into account in the supervision by the Financial Regulator of the individual financial institutions. The draft FSRs were initially discussed and ultimately approved at Joint Meetings of the Central Bank Board and Financial Regulator Authority.

The process of preparing the 2007 FSR commenced in May 2007 and the Report was published in mid-November 2007: therefore I served as Director General for the latter part of the process and hence my observations relate only to the issues raised in the 2007 FSR.

The role of the Central Bank was to identify macroprudential risks to the banking sector as a whole. These were the risks that may materialise and pose threats to solvency in the future. In assessing such risks the Central Bank took as a starting point that the banks were solvent, based on accounting and prudential conventions. It was the role of the Financial Regulator to assess the related qualitative factors such as risk management systems, the quality of assets in each bank, including undue concentrations of credit risk, and corporate governance.

FSRs do not attempt to predict future adverse events. Rather, their approach is to use economic analysis aided by stress tests to identify and assess areas of risk for the banking system. Using this methodology the 2007 FSR assessed that, on balance, financial stability risks had increased since the publication of the last report. However, the overall conclusion was that the Irish financial system's shock absorption capacity remained robust and that the system was well placed to cope with emerging issues. In the event, the stress tests used bore little relationship to the scale of the crisis a year later. Thus, I fully accept that this FSR, in its assessment of financial stability risks, did not anticipate or communicate the serious crisis that befell the Irish financial system culminating in the guarantee decision at end-September 2008 and the subsequent need for extensive bank recapitalisation.

In considering the reasons for this unduly favourable assessment of risks facing the financial system in November 2007, I would point to a number of factors that may explain why the risks identified did not lead to a better preparation for the crisis:

First, macroeconomic developments have a major influence on asset values. At the time of the publication of the 2007 FSR in mid-November, there was virtual consensus among both domestic and international forecasters that the Irish economy, while slowing somewhat from the growth levels recorded in recent years, would still record robust growth in both 2007 and 2008; second, the global recession and financial market meltdown that followed on from the events of September 2008 were not anticipated by virtually any commentator, at least in

terms of its unprecedented magnitude. For example, the ECB increased interest rates in July 2008 just before the latest phase of the crisis. It is generally agreed that these events had a major impact on valuation of the assets of domestic banks in the following months and years; third, many of the risk indicators (credit growth, house price increases, growth in private sector indebtedness and the banks' funding gap between private sector deposits and loans) that had been of concern earlier had begun to moderate at the end of 2006 and throughout 2007 and thus made the so-called soft landing for the property sector appear somewhat more likely; fourth, evidence of an overvalued property sector does not necessarily imply a disorderly adjustment. The IMF's World Economic Outlook of Spring 2008 can be paraphrased as stating that although a significant house price gap might be expected to be corrected over time, a decline in nominal prices is only one way for this adjustment to occur. Moderate inflation and support from the fundamental variables driving real house prices may also help close the gap over time (IMF, Spring Wor1d Economic Outlook, Box 3.1, page 113). A number of papers by academic economists suggested that the adjustment could occur over a period of years; finally, issues which subsequently proved decisive for the solvency of banks, such as risk management practices and collateral quality were not known to the Central Bank.

Although a number of financial market indicators were showing signs of stress, economic forecasts made as late as the summer of 2008 were still anticipating, at worst, a relatively mild recession in 2008 followed by a return to growth in 2009 and beyond. Moreover, price declines were not accelerating in either the residential and commercial property sectors and rents were either increasing, had stabilised or declined only marginally in both sectors, depending on the data source.

Clearly, the scenario outlined in the 2007 FSR is not what materialised. In reviewing internal Central Bank thinking for the period just before the guarantee, a picture emerges that recognized that financial stability risks had increased significantly but, like most commentators, the Bank does not conclude that serious economic and financial disturbance is imminent. This suggests that the confluence of increasing domestic vulnerabilities and international events following the failure of Lehmans and subsequent events in the US and European markets had a major impact not only on the timing but also on the depth of the crisis in Ireland. This view about the impact of the international crisis appears to be shared by Mr. Regling and Professor Ahearne in their evidence before the Inquiry. Thus, while there

were always going to be significant problems as the economy adjusted to a much smaller construction sector and as property prices returned to more sustainable levels, it is conceivable that, in the absence of the worst international recession in 80 years, the necessary adjustments could have been made over a period of years with a reduced cost to the banking sector, to the Exchequer and to the economy and society as a whole.

**Assessment and communication of liquidity risk**

Liquidity risk refers to the possible inability of banks to access liquid funds to facilitate their day-to-day operations. The Central Bank provides liquidity to the banking system on behalf of the ECB.

In the years before the crisis the Central Bank reduced the liquidity risk faced by domestic banks in a number of ways. New arrangements were put in place to enable banks to access ECB funding more efficiently and to use collateral located outside Ireland. In addition, it moved to address one of the problems with the use of Emergency Lending Assistance (ELA) - that its use required a floating charge on banks' assets that needed to be registered at the Companies Office. New legal instruments were introduced in 2007 to avoid this issue. Finally, there were frequent contacts between banks' Treasury Departments and the Central Bank's Financial Markets Department so the latter had timely information on day-to-day liquidity development s and these contacts became more frequent as the crisis intensified.

One of the features of the euro area is the existence of an integrated interbank money market which operated very efficiently from the setting up of EMU in 1999. As a result, banks were able to borrow in euro from other banks and investors throughout the entire euro area and not just in their own domestic market. However, it was recognized that it also facilitated a major build-up in private sector indebtedness and it raised the possibility of the sudden withdrawal of this liquidity with its consequences for both the banks themselves and the private sector as a whole.

The liquidity risks attached to a high share of non-deposit funding were outlined in the 2005, 2006 and 2007 Financial Stability Reports. In the 2007 FSR, stress tests were carried out to



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estimate the impact on liquidity of the withdrawal of 10% of Irish private-sector deposits and of reductions of 10% and 20% in the value of certain debt securities held by banks as part of their liquid assets. The FSR concluded that the banking sector's liquidity ratios appeared resilient to significant shocks to either deposits or liquid assets. The FSR was also reassured by the significant medium-term maturity element of many of the liabilities and as well as by the relatively wide range of funding options available, a sentiment echoed by the OECD and the IMF.

I now fully accept that the assumptions underlying these stress tests were insufficiently demanding and that the conclusions did not reflect the changing conditions in the global money markets that were beginning to emerge during September 2007 as the FSR was being finalised. However, the Governor's statement at the launch of the FSR in November refers repeatedly to liquidity stresses. It highlights how extreme turbulence in financial markets and its spillover effects are important for financial stability because of the potential impact on the real economy and the banking system, both globally and in Ireland. Liquidity issues were also raised at the Roundtable with the banks in February 2008. Also, a balance had to be struck between recognising the emerging tensions in the money markets on the one hand and generating sentiment that would amplify such tensions on the other. During the course of 2008, the previously integrated money market broke into national segments and the non-deposit funding sources became increasingly short-term. In my view, no stress test conducted at that time would have reproduced the liquidity conditions which, in fact, prevailed from the late summer and autumn of 2008.

More generally, with regard to money and capital flows within the euro area, the Central Bank could not have intervened directly to control such flows as such controls on the free movement of funds would not be consistent with the principles of a monetary union established in the Maastricht Treaty.

The Financial Regulator recognised the importance of liquidity risk and devised a system of controls where limits were placed on the mismatch between the maturities of assets and liabilities in various maturity 'buckets'. Performance against these limits were regularly reported by the banks and monitored by the Regulator.

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

The principal tasks of the Central Bank are, as part of its Eurosystem responsibilities, contributing to the monetary policy of the euro area and providing liquidity to the domestic banking system and contributing to the maintenance of financial stability both domestically and within the euro area.

Prior to 2003 the Bank also had responsibility for the supervision of banks and other financial institutions and for consumer protection. Following the establishment of the Financial Regulator in 2003, this responsibility transferred to the Financial Regulator. From that date contact between Central Bank staff and staff of the banks changed significantly: whereas previously there would have been meetings and discussions at the most senior levels, after 2003 this became confined to technical areas of the Central Bank's operations such as currency issue, payments and especially the provision of liquidity to the banks as part of the Eurosystem's operations.

This arrangement reflected a rational division of labour put in place by the new institutional structures established by the 2003 Act. In particular, from that time, the Central Bank did not have the staff with the requisite skills to interact with staff of the domestic banks in order to assess, for example, quality of the loan books, concentration of credit risk, the adequacy of their risk management systems and corporate governance practices.

There remained one area of contact in a non-operational capacity between Central Bank staff and the banking sector. As part of the annual financial stability exercise, stress tests were conducted and a Roundtable was held with senior commercial bank economists and heads of lending and staff of the Bank's Financial Stability Department. The Roundtable was chaired by the Bank's Director General and attended by the CEO of the Financial Regulator and provided an opportunity to discuss the implications of the financial stability reports.

**Effectiveness of the communication between the Central Bank and the Department of Finance**

The principal medium of communication between the Bank and the Department of Finance was the ex-officio membership of the Board of the Central Bank by the Secretary General of the Department of Finance. Although appointed in his personal capacity, this arrangement ensured that the most senior officer in the Department was fully aware of all the issues addressed by the Board. In addition to this permanent arrangement, the Governor at least annually wrote to the Minister in his Pre-Budget letter and had regular meetings with the Minister. Of course, there would also have been frequent contact between staff of the two institutions on day-to-day issues.

In the period prior to and during the crisis, the Domestic Standing Group (DSG) became the main forum for discussion and consultation between all the State institutions i.e. the Central Bank, the Financial Regulator, the Department of Finance and, from 2008, the NTMA. The DSG was established in line with EU requirements to deal with crisis management issues. It met at various levels, with meetings at technical level more frequent than at principal level. A Memo of Understanding between the Department of Finance, the Central Bank and the Financial Regulator entered into force in July 2007. The 2008 EU Memorandum of Understanding on Cross Border Financial Stability (ECFIN/CEFCPE (2008), 1 June 2008) provided that there would be a National Coordinator whose tasks included responsibility for the coordination of activities in order to enhance preparedness in normal times and facilitate the management and resolution of a crisis at national level. In the Irish situation, the Department of Finance assumed the role of national coordinator in mid-July 2007, including responsibility for determining the agendas, calling meetings and preparing minutes. The fact that the State was responsible for preparing legislation and for fiscal policy ensured that the Department of Finance played a central role in the DSG's activities.

From early 2008 the DSG was increasingly active in crisis management preparations, especially in discussions on the legislative changes necessary for nationalising a bank and on the circumstances in which a guarantee of all bank liabilities would be appropriate. As early as February 2008, it was agreed that such a guarantee was undesirable, in principle,

but should be considered where the survival of the entire financial system was at risk.

Although formal DSG meetings at various levels were regularly held during 2008, this underestimates considerably the degree of contact between all the State institutions during this period. Especially over the summer months of 2008, meetings were frequently convened at short notice, both at the principal and subsidiary levels, outside the strict DSG structures. This was supplemented by telephone contact and by teleconferences. Thus, it is my view that over the years 2007 and 2008 there was frequent and effective communication between the Central Bank and the Department of Finance.

**Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used**

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Although no expert advice was commissioned by the Central Bank, I had access to and examined some of the advice prepared for the Department of Finance/NTMA and the Financial Regulator. In this context, given the deteriorating environment over the late summer of 2008, it appeared necessary that this advice was sought from some of the major international investment banks not only for their views on financial market developments but also because many of them had been consulted by authorities in other countries and thus had a broader perspective to offer on the crisis. Also, it was prudent to get an informed and independent judgment about the quality of the loan books of some domestic banks to aid decision-making.

As regards the quality of the analysis of this advice, this varied according to the issue involved and the time available. In general, the expert advice on the quality of banks' loan books and their implications for capital adequacy did not appear to predict, like most other commentators, the unprecedented decline in asset values and subsequent solvency issues that emerged over the following two to three years as economic conditions both domestically

and internationally worsened. The fact that the external advice did not prove accurate, in my view, reflects the inherent difficulty of estimating outcomes at a time of unprecedented volatility in domestic conditions and global markets. Indeed, the ever increasing estimates of required capital injections, from the initial investment of €10 billion of State funds on 14 December 2008, to the injections provided in 2010 and finally in 2011, illustrates the difficulty of accurately determining asset values, and hence capital adequacy, at a time when the underlying economic and financial environment is deteriorating rapidly.

The other area where expert advice was important related to crisis resolution options, and in particular that offered by Merrill Lynch at the time of the guarantee. Merrill Lynch produced reports on 26 and 29 September 2008 (Public Accounts Committee Documents 3 and 4) setting out some crisis resolution options. I was not aware of the Merrill Lynch advice received by the Department of Finance on the night of the guarantee but this appears broadly consistent with its approach of 26 September. It firmly ruled out the option of allowing an Irish bank to fail and go into liquidation without any government intervention. In general, the advice was that a guarantee of all bank liabilities would be the most decisive measure in tackling the escalating and unsustainable liquidity losses but that it also raised issues about the credibility of the guarantee in the light of the huge sums involved.

**Appropriateness of the bank guarantee decision**

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The decision to guarantee most of the liabilities of the six domestic banks was taken by the government on 29/30 September 2008. While earlier having had some doubts, in principle, about guarantees of this type, in the circumstances facing the financial system at end-September, I concluded that it was likely to be the most effective option.

The Central Bank's Board discussed the possibility of a guarantee on 21 September and again on 25 September, noting that it could become necessary in the event of continuing liquidity losses.

The liquidity pressures which affected Irish banks in the months and weeks before the guarantee can be seen in the increase in the quantity of ECB support received by the individual banks and by the Irish banking system as a whole. This support was provided in the normal course of business and is collateralized by assets on the balance sheets of the banks which are deemed eligible by the ECB for this purpose. The level of ECB support was relatively stable in the first eight months of 2007 at around €5 billion. As the first tensions in the money markets appeared in September 2007 support increased sharply, particularly in the lead-up to year-end. The level of ECB support remained relatively stable over the first half of 2008 at about €10 billion but increased modestly in July and August: at the latter date support reached just under €15 billion. The impact of heightened tensions is apparent from the beginning of September reflecting developments in the international financial markets. The definitive event in mid-September was the filing for protection by Lehmans on 15 September. Between that date and the end of September international markets became extremely turbulent and the need for additional ECB liquidity increased dramatically, to reach €40 billion by the end of the month.

The liquidity impact on the Irish banks can also be seen from estimates of losses of corporate deposits; these deposits tend to be large and volatile. The impact of Lehmans is also evident here. Outflows of corporate deposits in the two weeks from mid-September shows a pattern of increasing losses and particularly on Monday, 29 September; **[DELETED]** The losses by Anglo were particularly severe **[DELETED]** over the two-week period **[DELETED]**. Losses on this scale were regarded as unsustainable.

The system could not continue on this basis without the banking system imploding. An urgent and decisive intervention was required that would not just finance the outflows but change the dynamic of the unprecedented scale of liquidity losses and prevent contagion from Anglo to the rest of the system. The policy instruments available for decision by the government were limited to ELA, a government guarantee of liabilities of all six banks or nationalization of Anglo and/or INBS with a guarantee extended to the other four banks. A Special Resolution Regime was not available at that time.

My attitude to the policy response was informed by three influences. The first is that, on the occasion of the increase in the limit in the Deposit Guarantee Scheme announced on 20 September 2008, it was stated that the Government is committed to the stability of our financial system, so that money placed with an Irish credit institution would not be at risk. Subsequent events demonstrated that this general commitment was insufficient to reassure depositors and other creditors about the stability of the Irish banking system and that more substantial measures were required. Second, within the Eurosystem a strong view emerged in the days before the Irish guarantee, and following crises affecting German, French and Belgian banks, that there was an expectation that governments would intervene to avoid the default of a bank in the euro area. Third, a strong sense of a rapidly accelerating crisis as a series of events emerged over the days before, and on the day of the guarantee: the failure of the US Congress to approve the TARP initiative to buy distressed assets, the US government sponsored mortgage banks "Fannie Mae" and "Freddie Mac" taken into public ownership, the rescues of Fortis, Dexia and Hypo over the weekend, and numerous special liquidity operations by the main global central banks including the ECB, all of which emphasized that the financial markets globally were in turmoil.

By late afternoon on 29 September it was clear that the situation was deteriorating rapidly. Share prices of all the quoted Irish banks had declined sharply and there were large-scale liquidity losses in all the banks but especially Anglo. I was present in Government Buildings from about 7 pm. I attended two meetings from that time until I departed about 3.30 am. The first was a meeting involving the Taoiseach, Minister for Finance, the Attorney General and officials from the Department of the Taoiseach, the Department of Finance, the Financial Regulator and the Governor of the Central Bank. The meeting was informed about the

current liquidity situation as well as other market developments. Anglo would have been unable to open the following day without emergency lending from the Central Bank. Arrangements had been made to provide funds to Anglo if necessary. However, the latter was regarded as a short-term measure only and one that, if made public, would likely exacerbate the liquidity problems of the system as a whole.

The meeting had a preliminary exchange of views on resolution options **[DELETED].** The main concern was to avoid contagion from Anglo to the other domestic banks and especially to the two major banks. The Chair and CEO of AIB and Bank of Ireland were then called to attend and I left the meeting at that point. I was not present when the two banks agreed to provide temporary funding to Anglo. I participated in one further meeting later that evening after the guarantee decision, at which some of the more technical aspects of the guarantee were discussed.

It has been argued subsequently that extensive use should have been made of ELA for the entire banking system rather than guaranteeing banks' liabilities. There are a number of reasons why this would not have been the preferred option. First, presumably for this option to be effective it would have been necessary to have made an overt declaration that the Central Bank was willing to provide ELA to the banking system in Ireland for some indefinite period. However, given that the previous general statement by the Government on 20 September was not effective, it is unlikely that a further statement of support, not backed by substantive measures, would have impressed the markets in an even more stressed situation than applied a week earlier. And it was never envisaged by the Eurosystem that ELA would be used in this ex-ante way. Second, the ECB would not have been in a position to approve an open-ended ELA commitment of this type since it would have been uncertain in terms both of amount and duration and thus it would not have been possible for the ECB to assess its implications for the monetary policy of the euro area. It should be recalled that ECB approval of ELA for a number of European banks over the previous weekend was for definite amounts and for specified maturities. Third, ELA simply finances the outflows of funds and was more likely to be regarded as confirming the critical liquidity position of the

domestic banking system than changing market behavior. It is of note also that the State was ultimately at risk in the event that a bank availing of ELA was unable to repay and thus it was not an option that offered potentially lower costs to the State.

In summary, any reluctance to make more extensive use of ELA was based on the judgment that the impact on confidence was more likely to be damaging than helpful. Moreover, as outlined above, ELA could not have been advanced to any other bank or to the system as a whole at that time. The critical requirement was to find a solution that would prevent contagion from Anglo to the remainder of the domestic banking system and provide a decisive intervention that would change market sentiment towards Irish banks as a whole on the opening of markets the following morning. The possible nationalisation of Anglo raised issues, both in terms of lack of an immediate legislative provision (although it could perhaps have been ready by the following weekend) but also because it might have been viewed by the markets more negatively than a guarantee. In these circumstances, a guarantee of bank liabilities seemed to offer the best prospect of avoiding a systemic banking crisis with all the attendant costs noted in the Honohan Report (paragraph 8.43).

**Effectiveness of reviews of banks' loan books and capital adequacy**

**[DELETED]**

Insofar as this refers to various reviews of loan books commissioned from mid-2008, it seems reasonable that the Department should rely on the expert investigative and analytical skills of major international investment banks and accounting firms and that it should carefully consider their conclusions.

With hindsight, it is clear that the external experts did not sufficiently build into their analyses the impact of the weak domestic economy and the global crisis on the value of domestic assets and the consequences of deteriorating asset quality for capital adequacy.



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**Decision to nationalize Anglo in 2009 and a review of the alternatives available and/or considered**

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**[DELETED]** [T]he government wanted to avoid if possible the nationalization of Anglo and wanted to see a market solution. If the latter were not possible the government would have to consider providing all the funds required. I can recall no other discussion in the Central Bank of alternatives to nationalization although I am aware that the government sought the advice of Merrill Lynch on this issue.

Tony Grimes
April 29, 2015