Tithe an Oireachtais
Houses of the Oireachtas

# Joint Committee of Inquiry into the Banking Crisis

## Witness Statement of

## Ann Nolan

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## Statement of Ann Nolan to the Banking Inquiry

This is the statement of Ann Nolan, Second Secretary General, Department of Finance, made in reply to the direction order of 13 May 2015. I have been Second Secretary General, Financial Services Division, Department of Finance since July 2010. Between 1 November 2008 and July 2010, I was Assistant Secretary in Financial Services Division and from December 2006 to November 2008, I was Assistant Secretary in Public Expenditure Division at the Department. Before that I was a Principal Officer in Public Expenditure Division from 2003 to 2006. I was a Principal Officer dealing with the International Financial Services Centre (IFSC) from 1998 to 2003. I was on the Board of the then State owned ACC Bank from 1995 to 2000. I have worked for the Department of Finance since 1985. Although prior to November 2008 I was not directly responsible for Banking matters, I was a member of the Departments senior management team. I share the collective responsibility for the Department's failure to prevent the crisis from developing. I am deeply sorry that this occurred and since November 2008 I have worked very hard to resolve the crisis and am proud of the Departments accomplishments since then.

I have been asked to refer to issues on the crisis management and the regulatory, supervisory and Government themes of the inquiry. I will deal with issues in a chronological narrative marking paragraphs in accordance with the inquiry themes, as appropriate.

**Crisis Management**

I started on the banking side on 1 November 2008 setting up a new division to deal with the new relationship with the banks following the guarantee. The guarantee had stabilised and improved the liquidity position of the banks. The Department was assured by the banks and the Central Bank that the banks were solvent. In retrospect, I think that was probably true at the time. However, the liquidity problem was caused by the markets looking at future solvency. The Irish economy had been contracting all that year and by the autumn of 2008, following the Lehman brothers collapse, the property market had collapsed with activity ceasing and prices falling. The solvency of the Irish financial institutions depended on the performance of the economy overall and the value of the (property) assets against which the institutions had lent money. Therefore, it was clear as the property market continued to decline that future losses on the property would be greater than had been previously expected and that future profitability would be less than previously anticipated. Thus, the liquidity crisis immediately indicated a likely solvency issue. (C2c)

In the last quarter of 2008, PWC were asked by the central bank to do a quick assessment of the banks biggest loans to evaluate their capital position. They produced a series of reports on the banks (except EBS) on their possible solvency position based on an examination of their larger loans. The overall assessment of this report was that the banks did not need more capital, whether on base case (the banks own assessment) or on two stress scenarios. More important than that assessment, the reports drew our attention to two important facts of which we were not previously aware, and which suggested that the vulnerability of the system was significantly greater than the stress tests indicated:

- The total amount of 'land and development' loans across the system (€62.6bn ). These loans were generally on rolled up interest payments, so were effectively unlikely to make any payments to the banks until the underlying developments were completed and the assets sold. The economic shock of 2008 meant that there was little demand for new developments, whether commercial or residential.

- The extent to which a small number of developers had absolutely huge debts across the system. The top 20 developers and their connected companies owed €24.5 bn to the institutions and frequently the institutions were unaware of the extent to which these individuals controlled companies which had borrowed significantly from other institutions. In our meetings with the institutions several of them mentioned that they had personal guarantees from 'high net worth individuals' which would protect them if the asset values proved less than the loans. When you realised that the same individuals also had significant loans to other institutions, it was clear the value of any such personal guarantee was limited.(C3c)

In view of these two facts, and the broad economic conditions, the Department immediately began discussions with the banks on the need to bolster their capital position. These discussions took place in December 2008 culminating in the announcement on the 21 December 2008 of a plan to recapitalise the three banks, Bank of Ireland, AIB and Anglo Irish Bank. In the course of these discussions, it became clear that the banks' managements had differing views on the need for capital in their institutions. The policy parameters within which the Department approached the recapitalisations throughout the period were as follows:

- Banks should take any action possible to reduce the capital need by making changes to their balance sheets.
- Assets should be sold
- Subordinated debt holders should be bailed in as far as possible
- Money should be raised on the markets, if available
- The risk to the guarantee should be considered
- The systemic risk (that is the risk of contagion if capital were not provided) should be considered
- State support should only be considered as a last resort.

Initially, Anglo talked of raising money in the private sector, but it became clear very quickly that the market appetite for investing in Irish banks was non-existent. Bank of Ireland considered that State support of the order of €2bn would reassure the markets and was anxious that that support was done in such a way that it could easily be repaid when the crisis was over. Of course, they also did not want State ownership of the bank. AIB said that they did not need support as much as the other two, but were anxious that they be treated the same Bank of Ireland. The PWC reports showed clearly that AIB had significantly higher exposure to land and development loans than Bank of Ireland. AIB pointed out that they had a share in an American bank and a Polish subsidiary which were valuable and could be sold to raise capital. Anglo said that they needed less than the other two as they were a smaller bank. All of the banks claimed that their loan books were better than average.(C4c)

[redacted] Oireachtas [redacted] Anglo [redacted]. The Chairman and Chief Executive Officer left in December 2008 and Donal O'Connor was appointed Executive Chairman on a temporary basis until a new CEO could be recruited. In view of what we had discovered, once the announcement of our intention to recapitalise the banks was made on 21 December 2008, we prioritised the due diligence of Anglo. Arthur Cox carried out the due diligence and their first report to us was on 15 January 2009. This showed other matters which had to be referred to the Office of Corporate Enforcement.

The decision to nationalise Anglo [redacted] Oireachtas [redacted]. The options were to continue with the original recapitalisation either by preference shares or ordinary shares, to nationalise or to try to disengage. The latter was not realistic in view of the guarantee, the expectation that European governments would stand by their banks and the extremely likely contagion effect across the Irish system. The Department did not feel that it could recommend recapitalisation without taking complete control as we had no trust in the organisation. In the event, because of the nature of the issues we had with Anglo it was decided to nationalise it and replace the Board and management. (C4a)

Through the early months of 2009 it was clear that the banks were not functioning properly and that there was a real issue with the land and development loans. A report was prepared by Peter Bacon for the Minister for Finance looking at the options dealing with this. The first draft suggested setting up a bad bank to take all the commercial loans and the land and development loans. The total par value of the loans to be transferred would be €160bn.

The Department examined this proposal with the Central Bank, Merrill Lynch and the NTMA. It was clear that the 'bad bank' (later NAMA) could only be funded by bonds that were acceptable as collateral by the ECB. For that to be effective, the bonds would need a State guarantee. The scale of loans being suggested initially was considered too large. We were concerned that the size of portfolio being guaranteed by the State would damage the sovereign debt market. It was not clear that the ECB would accept such a big issue of bonds. Furthermore, many of these loans were preforming loans that did not need to be removed from the banks. However, there was an issue with large borrowers who had land and development loans and other large loans which could pose a systemic risk to the system. There could also be collection issues if borrowers had loans to NAMA and also to the bank.

In the event following discussions the final version of the report recommended transferring to NAMA all the land and development loans and all other loans by the same borrower and connected parties from the covered institutions to NAMA (approximately €90bn). This recommendation was agreed by the Government. This was to be done for their long term economic value and they were to be paid for with Government guaranteed bonds which would be eligible for ECB funding. This was agreed with the ECB. (C4b)

Over this period (first quarter 2009), in discussions with Bank of Ireland and AIB, it was agreed that the preference share amount would be increased to €3.5bn each. AIB would agree to sell their American and Polish interests to make up the extra capital it was estimated that they would need as their portfolio was bigger. The estimated capital need for Anglo was also increased that May when their new Board asked for €4bn capital injection. This money was provided in cash. A Liability Management Exercise (LME) exercise was also carried out that August to gain €1.7bn capital. Apart from the LME exercise that was no other source of capital available to Anglo.(C4c)

During the rest of 2009 the NAMA legislation was developed and passed by the Oireachtas, the valuation methodology was agreed with the EU Commission (DG Competition) and the NAMA organisation was set up. The legislation has proved robust, giving NAMA sufficient powers and commercial freedom while ensuring they are accountable to the Minister and the Oireachtas on a quarterly basis. NAMA as an organisation has also proved to be efficient and effective.

The most controversial aspect of the set up and initial operation of NAMA was the transfer price (valuation of the assets) and the timing of the transfers. The valuation methodology was very complex and required a large amount of data to be collected and transmitted to the EU Commission. The loans were to be valued individually and transferred in tranches to NAMA. The process was cumbersome and time consuming. This was at the insistence of the Commission. The increase for long term economic value was about 22%. On the other hand, the valuation was done for a date in November 2009 which was significantly before the market reached the trough in 2012.

In the planning stage, NAMA had estimated that the haircut on loans transferred to it would be approximately 30%. In the event the haircuts were significantly higher than this for all of the banks, but with big differences between the banks. The biggest difference between the valuations we expected and the actual amount of paid for the loans was the amount of equity in the developments. In our exercise we had estimated a level of equity higher than actually existed. Indeed, the Anglo loans generally had little equity. In the event, haircuts averaged at 57%, ranging from 43% in Bank of Ireland to 61% in IBRC.

Overall, if I had it to do again, I would recommend the set up NAMA, I the transfer of loans based on a discount calculated on a broad stratified sample of loans for each bank. A detailed valuation later could result in a balancing payment (either way) on the wind up of NAMA. Such a change might have alleviated the increasing pressure on the banks in 2010 when the fear of ever growing 'NAMA losses' contributed to the liquidity problems in the summer and autumn of 2010. However, it is important to remember that the losses were real and resulted from the fall in property values and the relatively small amount of equity in the loans. These losses had to be manifested either in NAMA later (when any shortfall on the Government guaranteed bonds would fall on the State) or by means of a shortfall of capital in the banks, which fell on the Government (with exception of Bank of Ireland where only a small portion of the capital needs over the period fell to the Government). The State received shareholdings in the banks in return for its capital and for the continuing banks this investment can be recovered over time by selling the shareholding. The long term losses to the State arise because two of the organisations INBS and Anglo (later IBRC), had both incurred huge losses and had a business model which was so broken that there was no possibility that the losses could be made up by either future profits or resale of the organisations. (C4b)

The combination of the higher than expected haircuts and the slow staged nature of the process meant that the 'crisis' in the banks was continued in 2010. Furthermore, the continuing recession meant that other loans, including both mortgages and loans to SMEs, were registering a significant increase in arrears. The first PCAR stress test, run in March 2010 by the Financial Regulator found that the banks had very significant capital needs. Bank of Ireland met this need through a combination of raising capital on the market and a conversion of €1.7bn of their government preference shares. AIB sold their overseas assets with the balance of the capital (€3.7bn) being provided by the Government.(C4c)

Given how much the State had to invest in the banking system, the policy throughout the period was to burden share where appropriate. All of the original shareholders in the covered institutions saw their share value diluted to nothing or almost nothing. At peak (2007), the total share value of the institutions was €53.7 bn. In addition, €15.5bn of capital was raised through burden sharing with subordinated debt holders. Much of this was done through liability management exercises where debt holders were asked to voluntarily sell their debt back to the banks at a reduced price. We also passed legislation to allow the Minister get a Special Liability Order (SLO) from the Courts to change the terms of their bonds. This forced the bondholders to sell into the LME or have their bonds extended for a long period and interest suspended. The SLO was only used in AIB, but undoubtedly the existence of the legislation contributed to the success of burden sharing with sub debt holders in the other institutions.

When it came to options for extending burden sharing to other parties there were a number of difficulties. Firstly, the legal position at the time was that all of the remaining creditors ranked the same. In particular, depositors and senior bondholders were ranked pari passu. As a matter of policy, protecting deposits was considered necessary. Therefore, under the constitution it would be quite difficult to bail in senior bondholders without also bailing in depositors. In addition, there was a great reluctance at European level to allow the burning of senior bondholders. Clearly, this issue did not arise while the blanket guarantee was in place. It was considered seriously twice that I remember. Firstly in October and November 2010 when the guarantee had lapsed and the programme of assistance was being put in place. A number of the IMF officials were strongly in favour of burning any unguaranteed and unsecured bonds in Anglo. This was opposed by the EU and ECB officials. In the event, the matter was considered at a more senior level in the IMF and, as a result of a US Treasury veto, the IMF also came down against any such action. It would not have been possible for the Irish Government to act without troika consent. (C7a)

Throughout 2010, the position of the banks and the economy continued to be precarious. The imminent ending of the guarantee put liquidity pressure on the banks. The mounting losses, including the slow transfer of assets to NAMA also increased pressure. By the autumn, Ireland was locked out of the bond market and it was clear that we would have to enter into an EU/IMF programme. The ECB clearly wanted that outcome as they were concerned about the extent to which the Irish banks were using Central bank funding.

On the fiscal side, the Department prepared a National Recovery Plan and that formed the basis of the programme. On the financial services side, the extensive domestic legislative programme (see below), which had been started in 2009/2010 was one aspect of the programme. In the banking area, the programme concentrated on deleveraging, amalgamations, recapitalisation and arrears management issues. For the financial services side, I coordinated both the negotiations and the implementation of the agreed actions.(C5a)

The second PCAR stress tests in March 2011 resulted in further capital demands for the banks. Once again Bank of Ireland was able to raise money from the private but the other banks (AIB, PTSB, EBS) relied mainly on the State. The question of burden sharing with senior bondholders was considered again then but it was again ruled out by the troika. Further burden sharing with subordinated debt holders took place.(C7a)

**Regulatory, Supervisory and Government issues**

The financial crises exposed the shortcomings which had existed in the regulatory and supervisory framework. This led to a reassessment of the legislative framework for financial services both domestically and internationally. I will give a brief summary of the changes made. I will confine myself to the financial services area because that is the area I have been working on since November 2008, but equally important and extensive changes have taken place on the fiscal side. I will divide my comments into domestic and EU, though obviously the two programmes developed in tandem and the Department worked to ensure that they were consistent to the greatest extent possible.

On the domestic side, the first action was to amalgamate the Central Bank with the Irish Financial Services Regulatory Authority (IFSRA). Separating the supervisory and financial stability functions (albeit with a requirement to cooperate) had undermined the importance of the macro prudential aspects of the role of both organisations. This is a conclusion of the Honohan report on the banking crisis, though it also clearly states that the organisation structure 'cannot be held responsible for the failure of the CBFSAI to identify weaknesses sufficiently and take remedial measures as needed'. The amalgamation was effected through the Central Bank Reform Act 2010.

This was followed by an extensive renewal of the supervision and enforcement powers of the Central Bank through the Central Bank (Supervision and Enforcement) Act 2013. This latter legislation streamlined, enhanced and modernised the powers of the Central Bank. Again, while this was a necessary and welcome improvement in the legislative framework, the Central Bank had significant powers before this was enacted and indeed used them extensively in the crisis management in the period 2008 to 2013 prior to the new legislation.

The third major strand of legislation was providing for resolution powers. This was done initially through the Credit Institutions (Stabilisation) Act 2010, which gave extensive temporary resolution powers to the Minister for Finance to deal with the six covered institutions, as necessary, during the crisis. Subsequently, the Central Bank and Credit Institutions (Resolution) Act 2011 was passed. This provides for the orderly resolution of a financial institution in financial difficulties. The Central Bank is the resolution authority.

The final major piece of legislation in the Credit Reporting Act 2013. This is to enable credit institutions check what loans potential borrowers have from other institutions. This should prevent a reoccurrence of a situation where a small number of people can have large loans from many different institutions and pose a systemic risk. The credit register is currently being set up by the Central Bank.(C5a)

On the EU front, the crises lead to significant changes to the international regulatory framework also. The 2009 De Larosiere report recommended the establishment of a new European Systemic Risk Board and three new supervisory Authorities, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authorities (ESMA). These bodies set technical standards, resolve disputes between supervisors and assist in developing consistent interpretation of European law. Major legislative directives were put in place for all the financial services areas including the Capital Requirements Directive IV (CRD IV) (dealing with bank capital), Solvency II (dealing with insurance) and MIFID II (dealing with markets). (c6a)

This was followed by the Banking Union proposal which centralised banking supervision and resolution for Euro area countries (with possible opt in for non-Euro countries). The Single Supervisory Mechanism (SSM) was set up as a new branch of the ECB with responsibility for supervising the top 130 banks in Europe. The Bank Restructure and Resolution Directive (BRRD) was also agreed to provide for a single resolution mechanism to resolve financial institutions in difficulties.(C6b)

All of these changes represent a major reconfiguration of the regulatory and supervisory framework. Many of them have only just been implemented and some are not yet operational. It will be some time before their effectiveness can be assessed.

The Central Bank is independent and carries out its role under various statutes both domestic and European. I had little if any dealings with the Central Bank in the period 2003 to November 2008, so I had little direct visibility on the interaction with the Department at that time.

In the post November 2008 period, I can say that the only way the two organisations could successfully operate was by working closely and coordinating responses to the evolving issues. This meant significant sharing of information; for example, the PWC reports in the fourth quarter of 2008 were commissioned by the Central Bank and shared with the Department. Over the entire period information was freely shared in both directions and this definitely enhanced the performance of both organisations. Many actions had to be coordinated and this was done in a positive way. (R3c)

At the start of the period (end 2008, 2009), interaction with the banks on capital tended to be led by the Department and involve discussions with the banks as to what they considered they needed. This worked reasonably well with Bank of Ireland who had a realistic assessment of their likely needs but less well with AIB. AIB agreed with us in March 2009 that they would sell their overseas interests but failed to do so. By March 2010 when the Regulator ran the first PCAR he insisted that the assets be sold, they did it.

On the legislative side, both domestically and at EU level there was and is good interaction between the Department and to Central Bank, recognising that our roles are different and that legislative policy is a matter for the Minister and the Oireachtas while developing good policy requires input from the regulator (and other stakeholders).

On accountability both the Central Bank and the Department of Finance are accountable to the Dáil through Parliamentary Questions put to the Minister for Finance. They can be called to appear before Oireachtas committees, as appropriate. The Central Bank Reform Act 2010 introduced a requirement for an annual performance statement and this and the annual report are laid before the Houses of the Oireachtas. The Central Bank now publishes key performance indicators and we are currently working with them to improve these metrics and their usability for the firms regulated.(R3a)

The current working relationship with the Central Bank is very good. We have a monthly principals meeting where the top management of the Central Bank, the Department and the NTMA meet to discuss any issues arising. Staff from the Department also meet their counterparts in the Central Bank across a broad range of work areas where this is appropriate and we set up ad hoc working groups where necessary. This includes meetings with the regulator and his staff. In the role of managing the Minister's shareholding in AIB and PTSB, the Department has also had meeting with the staff of the SSM. All of these meeting are held in an open and professional manner where issues are discussed and each organisation respects the right of the other to disagree. (R3b)

During the crisis a higher level of coordination of actions was necessary. For example, there were a large number of troika commitments on the financial services side. The Department and the Financial Regulator discussed and agreed these commitments with the troika together. The coordination unit whose job it was to track those commitments was in the Department of Finance. This meant that the Department had a role in liaising with the Central Bank to ensure those items proper to the Bank were completed on time. The successful completion of the programme shows a positive working relationship based on shared goals.

Our relationship with the Banks has also evolved over time. We have developed two different sections dealing with the banks as shareholder and dealing with them as the Department. The shareholder management unit deals with our shareholding in the AIB, PTSB and Bank of Ireland. A separate unit deals with the banks from a public policy perspective. This unit has relationships with all of the banks, and interacts with them on appropriate issues. For example, this section deals with issues around mortgages and collects arrears statistics from the six largest mortgage providers. Our challenge will be, as we recover from the recession and sell down our shareholding, to maintain a regular relationship with the banks so we are aware of developments in the sector without allowing capture by vested interests. I would think the Department needs to do that independently of the Central Bank and the Financial Regulator. (R3b)

On the banking side, we received a lot of external expert advice over the period. Much of this was necessary and useful. Good legal advice was necessary for all of the many transactions we carried out, some of which broke new legal ground. I found financial advice useful when it was specific (e.g. advice on specific transactions). Advice on broad topics was less useful as it was often vague or impractical. Overall, no advice makes up for the necessity of having sufficient in house expertise. The secondment of private sector experts and amalgamating them with civil servants in the SMU allows for a very positive expert team which can replace outside advice in some instances and ensure it is specific and cost effective when it is needed.(C2b)

An example of this in action is the liquidation of IBRC. In March 2012, the Promissory note payment of €3.6bn was met by means of a Government bond, rather than cash. As IBRC did not have access to the ECB regular funding, this bond was swapped (repo-ed) with the Bank of Ireland and that bank got cash from the ECB for the bond. This was a temporary one year arrangement and the ECB were clear that it could not be repeated the next year. This meant that an alternative arrangement had to be put in place before the following March. To address this, we seconded 5 experts from the corporate finance side of AIB to work with our own SMU team to find a solution. This team worked with the Department's legal and international divisions to develop a solution which worked for us and could be noted by the ECB. This solution was put in place at the beginning of February 2013. After September 2012, liquidation of IBRC was agreed as an approach, but different arrangements for the Government bonds to be issued were discussed. In this process, the work done by the seconded staff was a great deal more useful than having outside advisors as we had the ability to check instantly the various options being considered. (R4a)

In terms of our relationship with the property industry, the Department's relationship in advance of the crisis was largely on the tax side, with the CIF making a prebudget submission and generally meeting with the Minister, or officials in advance of the budget. During the crisis we had relatively little direct contact with the developers. (R5d)

As a general principle, contact with as many stakeholders as possible and the soliciting a wide range of views are necessary components of policy making. Our current approach is to conduct public consultations on any major items of interest. The responses to these consultations as well as all prebudget submissions are published on the Department's website. This ensures the process is open and transparent. The introduction of the Lobbying Bill is welcome and will set standards for lobbying across the system. (R4d)

**Conclusion**

In conclusion, I have covered, in summary form, the issues you have asked me. I focused on C6a and C6b, for which I had responsibility, rather than C6c which was outside my areas of responsibility. It is important that the Inquiry being conducted by the Joint Committee succeeds in identifying the causes of the crisis and I will endeavour to answer your questions and assist the Inquiry as best I can.

Ann Nolan

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