

HOUSES OF THE OIREACHTAS

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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉI- REACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Déardaoin, 11 Meitheamh 2015

Thursday, 11 June 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D'Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O'Keeffe.
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

Nexus Phase

Central Bank-Financial Regulator - Mr. Liam O'Reilly

Chairman: We have a quorum, the Committee of Inquiry into the Banking Crisis is now in public session, is that agreed? Can I ask members and those in the public Gallery to ensure that their mobile devices are switched off. I would like to welcome everyone to the 32nd public hearing of the Joint Committee of Inquiry into the Banking Crisis. Today we continue our hearings with key figures from the Central Bank of Ireland and the Financial Regulator who had key roles during the crisis period. At this morning's session we will hear from Mr. Liam O'Reilly, former CEO of the Financial Regulator. Liam O'Reilly was assistant director general of the Central Bank of Ireland from 1998 and had been responsible for all of the Central Bank's financial supervision functions. He was appointed interim chief executive at the Financial Regulator in November 2002, and chief executive in May 2003 until he retired in January 2006.

Mr. O'Reilly, you are very welcome before the inquiry this morning. Before we commence proceedings I wish to advise you that by virtue of section 17(2)(l) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to this committee. If you are directed by the Chairman to cease giving evidence in relation to a particular matter and you continue to do so, you are entitled thereafter only to a qualified privilege in respect of your evidence. You're directed that only evidence connected with the subject matter of these proceedings is to be given. I would remind members and those present that there are currently criminal proceedings ongoing and further criminal proceedings are scheduled during the lifetime of the inquiry which overlap with the subject matter of the inquiry. Therefore, the utmost caution should be taken not to prejudice those proceedings. In addition, there are particular obligations of professional secrecy on officers of the Central Bank in respect of confidential information they have come across in the course of their duties. This stems from European and Irish law, including section 33AK of the Central Bank Act 1942. The banking inquiry also has obligations of professional secrecy in terms of some of the information which has been provided to it by the Central Bank. These obligations have been taken into account by the committee and will affect the questions asked and the answers which can lawfully be given in today's proceedings. In particular, it will mean that some information can be dealt with in a summary or aggregate basis only, such that individual institutions will not be identifiable.

Members of the public are reminded that photography is prohibited in the committee room. To assist the smooth running of the inquiry, we will display certain documents on the screens here in the committee room. For those sitting in the Gallery, these documents will be displayed on the screens to your left and right. Members of the public and journalists are reminded that these documents are confidential and they should not publish any of the documents so displayed.

The witness has been directed to attend this meeting of the Joint Committee of Inquiry into the Banking Crisis. You have been furnished with booklets of core documents. These are before the committee and will be relied upon in questioning and form part of the evidence to the inquiry. So with that said, if I can now ask the clerk to administer the oath.

The following witness was sworn in by the Clerk to the Committee:

Mr. Liam O'Reilly, former CEO, Financial Regulator.

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Chairman: Once again, welcome, Mr. O'Reilly, this morning, and if I can invite you to make your opening remarks to the committee, please.

Mr. Liam O'Reilly: Before beginning my oral statement this morning, I would like to make the following two corrections to my written statements to the inquiry, dated 14 May 2015.: at page 2, section 1.2, paragraph 2, the second sentence should read: "The other directors consisted of six Financial Regulator board members, together with five other members appointed by the Minister for Finance"; (b) at page 5, section 2.5, last paragraph, the first sentence should read: "Modest increases in capital requirements were agreed by the board in 2006 subsequent to my departure."

Senator Susan O'Keeffe: Sorry, Chairman, I can't find the second one.

Chairman: Just reference the second one again, Mr. O'Reilly, please.

Mr. Liam O'Reilly: Page 5, section 2.5, last paragraph. Yes, the first sentence should read, instead of "a 1%", "Modest increases in capital requirements were agreed by the board in 2006 subsequent to my departure".

Chairman: Okay, Mr. O'Reilly, whenever you're ready to go so, please.

Mr. Liam O'Reilly: Thank you for the opportunity to provide you with my perspective on the matters under review by the joint committee. First of all, I'd like to talk about principles-based regulation. The approach of the Financial Regulator was that of a principles-based regime. Such a regime was also the standard approach throughout Europe and was in line with the Basel capital requirements. The approach was well known and enunciated by the Financial Regulator, and by Government, and publicly accepted. It was the centrepiece of strategy of the Financial Regulator from the beginning. The policy laid a heavy responsibility on the boards and senior managements of banks. It demanded of them that they had high standards of corporate governance, a clear business risk policy, and risk controls in place to monitor and control that risk. Resources in the Financial Regulator were based on that premise. The Financial Regulator's main focus at the time was on determining the quality of corporate governance, including risk controls, within the bank. An important aspect of corporate governance regime was that non-executive directors had a controlling role in the audit committee and remuneration committee. The regime required direct reporting lines between both the internal auditor and external auditors to the board audit committees. The Financial Regulator asserted its influence by requiring a financial institution to take remedial action as a result of findings of inspections or as a result of other issues that came to light or in some other way. For example, issues might arise in the course of a review meeting with the bank during themed inspections, by a bank itself reporting a problem or by information supplied by the external auditor, the internal auditor or members of staff. There was a view that taking over-aggressive action might cause reputational damage to a banking institution, with possible consequent contagion effects. In general, the foregoing measures were seen as appropriate at the time. The approach then adopted by the Financial Regulator in line with our principles-based approach was to expect a board would implement the necessary changes and in an expeditious manner. With the benefit of hindsight, it is now clear that this system did not work. More robust and intrusive measures should have been taken.

At the time, the Financial Regulator was of the view that enforcement action would be more effective if there were in place a set of legally based codes and if administrative sanctions were applied for breaches of such codes. The appropriate legislation for administrative sanctions

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was enacted in 2004. The use of such sanctions was viewed as a more effective and lower key way of keeping non-compliant institutions in line. The system of codes was well developed in the consumer area and where a set of consumer codes were being finalised in 2005, towards the end of my tenure. Administrative sanctions would apply to breaches of the codes. A sanction could range from an official caution to monetary penalties or a disqualification of a service provider. In the prudential area, it was planned that sanctions would be imposed on institutions in the event of breaches of corporate governance codes and other codes. Updated requirements were being developed in relation to being a fit and proper person to hold a senior position in a credit institution. Directors' compliance statements were also being developed. These were to be implemented following an extensive consultative period.

Resources in the Financial Regulator devoted to regulation were determined by the principles-based approach which was not as intrusive as the present system. The idea was that the internal audit departments, risk committees and external auditors were to be leveraged to fulfil the role of the Financial Regulator. The Irish principles-based system was endorsed by the IMF FSAP report published in 2006. That report provided a favourable conclusion as to the adequacy and effectiveness of this system. However, it is now internationally recognised that the principles-based regulatory system was flawed. It failed, not only in Ireland, but worldwide. As a result, regulatory systems are now more intrusive and aggressive. Greater responsibility is being taken by financial regulators to ensure that adequate systems are in place to measure and mitigate risks. The Basel II initiatives have also been completely revised to ensure that capital is adequate to cover for adverse and unforeseen circumstances.

The interrelationship between the Central Bank and the Financial Regulator: it was clearly set out in a memorandum of understanding between the Central Bank and the Financial Regulator that macro-prudential stability was the primary role of the Central Bank and micro-financial stability, i.e. the soundness of individual institutions, was the role of the Financial Regulator. Both of these parties were determined to make this system work. This was our mandate under the law. One of the most important elements for its success was to ensure that there was adequate information exchange. To achieve this, the following mechanisms were in place: the CBFSAI board, chaired by the Governor, consisted of six Financial Regulator board members and five other board members. The secretary of the Department of Finance was on the board. All board papers of the Financial Regulator were circulated to senior management in the Central Bank and board minutes would have been made available to board members. A paper entitled, "Financial Regulator update", which reported on the activities of the Financial Regulator, was an item on the agenda of the monthly meetings of the CBFSAI board. All pertinent areas of concern of the Financial Regulator were communicated orally to the board and board minutes on these items were recorded. The offices of the Governor, the director general of the Central Bank, the CEO of the Financial Regulator and the prudential director were physically in close proximity to each other and day-to-day concerns would have been discussed as a matter of course. The channels of communication were always kept open. If any significant action was being contemplated, be it against a given bank or banks generally, such matters would have been brought to the attention of the Central Bank before implementation.

The effect of EMU on financial regulation: after the establishment of EMU, the Central Bank, the Financial Regulator and the banking system operated in an environment characterised by a strong exchange rate and low inflation, low interest rates. Cheap credit was available to the banking system from Europe. The control of credit growth, through changes in domestic interest rates, was no longer possible. Because credit was cheap, there was an over-reliance on short-term lending from the EMU interbank market. Customer deposits is usually the more

stable source of liquidity as a proportion of balance sheets continued to contract. Increasing reliance was being placed on large, commercial depositors which, by their nature, would have been more mobile. EMU was formed without the provision of mechanisms for measuring and controlling risks, arising from aggregate euro credit flows, in terms of their destination and-or a concentration in certain sectors. Therefore, the inherent risk of a financial stability problem on a pan-European basis, due to the build up of credit risk in certain sectors or countries, was neither being monitored nor controlled. This was a fundamental flaw of the EMU system at its inception. It was thought that individual countries could look after their own regulatory affairs and markets would do the rest. This flaw has now been rectified. Without the use of the interest rate tool, Ireland depended on euro interest rates changing favourably, changes in fiscal policy and moral suasion to rectify the situation over time. By way of a macro-prudential policy instrument to replace interest rates, two options had been mentioned in the Honohan report and in evidence to this committee: change general capital requirements to reflect the increase in risk and the application of sectoral limits on a mandatory basis. Subsequent to my departure, increases in capital requirements were applied to high loan-to-value mortgages and speculative property development in May 2006 and January 2007, respectively. However, in terms of their effectiveness, to quote from the Honohan report, “The measures were in reality also rather modest in their likely [effect].”

Concerns about credit growth: the Central Bank and the Financial Regulator regularly voiced concerns in its publications, quarterly bulletins, annual reports, financial stability reports, about credit growth and the increase in personal indebtedness, particularly in property. Concerns about commercial property lending were also voiced. The following are two examples of public statements made by the Financial Regulator. On 29 July 2005, the Financial Regulator warned about 100% mortgages, saying that they had to be appropriate to each borrower. Clearly such mortgages were not appropriate to first-time buyers. At the time, 100% mortgages were a very low proportion of mortgages provided. A warning also was given on 26 July 2005 in the Financial Regulator’s press statement at the launch of its report for the period 2003-2004:

There is an increasing debate about the rapid growth in credit in the economy and I want to address this area as a matter that could cause concern in the future. Along with the Central Bank, we are concerned about the rapid rise in the level of indebtedness in the economy and are well aware that if conditions changed adversely, many people could be severely affected. ... It is the responsibility of each financial institution to ensure that their credit standards, provisioning policies and levels of capital are appropriate to provide not only for today but in the event of a future downturn in the market. ... In short, institutions should only advance loans where they are confident [that their customers are ... have an] ability to repay. They have the responsibility to inform their customers about the risks they are taking on borrowing large amounts of money and that they retain some flexibility to cope with changes in their personal circumstances like unemployment and higher interest rates.

It is important to emphasise that, in making that statement, the Financial Regulator had no evidence that conditions might deteriorate to such a level that the banking system would succumb to a traumatic shock of the magnitude that occurred in 2008.

The following were the factors which provided comfort. There were demographic and other structural reasons for the need for increased activity in the construction sector and the increase in the level of credit necessary. However, a view emerged that property was becoming overvalued and there was a need for correction. At the time of my departure, that correction

appeared to be in train. Fiscal policy was moving in the right direction - through the removal of incentives in the building industry - interest rates in Europe were set to rise and house prices were stabilising. The regulator had no serious or imminent concerns about the solvency of any particular financial institution. As the IMF Article IV report emphasised, Irish banks had sufficient buffers of capital to meet any shock that faced the system. Annual stress tests reinforced this view. Moreover, the general consensus in the market was that the Irish banking system was well capitalised and the Irish economy was healthy and growing.

General conclusions. In hindsight, the principles-based approach to regulation had major shortcomings. The Financial Regulator can no longer place the same degree of trust which it previously did in the boards and senior management of banks. In future, the Financial Regulator must adopt a more intrusive and aggressive approach. Moreover, the regulatory system did not appreciate the full extent of the credit exposures. I deeply regret that these failures in the system were not recognised during my tenure in office.

Chairman: Thank you very much, Mr. O'Reilly, for your opening statement. We now commence questioning and let me invite our first questioner this morning, which is Senator Sean Barrett. Senator, you have 25 minutes.

Senator Sean D. Barrett: Thank you, Chairman. And I ... Mr. O'Reilly, you're welcome. I echo the Chairman's welcome for ... to you earlier. In a general question, you mentioned in your papers that you studied in Queen's in Kingston, Ontario. The World Economic Forum has rated Canada's banking system the soundest in the world seven years in a row. And, I think, in 2009 we were ranked 121 out of 123 countries - i.e., at the awful end of the scale. Did you pick up anything in your Canadian studies of economics that would help you in seeing what the difference between the two rankings is?

Mr. Liam O'Reilly: Well, when I was in Canada I was studying small open economy economics, I wasn't dealing with regulatory economics or regulatory systems. So, I wasn't conscious at that time. All I can say is that I would say that the ranking in Ireland plummeted from what it was in 2006 to where it was in 2009 as a result of the crisis.

Senator Sean D. Barrett: And, in your 39 years ... I think, 1967 you went to the Central Bank was that-----

Mr. Liam O'Reilly: Yes.

Senator Sean D. Barrett: -----until 2006, did you see the corporate culture of Irish banking change from being one of the most conservative to being, as you said there, one of the most lowly rated of 123 countries?

Mr. Liam O'Reilly: Sorry, Senator?

Senator Sean D. Barrett: Did ... yes, in your dealings with banks did you see them changing at all? Were they different from the ones you used to meet when in you were in the Central Bank first in 1967? And, what happened sub ... in 2006, '7 and '8?

Mr. Liam O'Reilly: When I was in the Central Bank first, I would have been dealing with them, first of all, in relation to money market operations - I was operating markets - and also in the foreign exchange area. And I found that the relationship was professional and there were pressures from day to day. I was around during the currency crisis. You can imagine what sort of, if you like, frenzy there would have been around that period. My interaction with them

during the time when I was in a regulatory position, I didn't ... I didn't notice any difference there at that time. There were issues that were arising, like the Ansbacher issues, like ICI in 1986, like the Rusnak issue. And these sort of issues, I think, had a wake-up call for most of the institutions. In ... AIB, for instance, would have been one of those. And there was a whole range of changes to corporate culture. And I remember, particularly when we were involved in the overcharging issue and the issues of inappropriate deal allocations, that there was a whole programme of work that we required within AIB to improve that sort of culture.

Senator Sean D. Barrett: And yet the ... it cost us in 2007-'08 40% of GDP ... after Iceland, you know, the most expensive bank rescue any place. I mean, did you see anything that ... were their lending standards lower in the '80s than they were in the '60s?

Mr. Liam O'Reilly: Well, I wasn't involved in the '80s or the '60s and AIB, I would have thought, at that time were ... were a pretty compliant bank. I suppose there was a change in their strategy, which was a business strategy - I think they went more into property than other institutions and that may have caused their losses to be greater.

Senator Sean D. Barrett: Were you acquainted with the arguments over the McDowell report? Did you participate in that? He recommended completely separate regulation and the Central Bank and the Department of Finance didn't like it much and a row ensued.

Mr. Liam O'Reilly: I was ... I was peripherally involved in it.

Senator Sean D. Barrett: Yes.

Mr. Liam O'Reilly: And the reason I was peripherally involved in it ... it wasn't felt appropriate that someone who would be working in financial regulation should be involved. So it was the director general of the Central Bank at the time involved himself, but that didn't mean that we were ... were not involved in discussions. And I know that there were discussions about worries that if the Central Bank functions of lender of last resort, of money market operations, of providing liquidity ... if there was a separation between that and actual day-to-day regulation, it could have caused disruption problems in the event of the institutions being separated.

Senator Sean D. Barrett: Having won the battle, did ... was the war lost, because an organisation of 1,200 staff or so combined put only 35 of them into the prudential regulation of banks?

Mr. Liam O'Reilly: Thirty five people were in the regulation of banks. I think it was 32, I think, in 2000. It had increased to, I think, 45 in the ... in 2005. The principles-based approach was not one that was new to the Financial Regulator. It was ... it was actually one that was continued on from the Central Bank culture, I would have thought. And not alone that, but this was an approach that was being taken in all countries and the Basel accord and Basel requirements were setting out that that was the way that things were moving. Indeed, the Basel II arrangements were going to be giving more autonomy to banks in determining how much capital they should hold by ... by stating that if you have your proper models in there, maybe you can reduce your capital. So, unfortunately, there was a mistaken view taken at that time as to who should be regulating banks and to what extent they should be self-regulated as opposed to having a full intrusive, aggressive system in place.

Senator Sean D. Barrett: Do you know was there ever parliamentary authority for that? Because here, I've never heard in my short time, a law being brought in and you can ... be implemented by principles, there are no penalties; say, you can, kids can go to school or not if

they like, you can drive fast or slow if you like. Was Parliament expressly consulted on this non-statutory regulation of financial institutions, which cost us €64 billion afterwards?

Mr. Liam O'Reilly: I'd say that the Government's White Paper on good regulation certainly coloured how this matter evolved. For instance, it did approve of the principles-based regulation system at the time, it said that there had to be a lot of consultation between ourselves and the banks, and I must say during my term in office, it slowed down the way in which we could implement things that we wanted to implement in a faster manner, and this whole idea of over-regulation was over-emphasised. And that was all part of Government policy.

Senator Sean D. Barrett: When you mentioned it slowed down we found extremely slow correspondence between banks and the regulator. In one case that ... in the Honohan report, I think, a bank was felt to be problematic - Bank A, I think, he called it - in 2000, and it collapsed in 2008. Why was it taking so long to achieve regulatory control over that particular Bank A?

Mr. Liam O'Reilly: Well, would you like me to talk about I think it's called Bank X-----

Senator Sean D. Barrett: The example I'm looking for is ... did people take much notice of when you were drawing matters to their attention in the Irish banking sector? And that's an example, an extreme one.

Mr. Liam O'Reilly: Would it be useful at this stage to tell a story about Bank X?

Senator Sean D. Barrett: Yes.

Mr. Liam O'Reilly: We, as the Financial Regulator, inherited a problem with Bank X. There were corporate governance issues early on, and those corporate governance issues we felt had been resolved by the appointment of a new chairman and two new directors, and as well as that, a chief operating officer. And, unfortunately, within a year - the beginning of 2003 I think it was - the chief operating officer didn't, didn't stay. He gave his ... his reasons at the time as he had personality differences. Also, which we were aware at the time there were continuing corporate governance issues. I suppose, the ... matters came to a head for us in early 2004, with the arrival of a management letter from the auditors of the institution, and concerns that we had as regulators at the time. As a result of that, we instituted a detailed investigation of that institution and we hired a firm of auditors to do that job. As a result of that, a set of proposals came from that institution, and the institution was required to carry out certain tasks. As well as that, I have been hearing in the inquiry here that there have been no sanctions. In that case, a sanction was applied to that institution and during the following year, we had two sets of audit firms within that trying to rectify the problem. And at the end of my tenure, I thought that progress had been made. Quite obviously, in hindsight, it wasn't enough.

Senator Sean D. Barrett: Thank you. Chairman, that's in the core documents, Vol. 3, for this and it's on page 8, the story of Bank A, and if it's of assistance to Mr. O'Reilly, it will come up on his screen and I thank him for his account. But, so if Bank A was seriously problematic from 2000, "persistently problematic", says Honohan, from the year 2000 onwards and "prosecution ... was given detailed consideration", it says at the end of box 4.2, "but other less intrusive prudential measures were taken. Ultimately, however, these proved to be ineffective." So what else could've been done over those eight years-----

Mr. Liam O'Reilly: Well-----

Senator Sean D. Barrett: -----to get-----

Mr. Liam O'Reilly: Well-----

Senator Sean D. Barrett: -----that-----

Mr. Liam O'Reilly: In hindsight-----

Senator Sean D. Barrett: -----Bank A compliant?

Mr. Liam O'Reilly: In hindsight, I think, the regulator and it could be said it was part of the principles-based report, was too patient and too dependent on the board and that's who we were addressing at the end of the day, the board, to solve these problems, including the, the urge, if you like, of the stick of applying a sanction which was vehemently opposed by the institution. But, when I look back on it now, and I've seen what happened, it is a regret that I didn't just put a condition on the bank at that stage.

Senator Sean D. Barrett: Was there consensus at the board level between the Central Bank and IFSRA about the regulatory approach to banks?

Mr. Liam O'Reilly: Well, let's put it this way - if we were going to move against an institution, at any stage, that ... we would've felt being banks, they have, they have the tendency to have contagion effects. An example I've seen in the inquiry is the one of the night of the guarantee, where there was a worry that if any question was raised about any bank, it could have huge effects on the whole system. It was that sort of attitude that was around, to a certain extent. That's why we felt we would be better with an administrative sanctions system and I can talk a little bit later about that. But, at the time, we should've applied a condition to the institution.

Senator Sean D. Barrett: Were pressures put on you by the Department of Finance in relation to compliance statements and corporate governance guidelines?

Mr. Liam O'Reilly: I was there in 2006 and I was developing this architecture going forward. As a matter of fact, before I had become Financial Regulator, I had set up a regulatory enforcement and development department, which would try and work out a policy as to how we would deal with recalcitrant banks. Another example, by the way, of actions that we took, were in the case of the AIB overcharging and other issues. We've also forced institutions to carry out their own inquiries and pay for them themselves on our ... and we would have specified the jobs. So, it isn't that actions weren't taken, but I think at that time, we should've taken a much more clear action. So, you asked me the question about the Central Bank-----

Senator Sean D. Barrett: The Department of Finance.

Mr. Liam O'Reilly: Was it the Department of Finance or Central Bank?

Senator Sean D. Barrett: The Department of Finance, did they have misgivings?

Mr. Liam O'Reilly: The Department of Finance, I don't ever remember being involved in saying, "Don't do this" or "Don't do that". No.

Senator Sean D. Barrett: So, they didn't object to your directors' compliance statements or your corporate governance guidelines.

Mr. Liam O'Reilly: Well, sorry, as I've said, the directors' compliance statements had been developed towards the end of 2005. It had gone into a preliminary consultation and I think it

did run into the sand in 2006 after my departure and I really am not privy to exactly why. And I know that the Honohan report has given some reasons, but since ... I'm just taking someone else's evidence. I have no straightforward or direct evidence of anything in that front.

Senator Sean D. Barrett: Did you find it difficult to get the banks to comply with sectoral concentration ratios?

Mr. Liam O'Reilly: I think that there was a confusion in the area of sectoral concentrations. To be quite honest, it seemed to fall into abeyance before the Financial Regulator came into place, and they seemed to be guidelines that were not applied. And just to say that during my term of office, we were searching around for what could we do to dampen credit. And I ... during my term of office, and I'm part of this, I never got a proposal that maybe we should bring to the board the idea of applying mandatory sectoral limits. Now-----

Senator Sean D. Barrett: How do you mean you never got a proposal? Could you not have made the proposal?

Mr. Liam O'Reilly: Well, what I'm saying is it didn't occur to me, but there is a second element to that. These limits ... we were in what was called the market paradigm period, where it was better to apply a price rather than to be trying to apply quantitative limits that can easily be got around, and I think the Honohan report did mention the fact that these sectoral limits could be too easily got around. So the concentration at the time, I seem to remember, was on how exactly could you apply capital ratios to increase ... to measure the increased risk that would be involved in this lending activity.

Senator Sean D. Barrett: Ms Burke wrote to a bank saying that they were outside what she regarded as the correct ratios, and they replied, "We're comfortable." Did you have difficulty in getting across to banks that they were over-concentrated in the property sector?

Mr. Liam O'Reilly: Well, the major element at the time, I think, was the ... the major instruments of macro policy, it seems to me, at the time. And even when capital limits were increased in 2006 there were several options, and the options seemed to vacillate between moral suasion and capital requirements. Now-----

Senator Sean D. Barrett: A similar, if I may say, non-response to correspondence about loans-to-deposits, that some banks said, "Never mind, we can borrow from our parents in other countries." You know, there seemed to be a view that the regulator could be dismissed by the banks when he expressed concerns?

Mr. Liam O'Reilly: I would say that we were in this market paradigm period where people bid for funds, and markets would work smoothly, but that isn't what happened. Markets ground to a halt, and all of a sudden there was a freeze, and interest rates increased at a very, very large rate at that time.

Senator Sean D. Barrett: Could I bring you to page 40 in Vol. 3, a report of the financial stability co-ordination committee in 2004, and the financial-----

Mr. Liam O'Reilly: What's the page?

Senator Sean D. Barrett: Page 40, Mr. O'Reilly. And the second paragraph refers to yourself, "The Financial-----

Mr. Liam O'Reilly: Yes.

Senator Sean D. Barrett: -----Regulator indicated his view that the banks were not convinced that there was an incipient risk building up in the banking sector.” Was that not your job? I mean, the people at the party aren’t going to object in the famous metaphor about taking the punch bowl away; they want the party to continue. Your job was to stop the party, not to ask them did they want the party to continue.

Mr. Liam O’Reilly: The question again was what instrument he used ... what was the instrument we could use to actually effect a change? And as I say, it seemed to me at the time that the policy, generally, in the authority and in the ... in the Central Bank particularly, was that we could talk them out of it. That, in hindsight, was just not effective enough.

Senator Sean D. Barrett: Like, should you not have insisted then, “Look, the overall growth of credit is going to build up risk in the Irish banking system, that’s my job, I’m in charge here, and I’m telling you that, whether you think so or not, there’s an excessive risk building up”, which we now know exploded three or four years later? What’s the regulator for if he’s not, you know, refereeing the match as he sees it?

Mr. Liam O’Reilly: Well, I suppose there are two answers to that. We should have done more; there’s no doubt about it, in hindsight. But ... but, second of all, there was ... the second issue was that if we were doing this, we felt that this was an aggregate problem, it was a macro problem, it was a problem that permeated the banks and it would have had to require an action against all the institutions. And, therefore, it wouldn’t have been just me, as the regulator, that would have been making this suggestion. It would have also had to go through the Central Bank and financial services authority board, and ... that was it. It just wasn’t-----

Senator Sean D. Barrett: Could I bring you-----

Mr. Liam O’Reilly: Yes.

Senator Sean D. Barrett: -----in the final question of the thing, Mr. Reilly, on this session, to page 42, just over the page. The financial stability co-ordinating committee 2006 were getting closer to the crisis. The first item in the second minute is: “It was noted that the ratings agency Fitch had placed Irish banks on lower-rated category for macro-prudential risks”.

Chairman: Last question now, Senator.

Senator Sean D. Barrett: “This downgrade would be discussed at the next Financial Roundtable.” I don’t get any impression of urgency. The banks had just been downgraded and we’re saying, “Yes, we’ll discuss that the next day.”

Mr. Liam O’Reilly: Just so say, Senator, I ... I was gone at that stage. I went in January 2006.

Senator Sean D. Barrett: Okay. Thank you very much, Mr. O’Reilly. Thank you, Chairman.

Mr. Liam O’Reilly: Thank you very much.

Chairman: With that - and I’ll just bring Senator D’Arcy in a minute. By January 2006, Mr. O’Reilly, were ... was the crisis already embedded by then?

Mr. Liam O’Reilly: In hindsight, I’m being told by all the “wise men”, including Patrick Honohan and others, that it was. I didn’t have that sense as I left the Financial Regulator, that

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we were in ... in ... in the beginnings of an imminent crisis. And as-----

Chairman: Okay, but that's Patrick Honohan's view. What's your view?

Mr. Liam O'Reilly: Yes.

Chairman: Now you-----

Mr. Liam O'Reilly: Well, my view then ... are you asking about ... for my view then-----

Chairman: No, no.

Mr. Liam O'Reilly: -----or now? Now?

Chairman: Were we embedded in a crisis already by January-----

Mr. Liam O'Reilly: In hindsight-----

Chairman: Or any-----

Mr. Liam O'Reilly: -----in hindsight, it looks we were, yes.

Chairman: Okay. That's your view, all right. I just want to return to a couple of issues there, just following on from Senator Barrett's questioning. When you ... when he was asking you about the McDowell report and, sure, you didn't have any input into that, and that may have been appropriate.

Mr. Liam O'Reilly: Sorry, it wouldn't be true to say that I didn't have any input into it.

Chairman: Okay.

Mr. Liam O'Reilly: But the direct input would have been carried out by the director general, but he might have been asking for papers and various documents to support his view, but they were generally done by other members of staff. I wouldn't have been, if you like ... I came into financial regulation in 1998 for the first time, so there were a lot of technical stuff that would have been dealt with with staff. But I did have a concern about one thing only, and that was that financial stability and prudential ... macro-prudential stability is very difficult to operate if it's not within the system of regulatory-----

Chairman: And that matters. My next question to you, Mr. O'Reilly, is that we know that a ... that from the McDowell report ... and there was an argument for a different model and that the Central Bank, Government, and Department of Finance were against recommendations that were in the McDowell report. The model, however, was developed and it was put in place and you headed it up. So can we ask you for what your views are on the model that was actually agreed?

Mr. Liam O'Reilly: I thought that it was a construct that was very difficult to operate. It was a construct that was awkward and, therefore, it was something that I thought we were given the job to operate but, if it had been up to me, I wouldn't have started from there myself, personally.

Chairman: Okay and what way would you have started it from?

Mr. Liam O'Reilly: I think that either you had a very, very clear view of having a single regulator for prudential matters for all financial institutions in one institution and if you wanted

to separate out the consumer elements and consumer protection, you could have had a sister organisation of that sort, either within the CBFSAI or separately.

Chairman: I just want to return to return to-----

Mr. Liam O'Reilly: But ... but just, sorry-----

Chairman: Yes, sure, yes.

Mr. Liam O'Reilly: -----to say that the concerns at the time was that the Central Bank didn't seem to care about consumers and, as a result of that, we have to take that whole area away from consumers. Whereas, I think it was in about 1996, a lot of the consumer elements had been taken away voluntarily, I think, from the Central Bank under the governorship of Maurice Doyle. So, what I'm saying is, if you have a financial crisis, you'd better be near the people who are providing the liquidity.

Chairman: Just on another matter - and it goes back to an earlier question from Senator Barrett as well - and that is the implementation on compliance which was first contemplated in 2004 but it took until 2006 to 2007 to be completed. Why was it ... why did it take so long to actually implement that?

Mr. Liam O'Reilly: Well, in my opening statement I think I mentioned about delays in consultation. I think that the consultation process, which was imposed in law, gave very little ... in some sense or other it all the time seems to be ... seemed to be applying a brake to the system. I think that the Financial Regulator nowadays can get things done much more quickly. I seem to remember Mr. Horan talking about, in his submission, that he had decided to go and make a change in capital requirements, without consultation. And it was the right thing to do but there was a censure immediately from the industry for having done it.

Chairman: Okay thank you. Senator D'Arcy.

Senator Michael D'Arcy: Thank you, Chair. If I could start, Mr. O'Reilly ... the memorandum between the Central Bank and the Financial Regulator dealt with responsibilities of the CBFSAI and IFSRA. Was there clarity in what should be dealt with by you, as the regulator?

Mr. Liam O'Reilly: I found clarity. I was very clear that we were responsible for micro-prudential supervision and we were responsible for communicating issues in relation to micro-prudential supervision to the Central Bank. But the Central Bank was responsible for macro-prudential supervision.

Senator Michael D'Arcy: And, with the clear analysis of each person's roles, was there any crossover or should there have been any crossover in a formal or an informal manner?

Mr. Liam O'Reilly: Well, the crossovers occurred in two ways. As I said earlier, from the point of view of organisational structure, there were six Financial Regulator board members on the board of the CBFSAI. So, there was an immediate crossover. A second one was that there was a financial stability committee and I, as the CEO, was a member of the financial stability committee. If there were weaknesses, I think that they were at an organisational level and I think that Professor Honohan mentions in his report that the ... there seems to have been a cultural issue generally. And he didn't just single out the Central Bank of Ireland, he said it seemed to be a culture in every central bank that economists and accountants find it very difficult to talk to each other in the same language. And I think if there was a lack, I think there should have

been a financial stability unit, if you like, permanently attached to the banking department. I ... I ... when ... in my time ... appointed an economist as a deputy manager in the banking department for that very reason. But I think we needed much more organised structures and much more communication about issues so that if there was a recognised ... a recognition, in some sense or the other, of the issues that were arising as a result of the growth of credit, on one side, on an aggregate basis and then, on the other side, the individual banks, if that had been put together more, I think we would have been in a better position at the end of the day.

Senator Michael D’Arcy: Mr. O’Reilly, on Vol. 2 of your documents, page 44, the Nyberg report-----

Mr. Liam O’Reilly: What page?

Senator Michael D’Arcy: Vol. 2, page 44. Mr. Nyberg was talking about the Central Bank and yourselves - the interaction between you both. The very last line of 4.2.2: “it was even suggested that detailed enquiries by the [Central Bank] regarding the basis for the [Financial Regulator’s] assessment ... could have been regarded as an unacceptable intrusion into the autonomous status of the [Financial Regulator]”. Do you think that that was the clear position of the crossover that should have been there, or not?

Mr. Liam O’Reilly: Sorry, just to ... to find it here again. It’s 4-----

Senator Michael D’Arcy: 2.2.

Mr. Liam O’Reilly: 4.4.2, is it?

Senator Michael D’Arcy: Oh, sorry, 4.4.2. Sorry, sorry.

Chairman: It’s on the screen in front of you there, Mr. O’Reilly, if you wish to look at it.

Mr. Liam O’Reilly: Yes.

Senator Michael D’Arcy: The last line on 4.4.2. Would you have felt it an unacceptable intrusion into the autonomous status of the Financial Regulator if the Central Bank - the Governor - had proceeded?

Mr. Liam O’Reilly: Certainly not. Certainly not. I would’ve felt relieved if some other part of the Central Bank came and said ‘Is ... this is ... this is what we should do here now’.

Senator Michael D’Arcy: So what you’re saying is that ... that does not apply to your period as CEO of the Financial Regulator?

Mr. Liam O’Reilly: No. I don’t believe so.

Senator Michael D’Arcy: You would have felt relieved?

Mr. Liam O’Reilly: In the sense that there was a credit issue. We all knew about the credit issue. If ... if there was a macro instrument to be used and we were searching around for what sort of ... of macro instrument should be used if ... if someone had come from the economist side to propose a macro instrument, I would have been quite ... I would have been quite-----

Senator Michael D’Arcy: Are you aware, in the Honohan report, where Professor Honohan states that there were tools ... tools available that were not used?

Mr. Liam O'Reilly: Well the two tools that were available were ... well, there were four, he said, in his ... his statement. He said, one was moral suasion, which was used a lot. A second was-----

Senator Michael D'Arcy: Did it work?

Mr. Liam O'Reilly: Obviously not. The second was capital ratios and-----

Senator Michael D'Arcy: Did they work?

Mr. Liam O'Reilly: The capital ratio. Well, there were two. Really, the way it was applied in the end was capital requirements were ... were required. And it seemed to be too little too late. And I know that - I might as well mention it now - that in on the 15th ... or some time in August 2005, Con Horan came to, well through Pat Horan ... Pat Neary, came to me with a suggestion on this. And I brought the idea to the director general of the Central Bank and the reasons for not applying it at that stage were that at that stage house prices were stabilising, interest rates were set to rise and property prices were stabilising. So ... but, generally, it ... they were brought again very quickly after that and they were applied. But, as Professor Honohan says, they were not ... they were not effective. And I suppose, just on a theoretical basis, the biggest problem was ... and I think capital ratios were the way to go - increasing capital ratios or capital requirements. The question was: what was the precise relationship between a 1% or an X% in the capital ratio and how it would affect credit? And I don't think enough work had been done on that relationship. And there would've been a danger, unless that work was done, that it would've ... it would've been either too easy or even ground the system to a halt. And there was a question of how that should be done and that comes back to my point that, I think, if there had been a unit in between of economists and accountants and maybe call them financial accountants ... financial economists ... if that had of been there, it would have been useful. As a matter of fact, the Larosière report says that the word "macro-prudential policy" didn't seem to enter the English language in any real way until after the crisis.

Senator Michael D'Arcy: But the usage of those tools, Mr. O'Reilly, and ... and the attempt to apply them, what sanctions were available to you to use if they were not adhered to by the financial institutions?

Mr. Liam O'Reilly: Well, just to say, the sanction ... the major sanction that we could've used was to put a condition on their licence. But that-----

Senator Michael D'Arcy: Did that happen?

Mr. Liam O'Reilly: That never happened.

Senator Michael D'Arcy: Never happened.

Mr. Liam O'Reilly: Never happened. Another one was-----

Senator Michael D'Arcy: Should it have happened, with hindsight?

Mr. Liam O'Reilly: Well, I've already mentioned one case in where it should have happened, yes.

Senator Michael D'Arcy: Should it have happened on more than one occasion, with hindsight?

Mr. Liam O'Reilly: I think condition is very, very strong. I must say, the best set of proposals and the best way of dealing with it was the use of administrative sanctions. And the administrative sanctions - I heard Mr. Horan's evidence on that ... the administrative sanctions system had been ... the actual law and the infrastructure had been built. I was the head of a project team in 2004 which was dealing with this. And in the case of the banking department, there is a document - and I think you have it in your ... in your store of documents provided by the Central Bank - there was a whole list of legislation that could have been turned into the codes. Now, I've been told that the reason it wasn't been done was there wasn't enough resources to do it. I think that was a pity.

Senator Michael D'Arcy: Did the Governor of the Central Bank ever try to influence the approach in relation to sanctions?

Mr. Liam O'Reilly: No.

Senator Michael D'Arcy: No. You-----

Mr. Liam O'Reilly: Sorry, I wanted to say that we apply a sanction. We increased the capital ratio of a particular institution at one stage.

Senator Michael D'Arcy: From zero to-----

Mr. Liam O'Reilly: And as well as that, sorry, the AIB one, which is in the public domain, we ...we ... while we didn't use any sanctions, we were able to force AIB to pay a lot of money back to customers. You could call it moral suasion, whatever, but we ... we used our powers to do that. Our powers of investigation, our powers to ... to go into the institution and find out what happened. And we did make findings in that situation. And ... and that was actually a job that covered both the prudential side, which was involved in it from the point of view of the deal allocations, and the consumer side, from the point of view of the overcharging.

Senator Michael D'Arcy: Mr. O'Reilly, you're ... there's only been two CEOs of the Financial Regulator isn't that ... yourself and Mr. Neary.

Mr. Liam O'Reilly: Yes.

Senator Michael D'Arcy: Mr. Neary is the public face of the Financial Regulator. Now, would it be fair to say that you're not the public face of the Financial Regulator?

Mr. Liam O'Reilly: I was the public face of the Financial Regulator from 2003 to 2006.

Senator Michael D'Arcy: What was your guiding philosophy as how the role should be performed in order to achieve the objectives, the goals of the Office of the Financial Regulator?

Mr. Liam O'Reilly: Well, there was the style of regulation which was agreed by the board ... principles-based. I was building an organisation at the time. We were putting together insurance, credit unions, consumer areas from the Director of Consumer Affairs. There was a lot of work in putting together an organisation, unifying that organisation and making sure that they worked cohesively. I felt I had done a good job in that area. I felt by the way, when I left the regulator, I thought I left it in a good state. Obviously, in hindsight, the issues were just an iceberg that I didn't see at the time.

Senator Michael D'Arcy: Can I refer back to Vol. 2 of your documents on page 3? And I believe this is a 33AK document, it's an aggregate of the documents, I'm not sure if it's going

to come up on the screen ... can it come up on the screen? But I'm going to read from it, Mr. O'Reilly. And this is a meeting in April 2004, you were in your job 12 months:

X reported under Financial Stability Matters on recent discussions at the boards of ... CBFSAI and IFSRA. He suggested that the CBFSAI had not convinced market participants that there may be "systemic risk" building up in the banking sector.

Do you recall that meeting?

Mr. Liam O'Reilly: I do, well, sorry I don't remember the meeting but I've read the documents so it brings it back, yes.

Senator Michael D'Arcy: It brings it back. In terms of ... this was discussed at both boards, am I correct?

Mr. Liam O'Reilly: No, this was discussed at the financial stability ... sorry, the message that I brought back was a message that was coming from the joint board meeting that was always held about the financial stability report.

Senator Michael D'Arcy: And in 2004 we were in the throes of the large growth of the bank balance sheets?

Mr. Liam O'Reilly: Yes.

Senator Michael D'Arcy: Were you concerned by the large growth of the banks' balance sheets?

Mr. Liam O'Reilly: I was concerned but as I said later, there were other ameliorating factors certainly at the time of my departure, but I was concerned about, to use an analogy, that the party was going on and no-one was listening. And I just felt that there was a need to get out there and to try and get people to listen. The major outcome of that was the forum of people that we got together every year, the executives of the banks and the economists in those banks. And as the Honohan report says, there seems to be a kind of a different memory emerging as to what was being said, as to what was being heard but I remember saying at that meeting that if, somewhat like I said in public in 2005, "if a shock hits this system are you ready for that shock, have you adequate capital for it?" And given the growth in credit and the growth in corporate credit at that stage even I think it was, that was in 2004.

Senator Michael D'Arcy: Can I just follow on in that paragraph:

Indeed, he indicated there may be a "degree of euphoria building up in the property lending markets and that the boards and management of banks are being myopic about the potential risks." X outlined a work programme including a "roadshow" designed to convince the bank boards of the "rationale to curb lending" no [direct] regulatory action was [recommended].

The "rationale to curb lending" we know certainly didn't happen because we know from the banks' balance sheets not alone did they not curb lending but they actually grew at a faster rate. Did this matter come up subsequently to April 2004, that there was a concern about systemic risk between both boards, between the joint meeting?

Mr. Liam O'Reilly: I think that this was a constant theme in the financial stability reports, the growth of indebtedness in the economy but it always came down at the end of the day - even

up to 2008 when I wasn't involved - that there was adequate capital buffers to deal with the issue and that was mistaken.

Chairman: There is a phone in proximity there, can I just ask members to put their phones on safe mode if they are not actually in possession themselves, because it does travel on.

Senator Michael D'Arcy: If you turn the page Mr. O'Reilly, at page 4, and again I think this should be able to come up, it's an aggregate document. Minutes of the meeting of the IFSRA regulatory authority 2003 to 2004.

Supervision agreed at the November ['03] meeting to put in place a ... Task Force to address [the issue] of corporate governance and commercial lending that had arisen following [the discussion] with former executives of an institution. The results of this Task Force have not been seen. [And it follows on that in] December 2004 meeting that work had now been completed on putting in place appropriate reporting of consolidated large exposures in another large bank.

One of the criticisms that is ... that has come from some of the bankers was that, while they were aware of their exposure to individuals, the only people with the consolidated data with the authority to request the information on the large exposures of individuals across the banks and could have seen that multiple banks were exposed for multiple hundreds of millions, were yourselves.

Mr. Liam O'Reilly: Yes, and that's when I-----

Senator Michael D'Arcy: Was that information ever compiled by IFSRA?

Chairman: Give Mr. O'Reilly time to respond now Senator.

Senator Michael D'Arcy: Okay.

Mr. Liam O'Reilly: I have already said this, that we did not, and I really regret it, we did not recognise the exposures at my time in office, for the commercial property lending and, particularly as we have seen in this forum, to individuals. I think it wasn't until 2007 that these issues began to be recognised and again I think it comes down to this whole idea of compartmentalisation, if you like, of work - where on the one side, you have economists working on aggregate data and on the other side, you have regulators dealing with individual banks. There should have been something in the middle where there was a team working on the aggregate position and how it evolved. That wasn't there at the time, it was a failure in the system.

Senator Michael D'Arcy: So just to be very clear, developer X had a billion with bank A, developer X had another billion with bank B and your staff never collated that?

Mr. Liam O'Reilly: Never, it was never red-flagged and that just is something that I have to take as responsibility, as the CEO, that the organisational structure did not bring that forward.

Senator Michael D'Arcy: Were you surprised when the information came out that 19 lenders within NAMA had €22 billion worth of loans?

Mr. Liam O'Reilly: But that would have been in ... in the later years, well beyond the time that I had retired, but I was flabbergasted.

Senator Michael D'Arcy: But it would have started in your period, the build-up?

Mr. Liam O'Reilly: Yes, I'm sure it did to a certain extent, but as I'm saying ... I ... we didn't recognise it at the time, and I think that that's said in the Nyberg report.

Chairman: It is about three minutes now Senator.

Senator Michael D'Arcy: Okay. Thank you, Chairman. What changes would you have introduced, going back to that period? What would have been the two major changes that you would have introduced into the model of regulation and enforcement?

Mr. Liam O'Reilly: Two things, two things. I think that the major, the major change would have been a more intrusive form of regulation with more resources to carry out that intrusive regulation. I think all the ... and I think I heard Cyril Roux talk about this yesterday, or maybe it was Mary O'Dea, you can have a lot of ... of sanctions, but the first thing to do is you have to have the information on which to base the sanctions. But second of all, I think that the administrative sanctions should have been put in at a much earlier date for prudential supervision. So, they would have been two things, and then the third thing would have been a much closer relationship between economists and financial regulators, sitting together, in a technical team, all the time watching how aggregate positions were evolving and how the aggregate risk was being recognised.

Senator Michael D'Arcy: Again, just to conclude, Mr. O'Reilly, Vol. 2, page 36, there's a letter to you from Michael Buckley, AIB chief executive. Is this allowed to be shown, Chair? This is not allowed to be shown. Section 33AK. It should be in front of Mr. ... page 36, yes.

Chairman: This is a letter, is it?

Senator Michael D'Arcy: It's a letter, yes.

Mr. Liam O'Reilly: Yes, have it.

Senator Michael D'Arcy: And the letter is December '03.

Mr. Liam O'Reilly: Yes.

Senator Michael D'Arcy: I put to Mr. Buckley, during previous testimony ... I asked him was the risk appropriate for his period as chief executive officer of AIB and he felt it was. Can I ask ... put that question to you, as the regulator, for all of his period of ... as chief executive of AIB.

Mr. Liam O'Reilly: Well, all I can say is that if I feel some sense of responsibility, having left office six months after Mr. Buckley, I would have said that there should be some sense of responsibility there as well.

Chairman: Thank you very much, Senator. Just, coming back to just an earlier engagement there that Senator D'Arcy had with you, Mr. O'Reilly, in regard to the memorandum of understanding between the Central Bank and the Financial Regulator's office. Could you maybe explain to us, was there sufficient clarity on what should be dealt with by the regulator and was there an expectation that the Governor should invoke his rights and intervene with the Financial Regulator and did that happen on occasion?

Mr. Liam O'Reilly: Well, the ... the relationship was a very good relationship and I don't think that, if the Governor had come with suggestions to me, as to what I should be doing, he wouldn't even have to have given me guidelines, we would have worked on it because any

macro issue would have been dealt with through the CBFSAI board and we would have complied with it.

Chairman: And at any time did the Governor come to you and say, in his responsibility, or his duty of care, which was the stability ... the financial stability of the State ... did he at any time come to you and says that we have stability concerns here and we would like to maybe examine the possibility of some regulatory matters that might assist or deal with the stability of the banks?

Mr. Liam O'Reilly: I just remember one incident a long time ago, and I'm depending on memory, where the Governor came back from an ECB meeting, where he said that the Spanish seemed to be increasing or being allowed to have a different regime for capital ratios, could we look at it here. And, I remember looking at it and it seemed to me that the reasons for it were very unique to, to Spain, and we were in a northern European environment where we had France and the UK and other countries who were applying a full, I think it's the IFRS, is it? The accounting standards. And there was certainly a feeling, at the time, that we could not deviate from that, at that time. Now I think-----

Chairman: And that was coming from where?

Mr. Liam O'Reilly: Sorry?

Chairman: Coming from the Central Bank or coming from Government or from finance? Where was that feeling coming from?

Mr. Liam O'Reilly: I can't say it was coming from anyone but a discussion we had within the bank.

Chairman: Okay. Right, thank you. Deputy Doherty, ten minutes.

Deputy Pearse Doherty: Go raibh maith agat a Chathaoirligh agus fáilte roimh an tUasal O'Reilly. Can I ask you, in relation to, and it's been touched on already, in terms of the statutory objectives of the Financial Regulator, was the promotion of the financial services industry in Ireland ... can I ask how did the Financial Regulator's office reconcile the objective with its prudential role as regulator?

Mr. Liam O'Reilly: With difficulty, I think. There was an issue that we ... we did always insist that the only way that we could promote the idea of the financial services centre was that we were operating a stringent regulatory system that applied to all. And I insisted there that people went out, that's the only way we could promote it.

Deputy Pearse Doherty: Was there a two ... two-track regulator system in place, one for the financial IFSC firms?

Mr. Liam O'Reilly: No, I think there was a determination to have a ... a one track, and it ... and it might have been one of the reasons why we ran into problems with the sectoral limits, where we weakened our regime to a certain extent, I think, because in the case of the financial centre there were a lot of monoline banks where it would have been impossible to set sectoral limits, and as a result of that it became a kind of a policy that we had to have the same system in both places.

Deputy Pearse Doherty: Okay. Can you clarify the "a kind of a policy"? Was there a policy within the Financial Regulator, at the time, that sectoral limits were being abandoned as

a result of the monoline firms within the Irish financial services centre?

Mr. Liam O'Reilly: I can only ... I can only say that the ... while I was in the regulator at the time before 2003, when the Nyberg report states, I think, that ... its a footnote somewhere, that it had stopped long before. Sorry, the policy, if you like, was being abandoned long before the Financial Regulator came into office. I would have been there before that so only ... I can only give you the perspective there and the-----

Deputy Pearse Doherty: Sorry, Mr. O'Reilly, I want your perspective. As Financial Regulator, from-----

Mr. Liam O'Reilly: As Financial Regulator-----

Deputy Pearse Doherty: Sorry, just let me finish.

Mr. Liam O'Reilly: Yes.

Deputy Pearse Doherty: From the period that you were Financial Regulator did sectoral limits exist or not, is the first question, to be clear? And then the second thing is, did you apply those sectoral limits to all institutions, including institutions in the Irish Financial Services Centre?

Mr. Liam O'Reilly: No, quite the opposite. There were guidelines issued and they applied, it seems and I've been following the, the debate here. They seem to have been used, if you like-----

Deputy Pearse Doherty: Did they exist, first, is my first question. Did sectoral limits exist when you were Financial Regulator? When you took over in 2003, did sectoral limits exist?

Mr. Liam O'Reilly: The guidelines were still around, yes.

Deputy Pearse Doherty: So they existed?

Mr. Liam O'Reilly: Yes. Yes.

Deputy Pearse Doherty: Okay. Did you apply them?

Mr. Liam O'Reilly: And, they were guidelines to banks and they were not applied in the sense that they were rules that had to be obeyed. And ... and, just to say, that in the second-----

Deputy Pearse Doherty: But if somebody breached them you would write to them, flagging up that you've breached the guidelines?

Mr. Liam O'Reilly: Yes, that we noticed that you have, you have breached the limits. But-----

Deputy Pearse Doherty: Okay. And did you write ... did you write to firms within the Irish Financial Services Centre to ... on all occasions, if there were occasions, where they breached those guidelines as well?

Mr. Liam O'Reilly: No, what I'm saying is they never applied to the IFSC.

Deputy Pearse Doherty: Okay. You've told me that there was no two-tier regulatory system, we're correct?

Mr. Liam O'Reilly: Yes. Yes.

Deputy Pearse Doherty: You told me that ... concentration limits existed when you were in 2003, but now you're telling me that they only existed for domestic banks and not for the IFSC-----

Mr. Liam O'Reilly: No, sorry-----

Deputy Pearse Doherty: So that seems to me that there is a two-tier regulatory approach here.

Mr. Liam O'Reilly: Well, what I'm saying really is that it was difficult to apply. Maybe can I just go a little bit forward and then I will come back? In 2004 I think it was, there was a move towards the Basel II limits and there seemed to be a crossover between which system should be used, but at no stage were there mandatory limits.

Deputy Pearse Doherty: We're well aware of that; we understand.

Mr. Liam O'Reilly: Well if you want to put it that way, my understanding and I'm only saying what my understanding is at the moment, would have been in that sense, there would have been a two-tier system.

Deputy Pearse Doherty: So there was, okay in that sense there was a two-tier system. How much of your time was spent promoting Ireland's financial services sector proportionately?

Mr. Liam O'Reilly: I would say, proportionately, it's very hard to say. But, basically, it involved making speeches to conferences where international companies would be coming here. And we would be talking about the regulatory system and we would be telling them how we operated and we would be telling them how we wanted everyone to operate.

Deputy Pearse Doherty: On your monthly hours that you put in, would it be 5%, 10%, 20%, less, more?

Mr. Liam O'Reilly: I would say less than 2%.

Deputy Pearse Doherty: Less than 2%, okay. Were there any pressures applied to the Financial Regulator's office to maintain a more favourable view of the Irish banking and financial services sector?

Mr. Liam O'Reilly: Sorry, in what sense?

Deputy Pearse Doherty: Was there any pressures applied to have a more favourable view? Was there pressures applied from politicians, from industry, from constructions developers, from friends, from people that you might have been out golfing with, any of that stuff?

Chairman: Or from the Department of Finance or the domestic standing group?

Mr. Liam O'Reilly: No.

Deputy Pearse Doherty: Never a pressure put on you in terms of more favourable approach? Okay.

Mr. Liam O'Reilly: Sorry, maybe I should put it this way though. We had these panels, okay. We had a consumer panel, we had an industry panel and they put pressure on, but this

was part of the legislation and it was difficult to get things done in them circumstances. The legislation in a way set tasks for us which sometimes was pretty impossible.

Deputy Pearse Doherty: In relation to, just to clarify this here, in relation to your own relationships, did you have any personal relationships with senior bankers of financial institutions that you would be regulating, none of those kind of social events that you ... you know ... outside of your duty?

Mr. Liam O'Reilly: The duties ... outside of my duties no.

Deputy Pearse Doherty: Can you explain the term “constructive ambiguity” and how it impacted and supported your tenure in the role of Financial Regulator?

Mr. Liam O'Reilly: I think “constructive ambiguity” is not a term used by regulators. I think “constructive ambiguity” is a term used by central banks and it relates to the fact that if you are a lender of last resort, you don't want to be saying to banks, “We'll look after you in the end”, because if you say that, then banks will behave as if they are going to get the money and take the risks as a result of it. So constructive ambiguity, as far as I'm concerned, is about the ambiguity to ensure that you're not promising anything so don't depend on us to bail you out.

Deputy Pearse Doherty: Okay. I just want to ask a question here because I noticed you mentioned the FX trading scandal or the overcharging in AIB, which was exposed to the public by very valuable reporting done by RTE in 2004. There has been evidence given to other committees in this House. I'm not sure ... I don't think you have ever been before them but given you're here under oath, was there ever a suggestion made to you in 2001 in a meeting and, in 2002, in a meeting, as has been suggested by an internal auditor of AIB, that there was an overcharging issue in terms of exchange in AIB going on at that time?

Mr. Liam O'Reilly: What ... I am reluctant to get into this but, you know, in terms of my take on the situation was that I knew nothing about any overcharging issue that occurred and was uncovered in the investigation in 2004.

Deputy Pearse Doherty: I just want to clarify this here because it is in our evidence books in terms of the report of the overcharging. It says a whistleblower informed the Financial Regulator in, I think, it was May 2004. The question I want to ask you just particularly is: did a whistleblower or an internal auditor from AIB make you aware of issues in terms of overcharging in this form in 2011 and 2012? Because that is testimony that is out there in the public domain and I just want you to answer that if you can.

Mr. Liam O'Reilly: Sorry in 2011 and 2012?

Deputy Pearse Doherty: In 2001, sorry, in 2001 and 2002. There were meetings with yourself in 2001 and two meetings in 2002.

Mr. Liam O'Reilly: The answer is emphatically “No”.

Deputy Pearse Doherty: No. Okay. The minutes of the meetings, do you have access to the minutes of those meetings?

Mr. Liam O'Reilly: The access ... I have no access now.

Deputy Pearse Doherty: Okay. I assume that the committee can get access to those.

Mr. Liam O'Reilly: Yes.

Deputy Pearse Doherty: The last thing I want to ask you is-----

Mr. Liam O'Reilly: Can I just say that in 2001, just to give a little bit of background, the internal auditor of AIB left AIB on sick leave and I was concerned about the fact that there was no auditor involved, so I called this internal auditor in. He made certain statements but the statements related to issues that we were dealing with at the time. The issues related, the issues talked about in 2004 which were none of those issues, were ever talked to me about in 2001.

Deputy Pearse Doherty: Or 2002?

Mr. Liam O'Reilly: Or 2002.

Deputy Pearse Doherty: That's fair enough. You've made that clear.

Mr. Liam O'Reilly: Not alone that but maybe I could just say that ... I just want to get this ... I want to say it carefully ... I don't know whether I can ask you a question.

Deputy Pearse Doherty: I don't think you can. You can try. I can tell you I know nothing about this. I know that there's allegations that have been made before a committee.

Chairman: Sorry, Deputy. I will invite you to ask a question and we will see how it goes.

Mr. Liam O'Reilly: What is your perception of who the whistleblower was in 2004?

Deputy Pearse Doherty: I have no understanding of who the whistleblower was in 2004 to the Financial Regulator or, indeed, to RTE, which exposed this programme to the nation and I believe resulted in, the following day, a formal inspection of AIB. My concern is the testimony that's been given to an Oireachtas committee here, which states categorically that you were put on notice of not just the events, not the overcharging that was leading up to 2001 but the exchange overcharging which was investigated in 2004 at meetings in 2001 and meetings in 2002.

Mr. Liam O'Reilly: I think you will find that the records of the whole story, which was told by two people from the regulator at the time to the committee, plus letters to that committee, are all available here.

Deputy Pearse Doherty: Thank you.

Chairman: All right. Thank you very much. Okay so, are now going to break, I propose we will break... It is coming up to 11.10 a.m. so we can break until 11.25 a.m. if that is agreeable, please, with members. With that said, I would like to remind the witness that whilst we break you are still under oath and that any engagement must be dealt with in that regard. So with the agreement so, I propose that we suspend and to resume again at 11.25 a.m. Is that agreed?

Sitting suspended at 11.09 a.m. and resumed at 11.33 a.m.

Chairman: I now propose that we go back into public session. Is that agreed? Agreed. And in doing so, I'd invite Senator MacSharry. Senator, you have ten minutes.

Senator Marc MacSharry: Thanks very much, and thanks, Mr. O'Reilly. Can I ask you was it appropriate that the domestic financial institutions were regulated in the same manner as the international institutions? I know this was touched on earlier. In your view, were the regulatory institutions of the State focused on non-labelling of the IFSC as an offshore haven

instead of ensuring the domestic banks were regulated in a sufficiently robust manner to mitigate against financial stability risks arising from the domestic sector?

Mr. Liam O'Reilly: I would say, in hindsight, that too much concentration was being put on the equality in terms of the way we dealt with everyone as opposed to looking after domestic exposures. Yes, I agree with ... I would say that, yes.

Senator Marc MacSharry: Did you feel that there was sufficient staff numbers and skill sets after the implementation ... or after the passing of the 2003 Act for CBFSAI to ensure that the regulation and supervision procedures were enhanced in line with the original intentions of establishing a totally new and autonomous regulatory authority?

Mr. Liam O'Reilly: Okay. I suppose that question has two parts. One is the consumer area and building up a whole consumer infrastructure and, certainly, it took us a while to build up that structure. In the case of insurance, we felt that it needed to be increased as well. In the case of banking supervision, certainly, what was happening was that the staff were ... were ... needed to be very specialised and, as a result of that, it was very, very difficult to continue to maintain the level of specialised staff. It's a constant battle to keep good people on board. In terms of numbers, I can say that, in 2000, the number of people in banking supervision was 32, I think; in 2005, it was 46. Was it enough? That kind of begs the question of was the regulatory regime a success? It would have been enough if principles-based regulation was a success. It wasn't a success; it was a failure. We needed more resources to do the job that eventually we recognised that needed to be done. Just to say finally that it was a constant battle to actually get specialised staff. I remember we'd just got an expert in Basel II in. He worked in the Bank of England and he was gone within a year to another bank. Competition was very, very tight to get specialised staff and to retain them. So to answer your question: did we ever have enough staff? I would say it was a constant struggle

Senator Marc MacSharry: And the skill set of those you had, was it sufficient?

Mr. Liam O'Reilly: The skill set to do the job of a principles-based regulator, yes. Perhaps we could have ... we could have put in more people of the economist persuasion within this central unit that I'm talking about. That would have helped a lot. But with a principles-based regulatory regime, the kind of staff that the regulator is looking for today, like people drilling down into loan books, etc., we didn't have them at the time and it wasn't seen to be needed because we were using this system.

Senator Marc MacSharry: Would ... would the staff make-up in the Central Bank have historically been, kind of, civil servants-based, that they went in, maybe like yourself, at the beginning of their career and stayed there? Was that-----

Mr. Liam O'Reilly: I would say-----

Senator Marc MacSharry: -----or were people coming and going all the time from the private sector, from different-----

Mr. Liam O'Reilly: I would say that if the flow was any way it was from the Central Bank to the private sector, because the skills that they were learning within the Central Bank were skills that were needed outside. So I would say, to be quite honest, that the flow was in one direction. I tried to, at times, moot the idea ... and we did it, at times, get seconded people from the ... from the ... from the private sector, from the banking sector. There were issues of secrecy, etc., but we seemed to get over them. And if we needed extra staff at the end of the day - and we

did - we did employ firms of accountants to do special tasks for us, like in the case of the AIB investigation and in the case of other investigations that we carried out.

Senator Marc MacSharry: In terms of career path, in your experience over quite a long time, and I'm not asking about your own specific case, because that wouldn't be fair, but was there a sense that seniority equalled promotion?

Mr. Liam O'Reilly: No. I would say that there were plenty of people left behind, if you know what I mean. I think it depended on qualifications, experience, diligence, and people who took responsibility, they usually got promoted.

Senator Marc MacSharry: Was there-----

Mr. Liam O'Reilly: It wasn't "my turn" sort of situation.

Senator Marc MacSharry: Okay. Was there, a situation where, all things being equal in terms of qualification and experience, the practice of not questioning one's superiors?

Mr. Liam O'Reilly: I've never found that. I've heard that being mentioned, and I decided to look over notes, for instance, of meetings that we would have had with banks, and I just saw that I was at it, the prudential director was at it, and either the manager of the banking department was at it, or if he wasn't there, on occasion the actual inspector who dealt with the institution was at the meeting.

Senator Marc MacSharry: We had testimony from Mary Burke and Con Horan. Con Horan described himself as the only dissenting voice, I think. Can you recall him being a dissenting voice?

Mr. Liam O'Reilly: Con Horan was a very good member of staff and I valued him in the job he was in. And, as I said, he would have been a man that wouldn't have been slow about voicing his opinion. But I think one of the jobs of a manager is to listen and to be carefully listening, I ... I may have disagreed with him at times and taken different decisions, but I always gave him a hearing voice, and my memory of my time in the regulatory office was that my door was open to anyone that wanted to come in.

Senator Marc MacSharry: Were there ever dissenting voices that you, with the benefit of hindsight, feel you should have listened to, and was he one?

Mr. Liam O'Reilly: I think maybe in relation to that capital ratios, capital requirements thing, maybe it should have been applied earlier. But, having said that, as Professor Honohan said, it was really ineffective in ... in making any change to the thing.

Senator Marc MacSharry: Do you feel in your role as CEO that you had absolute plenary independent status to take a decision on behalf of the regulator, or did you look to the Governor as higher authority?

Mr. Liam O'Reilly: Well, as I said earlier, if a matter came up with a bank, for instance, if we were going to take very firm action against that bank, and if we were sending a very sharp letter out to that bank, and if we were going to increase a capital ratio in that bank, I certainly would have been consulting with the Governor, because of the potential financial stability implications.

Senator Marc MacSharry: Okay, just two final questions of it's okay. Just very, very

quickly, as CEO did you ever refuse a request for additional resources in the banking supervision department, in particular?

Mr. Liam O'Reilly: No.

Senator Marc MacSharry: Okay.

Mr. Liam O'Reilly: You know at this stage, I think from looking at earlier, there was a process, the process was that, at the end of the day, it was the ... the budget and remuneration committee that decided on ... on staff numbers. And my abiding memory of that was that there were times when we had not filled our complement and the board said, "Well, how can we say you need any more when you haven't even got what you asked for in the first place?"

Senator Marc MacSharry: It was a difficulty getting the quality or the specifics-----

Mr. Liam O'Reilly: Exactly, exactly.

Senator Marc MacSharry: Very last question then. Yesterday we had some testimony from Mr. O'Connell, who, I know, was on the Central Bank side of the house and was the chief economist. But you served on the board of the authority for about six years, isn't that right? Three years?

Mr. Liam O'Reilly: Mr. O'Connell?

Senator Marc MacSharry: No, you did.

Mr. Liam O'Reilly: Oh, I did?

Senator Marc MacSharry: You did, yes. He mentioned to us how difficult he found it to-----

Mr. Liam O'Reilly: Sorry, the authority I served on it for ... 2003-----

Senator Marc MacSharry: Three years.

Mr. Liam O'Reilly: Three years.

Senator Marc MacSharry: Three years, sorry, yes. He was mentioning to us how difficult he found it to get his dissenting voice and points of view to the board level. He stated, that in his view, this was down to the political and property interests at the board. In your experience, at the board, did you feel there were political or property interests promoting an agenda, or suppressing another agenda?

Mr. Liam O'Reilly: Well, first of all, I'll say that if, if Mr. O'Connell was going up a line, he'd be going up to the Governor; that's the side of the building he was on. But I was a member of the Central Bank and Financial Services Authority of Ireland board, and I never saw a board member making any comments but those in the public interest.

Chairman: Thank you, Senator. Just in addition there to Senator MacSharry's question with regard to your request for additional staffing and resources, could I invite you, Mr. O'Reilly, to maybe comment upon the statement that Mr. Hurley gave that no request for staff was refused in a testimony here earlier and also to Mary Burke's statement that her department was under-resourced and request for additional staff were, were refused? Do you have any observation or comment you'd like to make on those two remarks?

Mr. Liam O'Reilly: Well, on the first one I ... I ... the Governor never refused staff. The way the matter operated was that staff requirements were set by the authority, and our budget was approved by the Minister. That's the way that worked. I never worked with Ms Burke at all so I can't make any comment on that.

Chairman: Okay, thank you. Right. Deputy Michael McGrath.

Deputy Michael McGrath: Thank you, Chair. You're very welcome, Mr. O'Reilly. Can I start by asking you, in relation to the banking crisis, and I suppose the fact it happened is the ultimate measure of the effectiveness of the use of supervisory powers but, in your view, essentially what went wrong and who was responsible, given the fact that banking supervision from 2003 to 2008 failed to prevent an unprecedented systemic crisis? What do you believe are the essential factors that led to that crisis and what went wrong?

Mr. Liam O'Reilly: I think, No. 1, the risks were not quantified properly and the financial stability reports and the IMF reports were all too sanguine even after my term in office - much too optimistic. So, I would say that that certainly didn't help in getting a sense of readiness or a feeling of danger around the place, okay. That's the first thing I'd say. The second thing I think I could say is that the system itself was not ... was not conducive to digging down into ... into detail enough. So the principles-based system didn't work. The Basel accord was not fitted in terms of what it required in terms of capital-----

Deputy Michael McGrath: Basel II is it?

Mr. Liam O'Reilly: Basel II.

Deputy Michael McGrath: Yes.

Mr. Liam O'Reilly: And even Basel I. The actual Basel system was not ... not fitted in terms of having enough capital available. And then on a personal level, I suppose, the ... and that might be to do with not having enough resources to dig down ... not recognising the extent of the exposures that were around at the time.

Deputy Michael McGrath: But can I put it to you, Mr. O'Reilly, that, you know, according to the evidence from Cyril Roux yesterday, principles-led regulation doesn't necessarily have to be non-intrusive, that it doesn't have to be light-touch, as such. Could principles-led regulation have been implemented better by the authority during the years in question?

Mr. Liam O'Reilly: If ... if on the condition ... it really is a question of definitions, etc., what's principles-based and what's rules-based, but, basically, you have to have principles, you have to have rules. I think it's the way you implement it, and the dependence that you place on the internal auditors and the external auditors of institutions, the risk committees of institutions. No longer can you trust those, and if you have to do the job then, the resources is the issue and, certainly, the way we had set up our system we didn't have enough resources. If we had had enough resources and, and applied ... I think whether it's principles-based or not, it's more about intrusive, aggressive, or, if you like, depending on boards too much. So, I think, principles-based plus intrusive, aggressive plus resources, I would agree-----

Deputy Michael McGrath: But is it the case that principles-led regulation could have been done differently, that it could have been more aggressive, it could have been more intrusive?

Mr. Liam O'Reilly: If it had the resources to do it. That, that-----

Deputy Michael McGrath: Did you ever request resources and were refused?

Mr. Liam O'Reilly: No, because the style of principles-based regulation that operated not alone in Ireland, but in Europe, was that it did put too much dependence on boards and did put too much dependence on the internal control systems. And that's the difference today. Now, people go in and they ask more questions.

Deputy Michael McGrath: Governor Honohan, in his report, reached a central conclusion in relation to regulation and he said:

... a regulatory approach which was and was perceived to be excessively deferential and accommodating; insufficiently challenging and not persistent enough. [It] meant not moving decisively and effectively enough against banks with governance issues. It ... meant that corrective regulatory intervention for the system as a whole was delayed and timid.

Do you accept that?

Mr. Liam O'Reilly: I naturally dislike words like "timid" and "deferential"-----

Deputy Michael McGrath: I'm sure you do.

Mr. Liam O'Reilly: -----but I would say that the system and the style was such that there was supposed to be, if you like, an agreed approach between boards and regulators as to how to do the job. I think, from now on, it has to be the regulator doing the job and the board-----

Deputy Michael McGrath: But I suppose, Mr. O'Reilly, people sometimes get frustrated when the word "system" is used. You know, there are people in a system. People operate a system. People are responsible for a system. People can change a system.

Mr. Liam O'Reilly: Yes.

Deputy Michael McGrath: So, you know, is it adequate to blame the system?

Mr. Liam O'Reilly: Well, let's put it this way: what I'm saying is the system was there, we operated a system, we didn't have the sense of danger that was required at the time. So, as a result of the fact that we didn't have a sense of danger, we didn't, at the time, recognise that there needed to be a change in the system.

Deputy Michael McGrath: Okay. And with the full benefit of hindsight - looking back now - what could you have done during the years that you were the Financial Regulator-----

Mr. Liam O'Reilly: Well-----

Deputy Michael McGrath: -----with the powers available to you at the time?

Mr. Liam O'Reilly: Well-----

Deputy Michael McGrath: What could you have done which might have-----

Mr. Liam O'Reilly: I think that-----

Deputy Michael McGrath: -----changed the outcome?

Mr. Liam O'Reilly: The ... I don't think ... well, sorry ... first of all, I think that the administrative sanctions should've been ... well, it couldn't have been implemented any quicker than

when I had it because it ... they really ... we were only ready to start applying them at the end of 2005. But let's take the whole period. I would've said that there was an urgent need, within the system, to ensure we had a comprehensive set of administrative sanctions for the prudential side and I think that that should've happened. We would've had ... we would have requested more resources to do that. And-----

Deputy Michael McGrath: When exactly did those administrative sanctions become available? Was it 2005?

Mr. Liam O'Reilly: The administrative sanctions were enacted in 2004-----

Deputy Michael McGrath: Yes.

Mr. Liam O'Reilly: -----but there was a need then to translate the processes and procedures ... fair procedures, etc., had to be developed. They were developed during 2005 and the first codes were being introduced towards the of end of 2005 in relation to consumer codes. What I'm saying is, there should've been a parallel attack on the prudential codes. And, I suppose, one of the central ones that I was very disappointed never happened was the corporate governance codes, which I think would've been the centre of getting to grips with things.

Deputy Michael McGrath: Just to clarify, when exactly were sanctions against banks on your desk and available for use?

Mr. Liam O'Reilly: They wouldn't have been available, I'd say, until early 2006, if the resources had been available-----

Deputy Michael McGrath: Okay.

Mr. Liam O'Reilly: -----to do it.

Deputy Michael McGrath: So they weren't available at all during your tenure?

Mr. Liam O'Reilly: No, no. We had built the architecture-----

Deputy Michael McGrath: Okay.

Mr. Liam O'Reilly: -----we had talked about director's compliance statements, we had talked about corporate governance codes, we'd talked about banking standards, we'd talked about fitness and probity of individuals and, not alone that ... but we had a project team which I'd put together for banking supervision - and it's in your documents, I can give you the reference later - of all the legislation that could've been translated into administrative sanctions.

Deputy Michael McGrath: Okay.

Mr. Liam O'Reilly: And it required resources ... the resources weren't used. I'm disappointed with that.

Deputy Michael McGrath: But you didn't request additional resources.

Mr. Liam O'Reilly: Well, it wouldn't have been something that I could've done because we were only at the stage of ... I think it's ... I was on the project group where we went through every department, every department set down pieces of legislation that could be translated into codes and it was at that point that we needed to put more resources in.

Deputy Michael McGrath: And can you comment-----

Mr. Liam O'Reilly: And I think Mr. Horan said and Mr. Neary said that there seemed to be a board decision that said "We'll prioritise the consumer codes" and I think that was a mistake.

Deputy Michael McGrath: Can you comment, Mr. O'Reilly, on the rapidly expanding balance sheets of the banks and was there a requirement, as a result of much more intrusive supervision, than what they actually experienced from the regulator for the period '03 to '06? Why did you not embark on more stringent intervention in light of this?

Mr. Liam O'Reilly: Well, I would divide the issues into two. There were some micro issues and I think I've talked about them. But I think that the major issue was that before EMU, if credit started rising, the Central Bank would've increased interest rates. It wasn't there anymore. And there was this whole quandary as to what can you do if you don't have the major instrument to quell credit. And I think it took a while to actually realise that what was needed was what's called macro-prudential supervision, which was what instruments do you use now to quell credit and credit growth. And we've talked about these capital ratios, sectoral limits, etc., and I think that the whole process of developing that and making sure you had the quantitative work done behind it, so that when you had an instrument, in certain ... for instance, in terms of interest rates, there would've been models that said if you increase interest rates by X, that's the effect on credit; if you increase capital ratios by Y, what is going to be the effect on credit? And there was a need for that sort of work to be done.

Deputy Michael McGrath: Thank you.

Chairman: Okay, thank you very much. Just before we go onto Deputy Murphy, maybe just put one question to you, Mr. O'Reilly. You are familiar with Mr. Neary's testimony?

Mr. Liam O'Reilly: Yes.

Chairman: Okay. And in that regard, would you say that your approach during your tenure to a principles-based regulation, both in terms of interpretation and application, were similar or differed from the approach taken by Mr. Neary during his tenure?

Mr. Liam O'Reilly: I would've said that it would've been the same.

Chairman: So it would've been a continued ... continuity of the same approach, same model, both in Mr. Neary's term and yours?

Mr. Liam O'Reilly: Well, just with the proviso that I did ... I was conscious of the fact that there was a need for sanctions and there was a need for sanctions to be applied quickly. Now I don't know what constraints Mr. Neary was put under but certainly there seemed to have been some sort of putting on the long finger of doing consumer legislation before prudential. But, if I had been there ... but it's very easy to second guess at this stage, hindsight, but I would've hoped that I would've been pushing for the implementation of administrative sanctions for prudential supervision.

Chairman: And, earlier this morning, when you were talking about your tenure coming to an end at 1 January 2006, you were of the view that the factors related to the crisis were embedded at that stage. Were you restricted in taking any actions in your tenure?

Mr. Liam O'Reilly: Was I restricted in taking any actions? No. All I would say is I always was of the view that any actions I took that involved a macro-prudential dimension required

consultation with the Central Bank.

Chairman: Okay, thank you. Deputy Eoghan Murphy.

Deputy Eoghan Murphy: Thank you, Chairman, and thank you, Mr. O'Reilly, you're very welcome. I'd like to look at Vol. 3, page 40, in the evidence books. It's 33AK, but in the summary document. Senator D'Arcy touched upon this earlier on. It's a meeting of the financial stability co-ordination committee in April 2004.

Mr. Liam O'Reilly: 2004, yes?

Deputy Eoghan Murphy: You have that?

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: Great. So what we see in front of us from the summary of that meeting is the Financial Regulator stating his concerns in relation to banks being blind to risks building in the banking sector, and euphoria existing in property lending markets, which we heard earlier. And it says, in bullet three: "He proposed roadshows so that CBFSAI's concerns could be communicated to senior management and boards of banks." What's a roadshow?

Mr. Liam O'Reilly: Well, I think it ... that was a kind of a term used in the board itself, and we scratched our heads, "What does that mean?" You can't go down to, let's say, ploughing championships and start talking about these things, like you can with consumers. So I would have said that, and the way I interpreted it, was that we needed to start communicating directly with chairmen and chief executives of institutions, and the ultimate piece that emerged ... and remember I was saying this to the financial stability committee, and they then had to work out some sort of strategy, and the major strategy that arose out of that was that we meet the banks, the chief ... the big executives in banks in the forum that we had, and the first one took place at the end of 2004, so that we could communicate our concerns.

Deputy Eoghan Murphy: This was following the financial stability report?

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: It was at that forum?

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: Okay. I'll come back to that in a second, if I may. If we look at bullet four it says, on that same page:

The Committee also agreed to follow up:

- the stress testing exercise,
- detailed analysis of the housing demand, and
- a study of previous crises versus current conditions in Ireland."

Did any of that happen? And did it ring any alarm bells?

Mr. Liam O'Reilly: I wouldn't have been in the areas that would have been dealing with that because they were responsibilities for the financial stability department. And I know of ... research papers would have been written about this. I don't know whether it was written before

or after this. There was one research paper that talked about us being ... what were the factors, which led to the question: were we in equilibrium prices? Were prices overpriced or not? And I know there was econometric work done in that area.

Deputy Eoghan Murphy: But given the serious concerns expressed-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----at this co-ordination committee, stability co-ordination committee meeting-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----and the committee agreed to follow up those three items-----

Mr. Liam O'Reilly: Yes. Well there was ... there were stress testing done later on that as well.

Deputy Eoghan Murphy: When did that stress testing, the follow-up stress testing occur? Was that the stress testing in 2006?

Mr. Liam O'Reilly: No, I think the ... I haven't got ... I think that they occurred much more frequently than that.

Deputy Eoghan Murphy: Okay. But what about then the detailed analysis of the housing demand and a study of previous crises versus current conditions in Ireland?

Mr. Liam O'Reilly: Well, I never eventually saw a paper on that, I'm afraid.

Deputy Eoghan Murphy: Okay, I mean, the reason I ask is because in the Regling and Watson report, on page 29, they spoke about the problem laying in plain vanilla property lending, and the quote that they have is: "...lending trends in the Irish banking sector – especially from 2003 onwards – feature a pace of expansion, and a rise in asset and funding risks, that should have rung alarm bells."

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: This is the stability co-ordination committee-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----concerned about systemic and stability risks, talking about doing the kind of research that perhaps could have rung those alarm bells, and you're not sure if it happened or not?

Mr. Liam O'Reilly: That's right. I'm afraid not. I can't remember at this stage. It's ten years, 13 years ago, and I can't ... and I looked through documents. As you know, there are a lot of documents to look through, so I didn't come across any and I can't remember it at this stage.

Deputy Eoghan Murphy: Okay, well then let's come forward to the end of 2004.

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: And the financial stability report, and in the round table that you had. At that point in time were you able to have an input into the financial stability report, in

co-operation with the Central Bank?

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: Okay.

Mr. Liam O'Reilly: And I think that financial stability report did talk about the problem of personal indebtedness in the property sector. It talked about commercial lending problems. So it did go through-----

Deputy Eoghan Murphy: Your concerns made it into the financial stability report?

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: Okay. And you met with the banks then to discuss these concerns.

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: Did the banks ignore these concerns?

Mr. Liam O'Reilly: Well, I read the Honohan report and there seems to be a difference of opinion as to what happened at those meetings, and unless we weren't speaking the same language, I don't know, but I remember making a statement in the 2004 report that the economy was exposed if there were an external shock to the system. We didn't envisage any internal, sort of, turmoil but I do remember making a statement of that ... to that effect.

Deputy Eoghan Murphy: You sit down with the banks at the end of 2004, and it's clear in the financial stability report your concerns about the property lending that's happening in the banking system. And in that same year, and I'll take one bank that's come up in evidence, Bank of Ireland, they have changed their income multiples, they've changed their loan-to-value policies, they've introduced First Start mortgages, and they've introduced more flexibility for seasoned multi-property borrowers. So they've done that in 2004. And at the end of 2004, you're warning them about this problem building. And then in 2005, they turn around and introduce 100% mortgages in response to moves by key competitors, First Active, Ulster Bank and PTSB.

Mr. Liam O'Reilly: And-----

Deputy Eoghan Murphy: Did they ignore you?

Mr. Liam O'Reilly: And just to repeat what I said in my opening statement, I made a statement in July saying that if you're giving away 200 ... 100% mortgages, you shouldn't be giving them to people that can't afford them. And I said that the banks must make sure that the ... that the ... that there is an ability to pay, etc., etc. So we were concerned, we were ... continued to be concerned. I suppose the big problem all the time is: what instruments were we using to put a stop to this? And, even in 2007, there seemed to be an awful lot of soul searching as to what could be done. And moral suasion and capital ratios ... or capital requirements were the two things that were being mentioned and they had little effect.

Deputy Eoghan Murphy: But did the banks ignore that statement that you made in 2005?

Mr. Liam O'Reilly: Well, I think it goes back to the euphoria. We failed, I suppose, to convince the banks that there was an issue.

Deputy Eoghan Murphy: Failed to convince them?

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: But could you not have done more than try to convince them? Could you not have actually-----

Mr. Liam O'Reilly: Well, that's-----

Deputy Eoghan Murphy: -----interceded, given the concerns, the systemic concerns you'd raised in 2004-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----which you had raised with them again in the financial stability report-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----in the forum. They then go and introduce this new product, which we'd never seen before.

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: And you're worried about it. You make a statement, it fails to convince them.

Mr. Liam O'Reilly: Yes, yes.

Deputy Eoghan Murphy: What then?

Mr. Liam O'Reilly: But just ... just to be clear, the whole idea of new products, etc., was a consumer issue and the consumer people felt that there was a need for making sure that if there was innovative products, they should be made available to people, but they also said that there needed to be an affordability, and not alone that but there was a code which said that you will be sanctioned if you mis-sell a product.

Deputy Eoghan Murphy: Taking all that-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----and taking that the consumer regulation-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----of course, is underneath the Financial Regulator, if we go back to 2003, in July, you wrote to Bank of Ireland after doing an examination into their mortgage lending policies and you said "The examination raises questions about the maintenance of lending standards in your institution, and about your ongoing monitoring, management, and control of risk in relation to residential mortgage credit." So what gave you any confidence in Bank of Ireland to responsibly administer this new product of 100% mortgage lending in 2005?

Mr. Liam O'Reilly: Just ... just 2003? What date is that?

Deputy Eoghan Murphy: That was July 2003. It was a letter to Bank of Ireland.

Mr. Liam O'Reilly: Yes. And another letter issued, I think, in ... on 24 December 2000 and ... sorry, 2003 or 2005?

Deputy Eoghan Murphy: 2003.

Mr. Liam O'Reilly: 2003. And we got a reply from the Bank of Ireland in February 2004 saying that they were complying with all policies. And we entered into some discussions with them about that and eventually the management letter from PwC came in saying that they were quite happy with all their lending policies. So we were still cynical. We were still trying to convince banks. There is still a question, and I agree with you: what instrument should we have been using? Eventually the instrument that was used was to increase the capital requirements in relation to the 100% loan-to-mortgage and to commercial lending. That would be 2006.

Chairman: It'll have to be supplementary now.

Deputy Eoghan Murphy: Yes. Thank you, Chair. But just coming back then to 2004.

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: And in the 2004 financial stability report-----

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: -----you also raised concerns about commercial property lending: "The persistent increase in the rate of lending to some parts of the commercial property sector is a concern." At that very moment in time, Bank of Ireland had set up a dedicated property unit responsible for managing relationships with a total group exposure in excess of €30 million, to write higher risk-higher return property transactions.

Mr. Liam O'Reilly: Yes.

Deputy Eoghan Murphy: Did you raise this with Bank of Ireland in the round table in 2004?

Mr. Liam O'Reilly: I didn't raise that particular issue-----

Deputy Eoghan Murphy: Were you aware-----

Mr. Liam O'Reilly: -----I raised the general issue. I ... at this stage, and at this distance in memory, I don't know whether I was aware of it or not.

Deputy Eoghan Murphy: Okay. But were you aware that at the same time as you were warning about these risks, banks were making moves in relation to commercial property lending that were going in the opposite direction of what you were warning against?

Mr. Liam O'Reilly: I wouldn't have been aware of particular issues. All I can say at this stage, and at this distance in time ... that I was cynical about whether they were applying the policies that they said they were applying. And, from that point of view, moral suasion seems to have been the only action that we took. We should have done more, in hindsight.

Chairman: Okay. Thank you very much Mr. O'Reilly. I just want to deal with a couple of matters there and one is in relation to loan-deposit ratios. The targets now are in and around 120% and lower. Why was this not a target during the 2002 - 2008 period, when it reached as high as 176% in Bank of Ireland and you think the level of loan-deposit ratios in the various

institutions was appropriate during your tenure?

Mr. Liam O'Reilly: I suppose we were ... we were worried about it all the time and the question all the time was: in a market economy can you actually start putting in quantitative limits into ... into institutions? And, in hindsight, it was a mistake that we didn't go further.

Chairman: Okay. Thank you. And can I also ask you with regard to the increased reliance on wholesale funding from 2003 onwards to finance growth in the various known portfolios was significant, were you aware of the issues and did you regard this as a fundamental risk?

Mr. Liam O'Reilly: I did. And I seem to remember around that time there were measures being taken by the ... by the regulator and, I think, they came into fruition eventually to have a whole new regime of liquidity management, which seemed to hold the banks in, well, good stead during that period. The problem, I suppose, was that again the market paradigm seemed to be working whereby if you could get cheap credit, you should use that cheap credit. The question of exposures, I suppose, was far from the mind because in some sense there didn't seem to be a consciousness at all that credit markets could freeze up and all of a sudden you're in trouble, and I think that that was a problem.

Chairman: Okay. And on the liquidity issue, Mr. O'Reilly, what was the IFSRA's role in analysing and overseeing the liquidity and solvency risk of the banks?

Mr. Liam O'Reilly: There was a set of rules that were set out and they were being monitored regularly and, as far as I know - because I wasn't there at the time, during the ... the crisis period and pre-crisis period, - there was a constant monitoring of where people were in terms of liquidity, how much liquidity had left, what ... what sort of risks were about. And the system, I seem to remember Dermot Gleeson saying that it was one of the most conservative in Europe at the time in terms of liquidity provision.

Chairman: Deputy Kieran O'Donnell.

Deputy Kieran O'Donnell: Thanks Chairman. Welcome, Mr. O'Reilly. For the purpose of an internal review, I'm going to document Vol. 3, page 40, which is effectively, it's a section 33AK document but it's ... it's in the aspect, really, of the internal view of the first crisis simulation exercise in 2005 that in a crisis scenario there is a limit in the type of information that can be provided by a principles-based regulator. Can you comment on this and how was this reflected in the next exercise?

Mr. Liam O'Reilly: Well, that was my last exercise, so I can't say what happened in the next one. But the idea behind it was that a principles-based regulator, with the level of staff that they had, wouldn't be able to cope with the demands that there would be around at the time of a crisis. And as a result of that there was a need to make sure that there were contingency plans in place to either get experts in, like, for instance, Merrill Lynch, or PwC, to make sure that we had people on stand-by, to be able to sit in banks who might be in trouble, and be there at the time of the crisis. And I think that that was the fundamental idea behind saying that you need more in the time of crisis in terms of staff.

Deputy Kieran O'Donnell: You would have been on the board of Merrill Lynch when they were appointed as advisers to the Irish Government.

Mr. Liam O'Reilly: Not the branch that ... it was completely different unit. From the US, I think, they came in. It ... there was a separation there.

NEXUS PHASE

Deputy Kieran O'Donnell: What unit were you a member of the board?

Mr. Liam O'Reilly: I was a member of the board of Merrill Lynch Ireland. As far as I know, the specialist team came from abroad.

Deputy Kieran O'Donnell: And how did you come to be appointed to the board of Merrill Lynch in Ireland?

Mr. Liam O'Reilly: I was asked to become a member of the board of Merrill Lynch in 2007. As I've said in my CV, I took a year of purdah. I didn't need to. It wasn't in the rules. I decided to and I will continue to be subject to the 33AK. And I thought, just with my experience, I might be helpful on the board.

Deputy Kieran O'Donnell: Was that a paid position?

Mr. Liam O'Reilly: Yes.

Deputy Kieran O'Donnell: And how did you come to be on the board of Permanent TSB?

Mr. Liam O'Reilly: In September 2008, again, I was approached-----

Deputy Kieran O'Donnell: Before or after the crisis broke?

Mr. Liam O'Reilly: In the middle of the crisis. I can tell you that I ... I was not keeping up with ... with information as to what was happening, and I landed into this crisis, and you can imagine, I said "What am I getting myself into?", but beforehand I thought it could be a help, and afterwards I felt I had a responsibility to continue in the role.

Deputy Kieran O'Donnell: Was that a paid position?

Mr. Liam O'Reilly: It was, yes.

Deputy Kieran O'Donnell: And did you feel that you ... there would be a conflict of interest in any way by going on the board of Permanent TSB, a bank that you had regulated ... had been the regulator of a short time previously?

Mr. Liam O'Reilly: It wouldn't have been a short time previously. It would have been four years.

Deputy Kieran O'Donnell: Well it was ... well you were a regulator up to January 2006.

Mr. Liam O'Reilly: Six, two years

Deputy Kieran O'Donnell: So it would have been-----

Mr. Liam O'Reilly: Two years. But I was very careful as to what institutions I got involved in and I made sure that any institution I ever got involved in there were no issues around the time that I was a regulator. And, you know, there were very few issues in that case.

Deputy Kieran O'Donnell: For what purpose were you brought on the board of Permanent TSB?

Mr. Liam O'Reilly: They felt that I would be useful from a point of view of my experience about corporate governance and about the whole regulatory compliance area that I might have been of some help to them in that area.

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Deputy Kieran O'Donnell: Did you want ... did you interact with the Financial Regulator on behalf of the board-----

Mr. Liam O'Reilly: Never.

Deputy Kieran O'Donnell: -----at any stage when you were on the board?

Mr. Liam O'Reilly: Never, no.

Deputy Kieran O'Donnell: How would you describe your relationship with the banking institutions? In hindsight, were there any aspects of these relations that you consider inappropriate?

Mr. Liam O'Reilly: I always acted with integrity with ... with the banking institutions, dealt with them with integrity and professionally.

Deputy Kieran O'Donnell: Chairman, can I refer FRG Vol. 1, page 102 in that context, and specifically the second last paragraph, and it says "Indeed, the Financial Regulator's record[s] of the meetings is incomplete". It was about meetings with the banks. How often in your time from 2002 to 2006 would you have met with the CEO of banks?

Chairman: What's the page number there, please, Deputy?

Deputy Kieran O'Donnell: Page 102.

Chairman: Thank you, wonderful.

Mr. Liam O'Reilly: I'd say rarely: five or six times.

Deputy Kieran O'Donnell: In that period?

Mr. Liam O'Reilly: Yes.

Deputy Kieran O'Donnell: And would you have met them on your own?

Mr. Liam O'Reilly: I ... I would have met them, I think, with the chairman when we would be having ... one of the times might have been at the time of the warning banks about their ... their positions.

Deputy Kieran O'Donnell: Which banks did you meet? When would you have met them?

Mr. Liam O'Reilly: It's a long time ago at this stage but I think ... I seem to remember a minutes that we met ... we met the Irish Life & Permanent people and we also met, following the AIB problems of 2004, we met to have a review of what lessons we both could learn from that issue. They're two ... but they were always business meetings-----

Deputy Kieran O'Donnell: Would you have met ... did you meet with any of the other banks? Bank of Ireland? Anglo?

Mr. Liam O'Reilly: I was invited to speak to the Anglo board-----

Deputy Kieran O'Donnell: Whence?

Mr. Liam O'Reilly: That would have been in 2000 and ... I think 2005.

Deputy Kieran O'Donnell: In what context?

Mr. Liam O'Reilly: The board were, in some sense or other, trying to get behind what the chairman is saying about his relationship with the regulator and what the regulator's take on it was.

Deputy Kieran O'Donnell: So it was a ... it was a bonding exercise?

Mr. Liam O'Reilly: It wasn't a bonding exercise. It was an interrogation exercise.

Deputy Kieran O'Donnell: Okay. Can I just go to, Chairman, page 71, Vol.1, FRG? And you were speaking at a ... at a ... you were the guest speaker at a financial Dublin conference ... page 71. I just want to quote you said "Finally, let me assure you [this was in 6 April 2005] ... let me assure you that we, as [a] Regulator, will not introduce or impose unnecessary regulatory burdens that will effect the continued competitiveness of our financial industry and minimise the impact of such burdens coming from Europe." And, I suppose, the question I want to ask: do you still stand over that statement and furthermore-----

Chairman: When was that made, Deputy, there?

Deputy Kieran O'Donnell: That was made on the ... that was made, Chairman. I'm conscious of time.

Chairman: Yes, sure.

Mr. Liam O'Reilly: 2007?

Deputy Kieran O'Donnell: No, 6 April 2005.

Mr. Liam O'Reilly: 2005.

Deputy Kieran O'Donnell: Okay.

Mr. Liam O'Reilly: Sorry, where on that page? Page 71, you're saying?

Deputy Kieran O'Donnell: Page 71, last paragraph. "Finally, let me assure you that we-----

Mr. Liam O'Reilly: Well, it says here "As we look back on 2007 ...", is it?

Deputy Kieran O'Donnell: No, no.

Mr. Liam O'Reilly: Am I missing a page?

Deputy Kieran O'Donnell: It's delivered on 6 April 2005. Vol.1, FRG, a conference you spoke at "The Future of Financial-----

Mr. Liam O'Reilly: Vol. 1, page?

Deputy Kieran O'Donnell: Vol. 1, FRG.

Mr. Liam O'Reilly: What's FRG?

Deputy Kieran O'Donnell: Page 71.

Mr. Liam O'Reilly: I'm looking at page 71 here.

Chairman: It's on the screen in front of you there but I'll just stop the clock for a second there just to give you time. The speech or statement refers to the "Finance Dublin Conference - 6 April 2005", heading of the presentation is "The Future of Financial Regulation: Principles or Rules - Issues for the Irish Financial Services Sector [addressed] ... address by Liam O'Reilly, Chief Executive, Financial Regulator."

Mr. Liam O'Reilly: Okay. I can answer that question. We had a mandate, under a Government policy, to follow what was called best financial regulatory practice or something. I forget the name of the document but it was a policy document about good regulation and one of them was you cut ... over-regulation was not a thing we should be doing. And it was in that context ... and it would have been generally in the context of what would be principles-based regulation. Now, would I ... would I do that now? Should I have done it? Certainly, in hindsight, we need to be more intrusive and I think over-regulation is a rule for the future.

Deputy Kieran O'Donnell: Chairman, can I go to page 60 of that same document?

Chairman: Sure.

Deputy Kieran O'Donnell: And it's dealing with principles-based regulation and the fact ... I suppose, what I really want in the context ... you received an internal memo in August 2005 where ... effectively during your tenure, where there was ... you could have had a very modest increase in the capital requirements for new high loan-to-value mortgages. Now, this wasn't implemented until 1 May 2006. So the question I'm asking is two questions: under principle-based regulation, what was to stop you - with your officers - going into the banks, looking at the process by which loans were granted? Not the process ... so ... to look at the type of securities they had and so forth. And furthermore, why didn't you implement this particular proposal during your tenure because it took nearly eight or nine months before it happened?

Mr. Liam O'Reilly: Six months.

Deputy Kieran O'Donnell: Six months. Well, August to ... it happened after you left and it said that the ... that ... why wasn't it put through? And, looking back now, based on the type of regulation that was in place with the Financial Regulator, were the banks regulating themselves?

Mr. Liam O'Reilly: Just to say on that particular item, I think I mentioned it earlier in my testimony, what happened was, I saw the issue as a macro-prudential issue. I discussed it with the director general of the Central Bank and, after the discussion, the general conclusion was that at that stage house prices were stabilising, interest rates were set to rise and the fiscal incentives that were in ... and which were actually inflating house prices, were all being reduced. So, it just was a timing issue. If you're asking me now, should we have done it earlier - yes. But, as the Honohan report says, the actual measure was modest in its effect. It really did have no effect on what happened afterwards, it didn't control the situation.

Chairman: Final supplementary there, Deputy.

Deputy Kieran O'Donnell: And, in hindsight, with the fact that the principles-based regulation we've had, were the banks, in essence, regulating themselves?

Mr. Liam O'Reilly: Well, as I said, there were plenty of controls within the system. The major control was ... if you were saying "Were the management of bank controlling the situation?", I would say no because what we said was that the non-executive directors had a direct

line to the internal auditors, we had a direct line to the non-executive audit committee and we ... and ... the internal auditors had a direct reporting line. So, what ... that was a kind of a control in place. It wasn't enough because, at the end of the day, it looks like non-executive directors, to a certain extent, were being led by management too much. There was a need for much more intrusive regulation.

Deputy Kieran O'Donnell: And, I suppose, in hindsight, could it be said that the type of regulation ... the principles-based regulation you had in place, was naive?

Mr. Liam O'Reilly: And a failure.

Chairman: Okay, thank you very much. Deputy ... sorry, Senator Susan O'Keeffe. Senator, you've ten minutes.

Senator Susan O'Keeffe: Thank you, Chair. Mr. O'Reilly, what was the nature of the discussion at board level - of the Financial Regulator and the Central Bank - in relation to internal contrarians in both the Financial Regulator and the Central Bank?

Mr. Liam O'Reilly: Internal contrariness-----

Senator Susan O'Keeffe: Contrarians.

Mr. Liam O'Reilly: Contrarians, sorry.

Senator Susan O'Keeffe: I beg your pardon.

Mr. Liam O'Reilly: Well, first of all, about contrariness, there was some tension about the supply of technology and the supply of people. And the Central Bank were ... and that was the biggest bone of contention. But there were some contrarians and we did have very robust discussions and we came to a consensus in the end. But the contrarians were listened to and ... reflected, to a large extent, I would have thought, in the financial stability reports. The problem, I suppose, was that the consensus was balancing risks, etc., that things were going to lead a soft landing whereas maybe certain contrarians were saying "Well, you know, you may say that but this could end in disaster". But, certainly, the contrarians would not have been a majority or anywhere near a majority on the board.

Senator Susan O'Keeffe: Mr. O'Connell gave evidence yesterday that he had at one point been asked by somebody senior to him to ring Frances Ruane in the ESRI to remove the reference to the fragility of the banks. I know that this wasn't during your time but not only ... that seems to me to be beyond, if you like, the Central Bank, that was asking another institution to change. How or ... was that ever ... did that occur in your time? Did you ever ask anyone to make such an intervention, either within or without your own office?

Mr. Liam O'Reilly: Never, never. And, just to say on that front, that would have been a Central Bank line in the sense that the line would have been economists writing a report and economists talking to economists. They were all on the Central Bank side. I ... I ... having said all that, I can't believe that it happened in that way but if the man says that, the man says that.

Senator Susan O'Keeffe: Can you describe the channel of communication between you and the Department of Finance while you were the CEO of the Financial Regulator? And how did you deal with emerging material issues before the domestic standing group was established, which, of course, occurred after your tenure?

Mr. Liam O'Reilly: There were very few ... the only early meetings I had with the Central Bank about ... about prices was the consciousness within the group. And this would have been in the early 2000s. It wouldn't have been during the Financial Regulator. It was that the Central Bank could not lend to an insolvent institution. So, therefore, if there was to be a saving of an insolvent institution, the Government had to be involved. So, I certainly felt at that stage "We need to get the Department of Finance involved in this process as quickly as possible." That ... that's the only one now in terms of crisis. Otherwise, we would have been talking about progress in legislation. For instance, there was an issue once about the building societies Act and this thing about, you know, demutualisation of building societies and there was an anxiety to see that that progressed. The administrative sanctions legislation, we would have been up there trying to get it passed as quickly as possible. And even in the case of the 2003 Bill, I remember being involved with the Department of Finance just talking about it. So general business issues to do with the progress of legislation, I think, more than anything else. Of course, as well as that, when our budgets started to go to the Department of Finance, we would have had an interaction with them then. But just to emphasise on that side, there was never an issue about, you know, cutting budgets or anything like that. It was more about how are we going to fund this? Should we get it off from the industry first or should we divide it between public or private funding? But these were the type of issues that we would have been talking about.

Senator Susan O'Keeffe: In relation to your own office in 2003-2004, the budget that you had for your ... to run your office was €39 million. Is that correct?

Mr. Liam O'Reilly: Yes.

Senator Susan O'Keeffe: And how much of that budget was given ... was paid by the financial institutions themselves?

Mr. Liam O'Reilly: I can't remember at this stage but I think it might have been half.

Senator Susan O'Keeffe: Okay. How did it arise that the financial institutions themselves were funding their own regulator?

Mr. Liam O'Reilly: I think there was a general view at the time that they should pay for it, but it certainly was a matter of payment and not a matter of "We won't pay the budget if you don't go easy on us". It wasn't that sort of relationship. It was going to be a legislative requirement that they pay the money.

Senator Susan O'Keeffe: Who paid the rest of the budget?

Mr. Liam O'Reilly: I think it was financed by Government or maybe the Central Bank funds but one is the same as the other.

Senator Susan O'Keeffe: Did you do anything during your time to increase the amount of money or decrease the amount of money paid by the financial institutions for the running of your office?

Mr. Liam O'Reilly: No, no. I was there for, I think, two years of the budget funding. I don't know whether I was there for a third year but even if I was, it went ... we had a finance department that dealt with the Department of Finance and there was an interaction between them and the Department of Finance. I don't ever remember issues arising of a policy nature other than that one about, you know, proportions.

NEXUS PHASE

Senator Susan O’Keeffe: You were at the Central Bank during the Ansbacher period, the National Irish, the Tony Taylor business. You were yourself when you were a director at Merrill Lynch you had ... there was a serious fine levied. So you would know about banks and financial institutions, if you like, getting into trouble, doing things wrong, breaking the rules. How then, with that level of knowledge, could ... could you have faith in the so-called principle-based system when you know and you knew every day that banks were breaching all kinds of regulations? I’m sure the Financial Regulator’s office is stuffed with, you know, letters and correspondences about banks breaching regulations. How could you, in all conscience, allow that to be the system it was run by?

Mr. Liam O’Reilly: But ... but I think-----

Chairman: Just make the question how is it doing it. We’ll-----

Mr. Liam O’Reilly: Yes-----

Chairman: Okay.

Senator Susan O’Keeffe: How could you ... how could you stand over that-----

Mr. Liam O’Reilly: Yes, yes, I understood the question. I think that’s why I say that the major dependence we had was with the internal audit departments and the audit departments and the external auditor for checking out what banks were doing. We weren’t necessarily trusting everything that the banks’ management were doing.

Senator Susan O’Keeffe: With all due respect in your own statement you say “The policy laid a heavy responsibility on the boards and senior management of banks”. You knew that; that’s what the policy was about.

Mr. Liam O’Reilly: I did. But I think I go on to say that the major dependence was between the internal auditor and the non-executive board.

Senator Susan O’Keeffe: But you had clear evidence of breaches on a constant basis. Your whole life had, you know, as a man in that position-----

Chairman: Senator, you are getting very leading here. Will you just ask a question, please?

Senator Susan O’Keeffe: Okay, okay, I’m sorry. You had seen, had you not, in your job, lots of breaches by various banks? How then would you have faith that banks could be in that position to ... to be responsible?

Mr. Liam O’Reilly: Well, let’s just take them one at a time. You mentioned the NIB-----

Senator Susan O’Keeffe: Well, no, I wasn’t looking to go into detail. Because, with due respect, I’ll be stopped. And I don’t actually want to. It’s about the ethos, I think, I’m talking about.

Mr. Liam O’Reilly: Okay. Just to say, in terms of ethos, what I found generally, when there was ... when there was a problem. it wasn’t a problem ... there were some culture problems, no doubt about that. And, for instance, in the case of, let’s say, the Ruznak affair and the overcharging affair, there was an examination of conscience again and there was a new corporate governance structure put in place. But generally, we found in institutions there was a very strong willingness to comply. The compliance problems didn’t occur generally as a re-

sult of misbehaviour by senior executives. There were always problems within banks because someone did something wrong, either because it was a mistake or in the case of ... well, in the case of the tax issue, I think that that was a big issue and I remember saying at the time that if someone was to have found to have evaded tax, they were not to be made a fit and proper person for banking.

Senator Susan O’Keeffe: Okay, so just finally-----

Chairman: Final supplementary now quickly.

Senator Susan O’Keeffe: So there was no ... would you say then that there was no push-back ever from financial institutions if they were asked about ... I mean we have heard evidence of push-backs so-----

Mr. Liam O’Reilly: Sorry, maybe I should say-----

Senator Susan O’Keeffe: Yes, I think-----

Mr. Liam O’Reilly: -----there were actual times when we said that a certain person cannot be a director of this board or we have said that person has to be removed from that board.

Senator Susan O’Keeffe: I’m talking about the push-backs from the banks themselves, though, in relation to your you know, interventions or your observations or your asking for change-----

Chairman: The question is made, Senator. Mr. O’Reilly, then I’m moving on.

Mr. Liam O’Reilly: I suppose, you know, just to answer the question. Banks are very proud of their own risk management systems and they don’t like to be criticised. And when we find fault, they sometimes push back. And we push back. Now, I think that ... that’s ... that was the principles-based approach. I think that the system now is “I don’t care what you say, do it.”

Chairman: Thank you. I just want to deal with the financial stability reports there just for a moment with you, Mr. O’Reilly, and in respect of the preparation of them and the manner in which internal and external contrarian economist views were considered. Were the concerns around supervision that grew over the period given adequate consideration and if not, why not?

Mr. Liam O’Reilly: Sorry, say that again?

Chairman: In respect of the preparation for the financial stability reports-----

Mr. Liam O’Reilly: Yes-----

Chairman: -----and the manner in which internal and external contrarian economist views were considered, were the concerns around supervision that grew over the period given adequate consideration and if not, why not?

Mr. Liam O’Reilly: I would have been communicating with the Central Bank and Financial Services Authority board about issues that were arising throughout all the period with problems we had with certain institutions. I would be doing the same in the financial stability committees. They were all taken on board. The bottom line in all cases was, from our point of view, were these institutions solvent and were they ... and what was their loan loss capacity and were they having losses ... loan losses? And I would say as well as that, I would have been heartened by the FSAP report about our system, I would have been heartened about the IMF assessment.

Now, they were wrong but, as a result of those, they may have swayed the issues that we might have had with financial stability ... sorry, financial supervision problems.

Chairman: And, as part of that assessment, how was the shock absorption capacity of the banks assessed?

Mr. Liam O'Reilly: The shock absorption of the banks was assessed - and this, I suppose, is another weakness that I didn't mention ... the shock absorption of the banks was assessed by stress testing the institutions. But we see now that there were weaknesses in the stress tests, number one, but much more important I think, there was ... the stresses that were being put on the banks in the stress tests were not stringent enough.

Chairman: Okay, thank you. Deputy John Paul Phelan.

Deputy John Paul Phelan: Thank you, Chairman. Mr. O'Reilly, you're welcome.

Chairman: Phone.

Deputy John Paul Phelan: It's not mine.

Chairman: It's in proximity to you.

Deputy John Paul Phelan: A couple of brief questions. And to start ... to continue on from where Senator O'Keefe asked about directors, can you outline for the inquiry the system that existed within the regulator during your time for reviewing the skill sets required for both executive and non-executive directors of banks that you were regulating at that time?

Mr. Liam O'Reilly: There was an IQ - in other words, a form - that had to be filled in and they had to make statements about various issues, their qualifications, etc. As well as that, had they got a criminal record, whatever. These were all filled in. Then they were interviewed and it was in that process it was decided whether a person was a fit and proper person to become a director. And those criteria were being updated. There was a major weakness in the system and that was: what about follow-up reviews? And I'm afraid ... and I think it's there now today, but once you became a director you know, how do you ... it's a bit like when you get in to a job, it's much easier to remove a person before they come in than when you have them in there.

Deputy John Paul Phelan: Well, some jobs are a bit different than that. You said also earlier, in answer to one of the previous questioners, that you felt that - and I don't want to misquote you - but I think you said non-executive directors were being led by executive directors. What did you mean by that?

Mr. Liam O'Reilly: Well, sorry ... when a board gets together there's a certain amount of loyalty between the board members and the question is to what extent can you have ... and I think most non-executive directors had it, a sense of detachment and a sense of independence from the institution.

Deputy John Paul Phelan: Okay but did you have specific examples?

Mr. Liam O'Reilly: No, that's just a feeling I have about the thing.

Deputy John Paul Phelan: Okay. I want to refer now to core document Vol. 1, at page 45, I think, the annual report-----

Mr. Liam O'Reilly: Sorry, what core document?

Deputy John Paul Phelan: Vol. 1-----

Mr. Liam O'Reilly: Vol. 1.

Deputy John Paul Phelan: -----page 45. Yes, it's the annual report from 2003. It's a reference in the middle of that middle paragraph about aggregate private sector credit:

... aggregate private sector credit increased strongly last year - the increase ... being almost 16 per cent - and the rate of increase has accelerated into 2004. There is clearly a limit to the extent that borrowers can sustain rates of credit growth that are substantially above nominal increases. [And it further goes on to state that] In the light of this, the Irish Financial Services Regulatory Authority will continue to liaise closely with the banking sector to ensure that [the] adequate [...] that adequate account is taken of lending risks.

Can you outline for the inquiry what form that liaison took place?

Mr. Liam O'Reilly: That, again, is 2003.

Deputy John Paul Phelan: It's on ... the annual report of 2003.

Mr. Liam O'Reilly: Yes. I would say that the major ways in which we would have been doing that was that ... in testing mortgage lending criteria. And when an inspection would be done of a bank, looking at the loan book, making sure that they were following best lending standards which we had introduced - like affordability - stress testing it for-----

Deputy John Paul Phelan: My time is limited and I don't want to cut you short but I get what you're saying. But that ... would you characterise that as a warning or a flag, at least, that there was a bit of an issue with private sector credit in 2003?

Mr. Liam O'Reilly: Yes and remember this is a published document meant to be communicated to individual banks and banks should have been reading these, along with the bilateral discussions we would have been having with them about these issues.

Deputy John Paul Phelan: Well in ... Mr. O'Reilly, in the three subsequent years private sector credit increased by over 30%. Can you explain for the inquiry how, when the organisation that you were chief executive of - in an annual report - had made this ... raised this concern in 2003, that not only does it appear no action was taken to remedy the situation but that the ... the situation got worse to the tune of over 30% in the subsequent three years?

Mr. Liam O'Reilly: Well, just ... this is just a matter of information. This is the Central Bank annual report?

Deputy John Paul Phelan: Yes.

Mr. Liam O'Reilly: But, be that as it may, the following year - well, certainly on my departure in 2005 ... when there seemed to be an increase in interest rates, financial incentives were being discontinued in the building sector and house prices were stabilising and we were getting these comforting statements from the IMF, these all, I'm afraid, led us astray in terms of our sense of danger.

Deputy John Paul Phelan: You made ... in the very first set of questions Senator Barrett asked, you made a statement which I think many people watching would find extraordinary and I'd ask you maybe to clarify it if you could. You stated that "during my term of office we were

searching around for a method to dampen credit.” Now, I think people would have expected that the chief executive of the regulator would have found, within a three-year period, a method of dampening credit.

Mr. Liam O’Reilly: Well, first of all, it is the role of the Central Bank to dampen aggregate credit, not the regulator.

Deputy John Paul Phelan: You ... but you were a member of the joint board-----

Mr. Liam O’Reilly: I was a member of the authority and ... and I agree with that. And what I’m really saying is, that we were in a new paradigm. All of a sudden interest rates disappeared. The Larosière report, which came out in 2009, actually states that entering in to the language of regulation is “macro-prudential” regulation and-----

Deputy John Paul Phelan: I have only two and a half minutes left and I want to keep it short-----

Mr. Liam O’Reilly: No, but I just wanted to say it isn’t something that was hard ... sorry, this was a hard question: what do you do?

Deputy John Paul Phelan: I understand ... I understand that and I accept that but I’m just saying ... and I understand that interest rates ... that facility was lost. But there are other methods you know, loan-to-value ratios-----

Mr. Liam O’Reilly: And the two methods-----

Deputy John Paul Phelan: -----and income multiples and other methods that could have been used that just weren’t used, despite the fact that in 2003 this was flagged in the annual report of the Central Bank as an issue.

Mr. Liam O’Reilly: Yes. Yes.

Deputy John Paul Phelan: Why did it not happen? And, outside of yourself, why did no action come from this?

Mr. Liam O’Reilly: Well, as I said, and, you know, I’m looking at it back, and I’ve been thinking and thinking about it ... why did it not happen? And I think there was great faith in moral suasion and ... it’s not enough.

Deputy John Paul Phelan: Do you have anything to say to people who borrowed in those years who are now struggling. Like, there’s a lot of people, potentially even watching here now-----

Mr. Liam O’Reilly: I’ve already said in my statement that ... that I deeply regret not recognising the exposures that existed on the credit side.

Deputy John Paul Phelan: Can I just, finally then ... and Deputy O’Donnell touched on it, when, a year and a half to two years after you left your role, you became a member of the board of Merrill Lynch-----

Mr. Liam O’Reilly: Yes.

Deputy John Paul Phelan: -----could you imagine how, to a member of the general public, that would look like a conflict of interest for somebody who had worked their entire life in

regulation and Central Bank and got to the position of chief executive of the regulator, retired on a substantial pension paid for by the taxpayers, and then ended up taking a position on the board of Merrill Lynch and, subsequently, on the board of Permanent TSB?

Mr. Liam O'Reilly: Well I ... I must say, Deputy, that I never, ever, in my life worked to make a lot of money. I was a public servant so financial gain was not top of my mind. What was on top of my mind was that I might be of some use, and that's why I did it.

Deputy John Paul Phelan: The question I asked though was the perception of the conflict of interest between the chief executive of the regulator then going, as it were, to the other side of the fence.

Mr. Liam O'Reilly: Well ... well, all I'm saying is, you know, I can understand that people have that perception, but, I suppose I'd just ask, when one retires, what is one to do? Am I to go down for the bread in the morning and have a cup of tea and-----

Deputy John Paul Phelan: I'm not making any accusations against you personally, Mr. O'Reilly, but ... but that perception exists.

Mr. Liam O'Reilly: Yes, but, you know, that's ... yes, and I can understand the perception, but I ... I think it's still a constitutional right, the right to work.

Chairman: Okay, thank you. Deputy Joe Higgins.

Deputy Joe Higgins: Yes. Mr. O'Reilly, what role did the regulator undertake in analysing the financial accounts of the banks?

Mr. Liam O'Reilly: The regulator itself had adequate information because every month it was getting in accounting information from the banks.

Deputy Joe Higgins: What was the nature of that information?

Mr. Liam O'Reilly: It was their balance sheets, their profits, their liquidity position, it ... it was a comprehensive set of information.

Deputy Joe Higgins: Was the concentration of credit on ... in property, and was the extent of individual customers' borrowing included?

Mr. Liam O'Reilly: In ... in the reports there would have been large sector ... large concentrations, large exposures, all that information would have been available, yes.

Deputy Joe Higgins: The chief executive of NAMA, Brendan McDonagh, in evidence, said that they took over 772 debtors' loans, which totalled €74 billion, and within that, 12 of those had over €1 billion each, and that 12 had €22.2 billion between them. A further 133 borrowers took between €100 million and €999 million, each having a total of €16 billion. Why didn't that ring massive alarm bells in the regulator when that level of concentration was being shown?

Mr. Liam O'Reilly: Well, all I can do is talk to 2006 and what happened to January 2006. And I've said, Deputy, that it is a huge regret of mine that it wasn't recognised ... the aggregate position was not recognised at that time.

Deputy Joe Higgins: But, pardon me, Mr. O'Reilly, would a child regulator not see the direction and the danger in which this was tending? This ... this was ... we haven't time to give

the figures again, but if we had the figures during the three or four years of your tenure, and the three ... two or three years after, the ... the lending, as a witness here, Bill Black, said, was growing like crazy.

Mr. Liam O'Reilly: Yes.

Deputy Joe Higgins: How could it not be-----

Mr. Liam O'Reilly: I would just say to you, Deputy, that there were no child regulators in the regulatory office. We had people who were working very hard at their job. Now, it may have been misdirected, but they were working very hard. And that's ... that's the position. It wasn't caught.

Deputy Joe Higgins: And, Mr. O'Reilly, you did ... in page 3 of your written statement to us you mentioned the principle-based regime, and financial institutions committing fully to a culture of integrity, and that the main method of asserting influence over the banks was moral suasion. And Senator O'Keefe raised and pressed you on this already. But, in view of the shocking banking scandals, whereas ... where, in the public domain, it is known that and proved that some ... some banks were found blatantly cheating taxpayers, why did you have some confidence that they now were going to be paragons of integrity? All of them.

Mr. Liam O'Reilly: Well, I ... I just will quote Eugene Sheehy on this one: "By and large I found the people in banking institutions to be people who are serious about their job, serious about their customers, serious in long-term profits", not short-term profits. I think that there were certain weaknesses in the system. For instance, I had spoken about ... in many speeches I made I spoke about ... bonus systems should not be based on profits, they should not be based on share prices.

Deputy Joe Higgins: Mr. O'Reilly, their profits were increasing hand over fist during the time you were there and after.

Mr. Liam O'Reilly: Yes.

Deputy Joe Higgins: They were after maximisation of profits. So that ... what-----

Mr. Liam O'Reilly: And the IMF was saying that the banking system had enough buffers to deal with any downturn in prices. And there were demographic reasons why we had increases in ... in lending. We had population increases. I can quote the OECD who list a number of things which would ... you would call structural issues-----

Deputy Joe Higgins: Yes, but-----

Mr. Liam O'Reilly: -----and beyond that there was an ... there was an excess of prices in-----

Deputy Joe Higgins: And, Mr. O'Reilly, as an experienced banker, you saw, as well, the Nordic collapse in the '80s and '90s, for example, and many other banking collapses, as a result of excessive property lending. Was the problem that you were gentleman regulators, really, depending on the banks to observe the ... the Marquis of Queensberry rules, but you weren't dealing with gentleman bankers, you were dealing with street brawlers who were out for maximised profits?

Chairman: Be mindful.

Deputy Joe Higgins: Would that be a fair analogy, perhaps?

Mr. Liam O'Reilly: I couldn't characterise people I knew as bankers as street brawlers.

Deputy Joe Higgins: Would the light-touch regulation be explained by another theory that has been raised, and I'll put it to you, Mr. O'Reilly, that following the massive deregulation of the international financial industry, starting with the Thatcher-Reagan period in the 80s, and then, according to a witness here, Bill Black, massively intensified by the Clinton regime, that the scale of the financial industry internationally and the scale of profits and interest that was involved, had led governments to wanting a share of this, and didn't want to curb the excessive profits that was going on, in order to gain from it?

Mr. Liam O'Reilly: At last, I can agree with you, Deputy. And, I would say that the Basel accord was a characterisation of that where you had the banks coming in and saying: "We have big technology systems, we can mind ourselves. If we mind ourselves more, maybe you will charge us less capital". That was wrong.

Deputy Joe Higgins: Okay, and can I further develop this point a little bit, Mr. O'Reilly? In his book, called *Ship of Fools*, the ... I think he is now deputy editor of *The Irish Times*, Fintan O'Toole, quoted the Industrial Development Authority, the IDA, referring to a flexible and business focused tax and regulatory system in Ireland, and then quotes directly the IDA as follows:

In 1998, the Regulator advised the banking licence regulations, its banking regulations, and it may now accept under certain circumstances applications from corporate entities to be licensed as banks. In the case of most group treasury and asset financing operations, the Regulator has disappplied its powers of supervision.

I'll repeat, "...the Regulator has disappplied its powers of supervision." Can you throw any light on what that means?

Mr. Liam O'Reilly: Well, I think that generally, there was a movement towards principles-based regulation which has been characterised as light touch, I don't like using that word, but certainly-----

Deputy Joe Higgins: Mr. O'Reilly this is the premier agency bringing big business, finance etc. into the State. They say that as a matter of policy you had disappplied the regulatory system.

Mr. Liam O'Reilly: Well I will go further and say it was a huge mistake to put into the 2003 Act that we should be involved in the promotion of this.

Chairman: Move faster, please.

Deputy Joe Higgins: You were conflicted by that were you?

Mr. Liam O'Reilly: I would say it was a confliction and it's gone, thank goodness.

Deputy Joe Higgins: Mr. O'Reilly, when I was ... in relation to that and the follow on and the consequence of that, when I was researching for your appearance today, I wanted to find out that ship of fools referred to and *Wikipedia* tells me that it's an allegory originating with Plato. It depicts a vessel without a pilot, populated by human inhabitants who are, among other things, oblivious and seemingly ignorant of their course. In hindsight, would it be very unfair to say that that was the Central Bank in relation to its control of what was happening in the banks or

the regulator?

Chairman: Last question now Deputy.

Mr. Liam O'Reilly: I couldn't characterise it that way but I can say that we made a mistake in applying principles-based regulation and we made a mistake in not recognising the full extent of the risks at the time. To say that we were rudderless, I cannot as a person who has worked that length of time in my life, call myself a member of a ship of fools.

Deputy Joe Higgins: Right and last point, briefly, Mr. O'Reilly-----

Chairman: Quickly now Deputy please, we will do the reviews later.

Deputy Joe Higgins: Six members of your board were also on the Central Bank board, isn't that correct?

Mr. Liam O'Reilly: Yes.

Deputy Joe Higgins: And they had a majority in fact.

Mr. Liam O'Reilly: No they didn't.

Deputy Joe Higgins: They didn't have a majority in the board.

Mr. Liam O'Reilly: No they didn't because the Chairman of the board was the Governor.

Deputy Joe Higgins: Okay but it was a substantial component.

Mr. Liam O'Reilly: It was six-six.

Deputy Joe Higgins: So can I just ask you a new-----

Mr. Liam O'Reilly: And usually the chairman has casting vote.

Deputy Joe Higgins: Yes. Can I just ask you in your time there, was there any one or two or three board members who were expressing, say, a serious opposition to the general light-touch regulation that would have made a mark on you?

Mr. Liam O'Reilly: No, I think the actual system of regulation was never questioned. I suppose if I remember and I don't want to single out one person because then, you know, you are saying one person. But I can say that there was a concern among a minority of members that the property development that was occurring could end in disaster.

Chairman: Thank you very much. I am going to move towards the wrap-up here Mr. O'Reilly. I just want to deal with one item before I invite the leads to come back with their own wrap-ups and that is as CEO of the Financial Regulator, can you outline your role in micro-prudential supervision of individual institutions, the banking sector and for financial stability generally?

Mr. Liam O'Reilly: I was the supervisor of the prudential area and the consumer area, and the prudential area had four departments I think, and the consumer area had two departments and as well as that, there was a legal department and an administration department. So I had the prudential regulator reporting to me and he was in charge of banking supervision, securities etc. So that was my line role in relation to that.

Chairman: So who were you responsible and accountable to?

Mr. Liam O'Reilly: I was accountable to the chairman of the board.

Chairman: Chairperson of the board, thank you very much. I am going to reference some documents and they are actually up in front of you in a moment. This is from Vol. 3 and it is page 40. What we have here is an aggregate summary, it's in relation to the financial stability report of 2004 and it's the very end of the page there Mr. O'Reilly, where it says "A number of risks to financial stability were highlighted in the report ... Irish banks growth rate 4 times that of the European average ... Irish banks accessing substantial funding from non-Irish sources ... continued increase in house prices [and] tax policy in favour of home ownership." Just moving on further, there is a summary of the actual final stability report of 2004 and that moves to page 45 of the same document. I just want to bring your attention to the end of col. 1, which is the heading, "Household Sector". Bear in mind this is for 2004, again during your tenure. The "Private-sector indebtedness, measured as the value of debt to gross domestic product ... has increased substantially since the mid-1990s and it is now at historically high levels". Moving down then to what would be the third paragraph on the second column it says:

First-time house buyers are now more heavily indebted by comparison with their peers in the early and mid-1990s. Consequently, the repayment burdens of first-time buyers have not fallen with the decline [of] variable mortgage interest rates, which are now at historically low levels, as households are opting [I maybe question the word "opting" here] for higher mortgage debt ... income ratios, higher loan-to-value ratios and/or longer maturity loans.

In layperson's language, this meant that the traditional way of buying a house over 20 years with three to four times one's income was now being pushed out in every conceivable way, 100% mortgages, loan-to-value ratios, the maturity levels over 35 years. This is all happening under your watch and it is happening in 2004. Can you give us an explanation as to how the standard, whatever about the standard banking model that was being referred to, I think by Deputy Higgins, and yourself earlier, where banks existed for 100 years, in a very short period of time, peoples' ability to buy a home had been completely refigured into a new model, all at additional cost? Even though interest rates now were historically low, it was still costing more to buy a house. Can you explain to us why that happened during your tenure?

Mr. Liam O'Reilly: I would say that my statement in the middle of 2005, which actually expressed those concerns and was saying that we were reaching the stage where institutions must make sure that people can afford this. And that was a worry that was being expressed there, that people wouldn't be able to afford houses. The situation had developed, there's no doubt about it, and it's a question of how it developed. I think that maybe we should not forget the incentive systems that were being provided for to buying the houses, as well as the easy availability of credit. But I would also say that there was a competition going on between financial institutions, this is in hindsight, which was totally inappropriate for the time.

Chairman: In that regard so, because Ms O'Dea in questioning on a similar line of questioning yesterday, said that what was coming out of the Financial Regulator's office was a lot of advice about these products and to be mindful, "put on your seat belt" was the kind of analogy that we discussed with her. But really there was a product here being put out, that was a series of products, that if you were giving warnings to the consumer there did not seem to be any particular action and I'll maybe get further clarity on you. At an institutional level, what were you doing to the institutions to go in to deal with exactly the type of problems you are talking about now?

NEXUS PHASE

Mr. Liam O'Reilly: Well, for instance, the loan to value mortgage issue was addressed in May 2004 with the increase of higher capital requirements for people who lent money at 100% mortgages. The risk weight was increased, which was a disincentive. But, you know, in all honesty, moral suasion was the major instrument and it was ineffective and I can't say any more than that. In hindsight, I'm saying it was a mistake.

Chairman: Okay, thank you. Deputy Barrett or Senator Barrett.

Senator Sean D. Barrett: Thank you, Chairman. The same document that the Chairman has been discussing with you, Mr. O'Reilly, on page 9, please; that's the Vol. 3 one, yes.

Mr. Liam O'Reilly: Vol. 3, page 9?

Senator Sean D. Barrett: Yes, page 9, yes. Now, in the-----

Chairman: Now, Senator.

Senator Sean D. Barrett: The second-last sentence, it says, "Two of what the [Financial Regulator] regarded as key elements of the governance architecture of principles-based regulation - Directors' Compliance Statements and the Corporate Governance Code were not ... in place." That's from Honohan. Was that because of the pressures we mentioned earlier from the Department of Finance?

Mr. Liam O'Reilly: I would say that ... and I've said it earlier, I think we were ... and I don't know whether it was ... well, it was part of the political philosophy, I suppose, but we were bogged down all the time in consultation. It was a partnership approach between the banks and the regulator and that doesn't work and that was the problem.

Senator Sean D. Barrett: Did you act in a deferential manner towards the Department of Finance?

Mr. Liam O'Reilly: No, never.

Senator Sean D. Barrett: The exceptions to credit policy when the banks were in ... that ... could you discuss those with us? There seemed to be quite substantial increases outside normal guidelines in lending. I think in some cases the exceptions were nearly as large as what was within guidelines. Did you have discussions with them about those?

Mr. Liam O'Reilly: Yes. With the banks?

Senator Sean D. Barrett: Yes.

Mr. Liam O'Reilly: Yes. Yes, we wrote to the banks. I remember one set of letters which went directly to the chairman of the board of each lending institution warning them about general issues within the industry and, where their high loan-to-value ratios were in place, we warned them, "Is this ...how are you dealing with the risks attached to that in your lending policies?"

Senator Sean D. Barrett: Did they take your concerns on board?

Mr. Liam O'Reilly: Well, we were getting board minutes back from the banks plus assurances that they had changed their policy in that regard and they were making sure that they were well looked after.

Senator Sean D. Barrett: The final one, in your opening statement, you referred to the role of the non-executive directors on principles-based regulation. Was that, with respect, not naive? They turn up, say, one day a month for meetings. The executive directors were there. We rescued six banks; if they'd five non-executive directors, about 30 people. You had 318 full-time staff. Should you not have taken that task on board rather than leave it to the non-executive directors?

Mr. Liam O'Reilly: Well, as I say, we were operating a principles-based approach which had then attached to it a certain staff complement and we felt that that leverage, which wasn't alone the non-executive directors, remember, it was that the non-executive directors, who were ... the chairman of the audit committee, for instance, had to, at every meeting of that meeting, meet the internal auditor without any other management being there and we were using these resources in our system. Is it enough? Not any more.

Senator Sean D. Barrett: Thank you.

Chairman: Thank you very much. Senator D'Arcy and then we'll close.

Senator Michael D'Arcy: Mr. O'Reilly, just one point. The principle-based regulation within our jurisdiction was the same as the principle-based regulation in other jurisdictions; is that correct?

Mr. Liam O'Reilly: I would say that the ... maybe we were behind the line on getting administrative sanctions in place.

Senator Michael D'Arcy: We weren't as ... as-----

Mr. Liam O'Reilly: We weren't as advanced.

Senator Michael D'Arcy: Okay. Well, can you explain why, in our jurisdiction, the debt ratio between what the banking collapse cost this State, in comparison to our GDP, was a multiple times other countries'?

Mr. Liam O'Reilly: Sorry, is the question was it or-----

Senator Michael D'Arcy: No, why? Why was it?

Chairman: Why it came to pass.

Mr. Liam O'Reilly: Why ... why was it?

Senator Michael D'Arcy: Yes, when you had the same-----

Mr. Liam O'Reilly: I think-----

Senator Michael D'Arcy: -----principle-based approach.

Mr. Liam O'Reilly: I think that the big thing that might be missed a little bit is the fact that the Lehman's crisis was only the first wave of what happened. After that, there was a world depression. After that, there was a plummeting in prices so that, by a year and a half later, prices were at an exceptionally low level. They're actually recovering now, but I would say that that made a fair contribution to the amount of money that had to be paid out to recapitalise banks.

Senator Michael D'Arcy: Just to finish off that line of questioning, Mr. O'Reilly, was it

not the standard of the loan book was the real issue for the Irish banking sector?

Mr. Liam O'Reilly: I would say-----

Senator Michael D'Arcy: The assets on-----

Mr. Liam O'Reilly: I would say another element in that was, particularly in the case of commercial loans to a small number of individuals, was the other big issue that cost money.

Chairman: Thank you very much, Senator. So, with that said, is there anything else you'd like to add, Mr. O'Reilly, before I bring matters to a conclusion?

Mr. Liam O'Reilly: No, just thank you very much for listening to me and best of luck with the rest of your inquiry.

Chairman: Thank you very much, Mr. O'Reilly. So, with that said, I'd like to thank you for your participation here today and for your engagement with the inquiry. The witness is now excused and I just ... before we suspend the meeting, there's just one matter we have to deal with in private session there with lead investigator Pat McLoughlin in a few moments. So, with that said, I'll excuse the witness and then very ... suspend for a few moments to go into private session.

Sitting suspended at 1.16 p.m., resumed in private session at 1.18 p.m., suspended at 1.21 p.m. and resumed in public session at 2.41 p.m.

Central Bank-Financial Regulator - Mr. Brian Patterson

Chairman: I now propose that the Inquiry into the Banking Crisis resume in public session. Is that agreed? Agreed.

And can I ask members and those in the public Gallery to ensure that their mobile devices are switched off. Today we continue our hearings with the Central Bank of Ireland and Financial Regulator. At our session this afternoon, we will hear from Mr. Brian Patterson, former chairman, the Irish Financial Services Regulatory Authority. Mr. Brian Patterson was interim chairperson ... or, chairman of the IFSRA from November 2002 to April 2003. He became chairman of the Financial Regulator in May 2003, a position he held until April 2008. He was also a member of the board of the CBFSAI from May 2003 to April 2008. Mr. Patterson, you're very welcome before the committee this afternoon.

And before hearing from you, I wish to advise the witness that by virtue of section 17(2)(l) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to this committee. If you are directed by the Chairman to cease giving evidence in relation to a particular matter and you continue to do so, you are entitled thereafter only to a qualified privilege in respect of your evidence. You are directed that only evidence connected with the subject matter of these proceedings is to be given. I would remind members and those present that there are currently criminal proceedings ongoing and further criminal proceedings are scheduled during the lifetime of the inquiry, which overlap with the subject matter of the inquiry. The utmost caution should be taken not to prejudice those proceedings. In particular, there are ... or, sorry, in addition, there are particular obligations of professional secrecy on officers of the Central Bank in respect of confidential information that they have come across in the course of their duties. This stems from European and Irish law, including section 33AK of