WITNESS STATEMENT OF DAVID DOYLE

FORMER SECRETARY GENERAL

DEPARTMENT OF FINANCE

20/05/2015

I was appointed Secretary General in July 2006 and retired in January 2010. Prior to this, I was Second Secretary General in the Sectoral Policy Division (Public Expenditure Division) of the Department of Finance from spring 2001 to June 2006. I served as Assistant Secretary in the Finance Division from 1999 to 2000 and in the Budget and Economic Division in 1997 to 1999. Prior to this, I was in the Public Expenditure Division from 1975 to 1997.

C1a: Inter-departmental contact and the Memorandum of Understanding with other EU states on the issue of Banking

The June 2008 Memorandum of Understanding was primarily aimed at tackling issues of cross-border financial stability and not at addressing country specific issues.

My recollection is that the Memorandum of Understanding was not deployed in the context of the September 2008 international financial crisis.

An emergency meeting of Heads of State or Government on 12 October 2008 adopted a declaration on a concerted European Action Plan of the European Countries to:

- Ensure appropriate liquidity conditions for financial institutions
- Facilitate the funding of banks
- Provide financial institutions with additional capital resources so as to continue to ensure the proper financing of the economy (each Member State will make available to financial institutions tier 1 capital)
- Allow for an efficient recapitalisation of distressed banks. (Governments remain committed to support the financial system and therefore to avoid the failure of relevant financial institutions, through appropriate means including recapitalisation)
- ensure flexibility in accounting rules
- enhance cooperation among European countries

C1c: Role and responsibilities and objectives of the DSG

I was not a member of the Domestic Standing Group (DSG). My understanding is that the DSG consisted of representatives of the Central Bank of Ireland (Central Bank), the Irish Financial Services Regulatory Authority (Financial Regulator) and the Department of Finance (Department).

The Group was chaired on a rotating basis by the Department and the Central Bank and comprised high-level representatives of the Department, the Central Bank and the Financial Regulator. The DSG was the principal mechanism for the exchange of information relevant to the discharge of the parties' respective responsibilities in relation to financial stability. Through the DSG, the parties were to develop a framework aimed at managing potential systemic crises by overseeing the preparation of contingency plans and conducting simulation exercises and stress tests, as well as by participating as appropriate in these exercises and reviewing the outcomes.

The work of the group took place against the backdrop of the stance of the individual banks that they were all profitable, well capitalised and well managed.

This was reinforced by the view of the Financial Regulator that this was indeed the position of the banks. The Central Bank, from a financial stability point of view, had not identified any system wide threat of a crisis.

At an early stage in the work of the Group, it was concluded that legislation needed to be prepared against the eventuality that there could be a failure of a financial institution. Over 2008 that work progressed to the point that the legislation was virtually finalised by September 2008.

Developments in the financial markets in September 2008 led to the decision to introduce a guarantee.

C2b: Role of advisers in analysing the crisis (to include crisis management options)

Throughout the period of the crisis, and particularly in the weeks preceding the decision to introduce the Guarantee, the Minister for Finance consulted with the Central Bank, the Financial Regulator and the National Treasury Management Agency (NTMA), being the institutions that had the relevant expertise in financial markets. He also had available the advice of the Attorney General, Arthur Cox, PwC and Merrill Lynch among others. These discussions intensified following the virtual freezing of credit markets in September.

The key external advisers in relation to the bank guarantee decision were Merrill Lynch, who were commissioned by the NTMA on behalf of the Minister. I propose to outline the advisers input into that particular aspect under this heading. I am sure that the Department can supply the full details of all the advisers who were appointed, and the relevant circumstances in each case.

On 26 September 2008 Merrill Lynch presented a number of options. Analysis was based on information and conversations with: PwC regarding Anglo Irish Bank (Anglo), Goldman Sachs regarding Irish Nationwide Building Society and limited verbal information from the Department and the Financial Regulator.

The options outlined were:

- Secured Lending Scheme / emergency liquidity assistance
- Good Bank, Bad Bank
- Protective Custody of Anglo/Irish Nationwide Building Society
- Guarantee for 6 primary regulated Irish banks
- Liquidation

Merrill Lynch advised that over the few weeks previously there had been “a dramatic worsening of market conditions. Uncertainty regarding the fate of financial institutions had led to a total paralysis of the capital markets with only overnight funding currently available”.

In a meeting which took place on 26 September 2008, Merrill Lynch noted that liquidity was being affected by large outflow of funds. A comment was made that this was the worst credit crisis ever. Ireland was not an isolated case.

Merrill Lynch presented formal advice on the night of the Guarantee including the following the key points:

- They said the global markets were witnessing unprecedented levels of volatility.
- **They said it was important to stress that, at present, liquidity concerns aside, all of the Irish Banks are profitable and well capitalised.** (*Writer's emphasis*)
- They said liquidity issues facing Irish banks were compounded by investor concerns with regard to high concentrations of loans for commercial property.
- They pointed out there is no right or wrong solution to the issues.
- **The important issue, they said, is for the Government to preserve the stability of the Irish financial system overall and to safeguard the interests of individual bank customers to avoid widespread panic.** *(Writer's emphasis)*
- Irish Nationwide Building Society: In an extreme stress case analysis total write offs could deplete reserves by €1.8 billion.
- Anglo: Applying the same stress case could deplete capital by €7.5 billion. The main issue was liquidity.
- Irish Life and Permanent: Asset quality is good. There are liquidity issues.

Merrill Lynch considered the implications of allowing an Irish bank to fail and go into liquidation without Government intervention. They said the resulting shock would be very damaging, would lead to dramatic asset deflation, major write downs by other banks and no access to equity and capital markets. They did not support allowing a failure. They recommended a more controlled interventionist approach.

Such interventions could include:

- **Immediate liquidity provision by the Central Bank.**
- **Take Anglo and Irish Nationwide Building Society into State custody while a State Guarantee would be given to all depositors and senior creditors as well as dated subordinated debt holders** (given the cross over between these two holders). Equity holders and undated junior subordinated debt holders would receive nothing. It would be important that all other creditors be reimbursed to avoid a contagion effect.
- **Secured lending scheme for banks generally to convert non-ECB eligible collateral into liquidity**. But, any institution seen or rumoured to be relying on such a facility would likely suffer a dramatic loss of confidence and significant outflow of funds. (Given small nature of country identity could become known and trigger emergency liquidity assistance. A bank in emergency liquidity assistance becomes rapidly known and vulnerable then to a loss of market support.)
- **Good banks/Bad banks**
- **Consolidation of Irish Life and Permanent and Educational Building Society with other banks.**
- **Guarantee for six primary banks**. This should stem outflows, but the scale of guarantees of over €500 billion would raise concerns for the Sovereign debt market. Might be poorly received by other European states.

Merrill Lynch concluded

"Even if the situation stabilises the immediate outlook for monoline single asset class lenders is increasingly uncertain. In this context it is important for the Government to act quickly and decisively to step in and prevent a systemic problem." *(Writer's emphasis)*

C2c: The liquidity versus solvency debate

Liquidity is essential to all commercial operations and especially banks who have to be in a position to meet their responsibilities to retail and wholesale depositors and other lenders on the contracted terms. Solvency is equally critical whether it be a bank or a commercial company.

In the case of banks, an insolvency position arises where they have negative shareholder funds. If the capital adequacy requirements of the Financial Regulator/Central Bank are not met, major issues will automatically arise once reserves fall below approved levels. (At best they would be under regulatory instructions to get new capital. At worst, if capital was not addressed, they would be forced to either merge, sell, or close).

Where liquidity becomes an issue to the point that a bank has overcommitted its resources and cannot meet demands for deposit and bond redemptions, an insolvent position can rapidly emerge either through resort to extremely expensive replacement borrowings, or through suspension of banking licenses which would torpedo the commerciality of the operation.

There were however concerns in the Department, the Central Bank and the Financial Regulator about liquidity in the market generally. The concerns in the international financial markets, post Northern Rock etc. fed into this perspective. The domestic banks were ascribing these liquidity issues to international pressures while asserting that they (the banks) were sound, well managed, and well capitalised – a view echoed by the Financial Regulator.

As 2008 progressed, international concerns about liquidity heightened further and these escalated dramatically in September 2008 with tightened interbank markets. This had a major impact on the Irish Banks. Separation of the international dimension and the domestic context muddied the waters. All of the Irish Banks continued to assert publicly and privately that while there were liquidity issues (which they ascribed to unjustified backwash from the international mood as well as domestic lack of confidence), they were still profitable and solvent.

The Financial Regulator and Central Bank continued to assure the Minister and the Department that the banks were solvent. As share prices declined and liquidity ebbed away, money markets tightened, and public concern about retail deposits heightened, the Government decided to increase the Deposit Guarantee limit from €20,000 to €100,000. This settled small depositors with banks but not major corporate or institutional lenders. The drain of funds from the banks accelerated and as the month of September progressed this put a major strain on the system. Detailed work on legislation was undertaken over 2008 and by September legislation was ready to facilitate a nationalisation of a bank.

On 29 September it emerged that Anglo had exhausted all avenues in terms of raising funds and was heading for the “red” with the Central Bank. This was a key trigger for intervention. The other banks had experienced severe liquidity issues also.

A failure to address the liquidity issues would have been catastrophic. The option of doing nothing was simply not a runner.

C3a: Appraisal of the conditions prior to increasing the deposit guarantee scheme

The Deposit Guarantee Scheme prior to September 2008 was limited to €20,000 since 1999. This was not an unusual level in Europe generally.

Information from the Central Bank and Financial Regulator was that funds were flowing from the banks and that their ability to raise funds from the European Central Bank (ECB) on pledged collateral was reducing.

At a domestic level a general sense of unease was palpable throughout the country regarding the safety of savings. The previous year had seen a panicked reaction in the UK to the revelation that Northern Rock had been given access to emergency lending assistance from the Bank of England. This led to a massive run on Northern Rock across the UK, and in Dublin, which led the UK Government to announce that it was guaranteeing all deposits with the bank. It then went on to nationalise it.

Media coverage of the concerns regarding the safety of savings in September 2008 led to a heightening of general worry about the safety of deposits. A rebroadcast by a television station of the previous year’s queues outside the Northern Rock office in Dublin seemed to create the impression that panic had broken out again regarding Northern Rock and accelerated those domestic concerns further.

The international financial markets throughout were exhibiting increasing signs of stress.

Also, there was an EU review of the deposit guarantee scheme taking place at the time and it was pretty obvious that a recommendation to increase the level of coverage was going to emerge from that as there were a number of EU countries which already had a higher level. For instance Italy had €100,000 coverage at that stage.

In response to the concerns amongst deposit holders, the media and the political system, an increase in the deposit guarantee scheme to €100,000 was approved by Government and announced by the Minister on 20 September 2008, who said

“I want it to be known that the Government is confident about the strength and resilience of the Irish financial system. The Government is committed to the stability of our financial system, so that money placed with an Irish credit institution would not be at risk. As I said yesterday, the Irish Government wants to protect the whole financial system, secure its stability and ensure that all deposits in Irish financial institutions are safe.”

The Minister added "the Central Bank and Financial Regulator have stressed the soundness and stability of the Irish financial system. This measure provides additional reassurance to depositors in Ireland that their savings are safe".

The upshot of this increase in the guarantee ceiling was that while the small retail depositors were reassured, the larger depositors and the wholesale market were not.

C3b: appropriateness of the bank guarantee decision

The option of doing nothing in response to the crisis that emerged in September 2008 was not a runner. A liquidity crisis had emerged. Letting it continue would have been disastrous. The option of letting the system fail was not an option either. Steps had to be taken to secure the banking system and the economy.

The situation that presented at the end of September 2008 was that the increase in the guaranteed deposits level to €100,000, and the expression by Government that it intended to stand fully behind the banks, had had no substantive effect on the liquidity position.

On the night of the Guarantee Anglo was found to be illiquid, the Financial Regulator was still supporting the view of Anglo that it was profitable and solvent. All the banks were suffering from liquidity pressures. But Anglo was facing imminent collapse in the absence of access to liquidity. This was the reality facing the Government on the night of 29 September 2008.

The question of emergency liquidity assistance was considered for Anglo. The ability of the system to hold emergency liquidity assistance secret was regarded as slim to none. Too many parties would have known and the view was that the information would leak with dire consequences.

The experience of Northern Rock where a leak that it had been given emergency liquidity assistance led to a significant media exposure, followed by a run on the bank, followed by a UK government guarantee for all deposits in Northern Rock was etched in everyone's consciousness. The extent of likely emergency liquidity assistance was unknown. The greater it would be, the greater the potential impact in the panicked market conditions.

On the night in question, concerns about the sustainability of the Anglo/Irish Nationwide Building Society models were heightened. The two major banks emphasised those concerns and argued they should be addressed and a guarantee for all banks introduced.

The Financial Regulator assured the Government that all the banks were solvent. Merrill Lynch in their document of 29 September said "it is important to stress that, at present, liquidity concerns aside, all of the Irish banks are profitable and well capitalised."

Nationalisation of the two organisations was seriously considered on the night of the Guarantee.

The first major issue addressed was should Anglo/Irish Nationwide Building Society be nationalised. There were reservations about the quality of the loan book, but no actual evidence to counter the views of the two banks or their Boards as to their viability.

The case for nationalisation was that the business models were regarded by the major banks as suspect, and there was a real concern that there could be a serious problem with their loan books, regardless of what the Boards and Managements were saying.

An involuntary liquidation would have created a real danger of a complete collapse in the banking system with all that would entail for the economy as a whole.

It should be emphasised that nationalisation would, given the conditions in the market, not have involved simply taking control of the loan book and abrogating all the liabilities to depositors and lenders generally.

An orderly nationalisation, given the conditions at that point, would have taken over all the assets and liabilities, as occurred in January 2009.

If Anglo had been nationalised that week, and a guarantee issued to other banks, the outcome, as regards Anglo, would have been essentially the same as what happened when the bank was nationalised in January 2009.

- The State would have immediately appointed a new Board.
- The Board would have been tasked with securing the loan portfolio.
- The Depositors and lenders to Anglo, other than undated subordinated debt would have been guaranteed. A failure to do so would have sunk the rest of the banking system.
- The Government would have ensured that the capital needs of Anglo were provided, in the absence of private sector subscriptions.
- The shareholders would have been told their shares would be subject to a process to establish what if any value they had.

The reservations about nationalisation at that point centred round:

a] whether this was warranted

b] whether this could be done on its own without having a domino effect on the other banks

c] whether a guarantee scheme would have to be given to the rest of the banks anyway and

d] the view of the ECB that a bank failure could not be allowed.

In relation to the first point, while there were concerns, no quantified evidence had been produced which showed insolvency. The view of the Financial Regulator was that they were solvent. On the basis of stress tests, it was clear that Anglo was exposed.

On the second issue of a potential domino effect, one view was that nationalisation could lead to the undermining of the other banks even with a full guarantee, as it could raise the question, well if Anglo is that bad, the others could be equally exposed, so the Guarantee might not have been convincing, from day one, and might have failed.

On the third issue the view was that nationalisation or not, a guarantee would have to be given to save the banking system, on strong conditionality terms, as regards fees for a guarantee, and structural change.

On the fourth issue, the view of the ECB as quoted to the meeting by the Governor on the night was that Mr Trichet had advised him that no bank failure could be allowed, or words to that effect. On this point, the domestic and international market turmoil was such that this view was shared by all concerned at Ministerial, Central Bank and Department of Finance official level. Nationalisation would not of course have been a bank failure per se but it could have been regarded in the panicked market conditions as tantamount to a failure, and indicative of greater dangers.

The simple fact was that if emergency measures were not taken that night to address the problems created by the banks, there was a very real danger of a collapse in the domestic banking industry, not just in Anglo but quickly in the rest of the banks through a widespread loss in confidence.

The damage to individual depositors, large and small, at personal and business i.e. at all levels would have been extreme. The potential reputational damage would have undermined consumer business confidence, domestic and international existing and future investment.

A collapse in the banking industry would have led to the Sovereign borrowing reputation and capacity being irretrievably damaged. A collapse on this front combined with impacts on revenue would have resulted in Government services and investment across the board being summarily cut or suspended. No one was prepared to countenance this.

Even if Anglo had been nationalised, the capital costs that ensued could not have been avoided without contemplating an involuntary liquidation which would have resulted in the most disastrous consequences for the banking industry and the economy. Similarly the capitalisations that proved necessary once the due diligence forced by the National Asset Management Agency (NAMA) legislation and actions on the banks would have happened if the Guarantee had not been granted. Those capitalisations would inevitably come from the Exchequer given the scale of the requirement and the lack of any real private sector appetite at that point.

Throughout the night of the Guarantee the pros and cons of

a) nationalising Anglo and having a guarantee or

b) having a guarantee

were debated several times and late into the night.

The main viewpoints in the debate were

- There was a strong case for immediate nationalisation
- The nationalisation at that point could lead to an undermining of the banks and the Guarantee.

The Taoiseach and Minister left the room at some point. On their return, my recollection is that the Taoiseach said they had decided to recommend a guarantee to the Cabinet and that Anglo would not be nationalised for the present.

C4a: Decision to nationalise Anglo in 2009 and a review of the alternatives available and or considered

Following the Guarantee, early meetings were held in October 2008 with Anglo and the other banks by the Minister.

In the case of Anglo, the then Chairman and CEO (throughout the last quarter of 2008 and prior to their resignations) asserted the solvency and viability of Anglo and that they were confident of attracting additional private sector capital of around €1 billion, which they felt would be adequate to bolster their balance sheet. They said they had a long standing track record, excellent relationships, and significant collateral and income streams pledged against their loan book. They were adamant that they had a viable future and were confident that they were an essential part of the Irish banking industry.

Their defence of their model, one aspect of which was that they paid more for deposits and charged more for loans, did not engender confidence. Concerns increased about the operation. They continued to assert their viability and confidence. The confidence of the Minister and the Department in Anglo's ability to survive as a private entity were progressively undermined.

A PwC report subsequent to the Guarantee decision pointed to end September transactions with another bank which raised serious questions. This was referred immediately to the Financial Regulator for review.

It emerged subsequently that other corporate governance issues regarding Directors loans and the nature of certain other loans also raised serious concerns.

It was also clear that any question of an existing or new shareholder subscribing fresh capital was not going to happen. Equally, a "White Knight" private sector approach was untenable due primarily to the concerns about Anglo, and the problems the rest of the domestic banks had anyway. The concentration of the domestic banks was to address their own corporate challenges.

All this further undermined confidence despite the appointment in December 2008 of a new Chairman Mr Donal O'Connor and public interest directors.

The loss of confidence in the bank and the realisation that additional capital could only come from the Government, led the Government to decide in January 2009 that full control of the bank had to be taken to ensure confidence in the banking system, for the same reasons adduced elsewhere that a bank closure had to be avoided.

To reiterate the point, allowing Anglo to be liquidated at that point would have fatally undermined depositor and wholesale money market confidence in the Irish banking system leading inevitably to a catastrophic overall banking and economic collapse and severe impact on public services. The press announcement on 15 January 2009 said that the decision had been taken after consultation with the Central Bank and the Financial Regulator who had confirmed that Anglo remains solvent.

C4b: Establishment operation and effectiveness of National Asset Management Agency

In early 2009, the Minister for Finance, on foot of increasing concerns about the deadweight on the banks' balance sheets of poor quality loans, asked the NTMA to commission Dr Peter Bacon to undertake a review of how that could be addressed.

His report concluded that the market would continue to have no confidence in the Irish banks if concerns over that deadweight continued. It recommended that land and development loans be transferred on an appropriate discount to a new property management agency that would proceed to recover the maximum amount of the loans.

The proposals were endorsed by the Central Bank, the Financial Regulator, the NTMA and the Department, and recommended to the Minister for Finance and the Taoiseach.

The question of the operation and effectiveness of NAMA relates to a period after my retirement from the Department.

C6d: Role and influence of the ECB

Prior to the establishment of the ECB the Irish Central Bank was fully responsible for monetary policy and financial stability and regulation.

It set interest rates at a level that were appropriate to the specific conditions of the Irish Economy.

It lost this authority following the entry into the Euro.

The ECB did not appear to regard the question of curbing asset prices or excessive credit growth through the interest rate mechanism as appropriate, viewing this as a matter for the domestic central banks and regulators.

The ECB pursued its Treaty mandated primary role, the maintenance of price stability and pursued this objective through interest rate policy which took account of the overall economic conditions in the Euro zone.

There was a significant mismatch between those overall economic conditions and the conditions in Ireland. Interest rate policy over the much of the early 2000's period operated as a booster element in the Irish context, i.e. low rates encouraged inappropriate borrowing. Then in the mid 2000's as the property market started to cool interest rates increased.

The regulation of banking in the Euro area remained with the national authorities, in Ireland's case with the Central Bank up to the time the new arrangements were adopted from 2001 when a decision was made to establish the financial services regulatory authority. In deciding on those arrangements, the Minister of the day and the Department was concerned that it would be unwise

to take the Central Bank off the pitch totally on regulatory matters as the question of financial stability of the system could not be separated from regulation.

I understand that in the context of legislating for the new regulatory arrangements within the revised Central Bank structure, the question of the availability of powers for the Central Bank to address financial stability issues was considered. Section 33D of the Central Bank Act 1942 as introduced in the 2003 legislation expressly provided that

"(1) Either the Governor or the Board may, with respect to the functions of the Governor or the Board, issue to the Regulatory Authority guidelines as to the policies and principles that the Authority is required to implement in performing functions, or exercising powers, of the Bank.

(2) The Regulatory Authority is required to comply with guidelines issued to it under this section."

The Treaty on the Functioning of the EU did state that the European System of Central Banks, which consists of the ECB and the national central banks of all Member States, "shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Article 127.5).

The ECB is completely independent of Government.

The Governor of the Central Bank of Ireland is also completely independent.

While the primary concern of the ECB in the discharge of its monetary policy functions has been with interest rates, the question of whether the level of credit growth should also have been of equal concern in monetary policy terms must be considered.

In a situation where the levels of credit growth vary significantly across the Euro zone, the average growth rate may be regarded as one key determinant of interest rates. The interest rate regime applicable to that average growth rate does not address the outliers experiencing excessive credit growth, with all that entails in terms of fuelling excessive levels of consumption, over rapid investment in housing and construction generally.

It is a matter for the Central Bank to say whether the ECB advised the Irish Central Bank, and any others experiencing excessive credit growth rates, that specific measures needed to be taken to curb this.

C7a: Options for burden sharing during the period 2008 to end 2009

As noted elsewhere the view taken at ECB level in Autumn 2008, as quoted by the Governor on the night of the guarantee, was to the effect that there was to be no bank failure within the Euro zone and that the Irish Banks had to be saved.

Domestically the view taken was that, in the context of the meltdown of the financial markets generally, and the clear fears that already existed amongst lenders to Irish Banks that any move to force lenders to banks to forego their loans in whole or in part would lead to a potential collapse in the Irish banking system with all that entailed.

The shareholders in the banks were the first to be wiped out.

Burden sharing on depositors and lenders to banks generally could have been enforced by forcing some of the banks into involuntary liquidation, but that was ruled out. If it had been contemplated such a failure would have completely destabilised the Irish banking system, the economy and the ability of the Government to provide for public services

In relation to dated subordinated debt, my understanding is that the potential to pursue burden sharing on this category and give a capital gain to the banks was identified in 2009.

R1a: Appropriateness of the regulatory regime

As noted earlier, the regulatory regime in Ireland post the Government Decision to restructure the Central Bank in 2001 consisted of a Regulatory Authority with its own Board as one pillar of the Central Bank with a significant number of its Board members sitting on the Central Bank Board itself.

The Regulatory Authority with its own Board was charged with the full task of regulating the financial sector and ensuring that the sector addressed the whole question of consumer education and protection.

The Regulatory Board was established on 01 May 2003 (although a temporary board had been in existence for a period before this).

The legislative framework provided in 33C (9) of the revised Central Bank Act 1942 that

> "(9) If a matter relating to the financial stability of the State's financial system arises in connection with the performance or exercise by the Regulatory Authority of its functions or powers, that Authority shall consult the Governor on that matter.
>
> (9A) The Regulatory Authority may, if it considers it prudent to do so, give a written report to the Minister on any matter of the kind referred to in subsection (9), but may act on such a matter only with the agreement of the Governor".

It is a matter for the Central Bank to advise whether any such consultations took place. The Department has informed the writer that it can find no record of a report sent by the Financial Regulator or the Central Bank to the Minister regarding any financial stability issue prior to September 2008. The Financial Regulator did have concerns about the credit union sector. As noted earlier, the Central Bank was assigned force majeure authority under the relevant legislation to issue guidelines to the Financial Regulator which the Financial Regulator would have to comply with.

The combination of express authority given to the Central Bank, and the requirement on the Financial Regulator to put any financial stability issue to the Central Bank, and the fact that it operated through common membership of the Boards, did provide for an effective corporate governance structure. Properly operated, while somewhat cumbersome, it was an appropriate regime.

In August 2006 an International Monetary Fund (IMF) team report on the Irish Regulatory system was published: "Ireland: Financial System Stability Assessment Update."

While pointing out the risks facing the financial sector and the economy, this gave a good report as regards the effectiveness of the regulatory system.

The analysis pointed out that while there were risks facing the economy, they were satisfied that "the results of stress tests undertaken through the Central Bank and Financial Services Authority of Ireland (CBFSAI) and the major lending institutions confirm that the major domestic lending institutions have adequate capital buffers to cover a range of large but plausible hypothetical shocks..."

As regards the new and consolidated regulatory system (insurance sector and credit unions were transferred to its remit) the Report said "Notwithstanding the higher profile of the IFSRA's consumer protection activities, there have also been significant achievements in the prudential framework. The IFSRA has combined the central bank's pre-existing sectoral supervisory responsibilities with the additional ones that were transferred from other agencies in a seamless manner. While responding to the challenges imposed by EU legislation, it has created an organisational structure and a consistent corporate culture that are likely to enhance financial stability. Centralisation of common functions and harmonisation of processes and procedures have helped reduce the cost of regulation. Exchange of information and expertise between different areas of supervision has been facilitated, and there have been significant efforts to achieve a consistent approach to prioritising supervisory resources across institutions." (Source: 2006 IMF Article IV Review of Ireland)

While the report clearly supported the regime, the risk analysis that it undertook did not allow for the impact of the subsequent international financial crisis, the dramatic scale of the domestic economic downturn or the speed and scale of the property market correction.

Following that assessment by the IMF the financial stability analysis produced by the Central Bank in 2006 and 2007 suggested that while concerns were heightened about escalating house prices and associated banking exposures this would not lead to any solvency issues.

As regards the effectiveness of the regime, it is clear looking back over the period up to the turning point in the property market that mistakes were made on many fronts.

The banks

They made major mistakes in relation to the quantum and quality of their loans, which they have acknowledged.

The financial assessments of the banks themselves, as set out in the Report and Accounts, were insufficiently critical about the risks inherent in their balance sheets. It is clear that audited accounts right up to September 2008 painted a picture that did not include realistic assessments of those risks.

The assessment by the banks and their presentations to the market generally were to the effect that while they had liquidity issues, their businesses were profitable and financially sound.

The Financial Regulator

The Financial Regulator operated a principles based regulatory system which obviously took at face value the assessments of the banks and did not exercise independent judgement on their exposures and the quality of their loan books.

The Central Bank

The overview of financial stability exercised by the Central Bank similarly took at face value what the banks were reporting to the Financial Regulator. The level of growth in credit was seriously out of kilter with growth in the economy.

Measures could have been imposed by the Central Bank and the Financial Regulator through appropriate rules to significantly increase capital requirements. Alternatively, the banks could simply have been instructed by the Financial Regulator and or the Central Bank to reduce the rate of increase in their loan books or to reduce their loan books. If the banks had not complied, the Central Bank could simply have issued appropriate public statements and then used their existing legal powers, or requested new powers to implement restrictions.

This would have taken the heat out of the market, through rationing available credit and thus reducing construction levels. A minor tightening of capital requirements decided in 2006 to address 100% loan-to-value loans was not implemented until early 2007. It was too little too late.

Stress tests conducted by the Central Bank and the Financial Regulator to assess macroeconomic risks were not based on the worst possible outcome. The exercises failed to include the actual scale of the property crash, the extent of financial market volatility and the international financial crisis, and the impact of the foregoing for domestic economic activity, and can thus be termed, with the benefit of hindsight, as inadequate.

The Department of Finance, while concerned about over reliance on the property market, pro-cyclical fiscal measures and loss of competitiveness did not anticipate the severity of the property crash, and the international financial crisis.

The Department accepted the consensus view of the Central Bank, the Economic and Social Research Institute (ESRI) and others that the construction sector was facing a soft landing, i.e. a significant reduction in activity levels over a number of years to a much lower level. The reliance on consensus forecasts was a mistake.

The Department was wrong to take the assessment of the Central Bank, the Financial Regulator, and the banks for assurance about the state of the financial sector without challenge.

R2b: Nature and effectiveness of the operational implementation of the macroeconomic and prudential policy

The two main regulatory macroeconomic policies are fiscal policy and monetary policy.

Fiscal policy is the macroeconomic policy where the Government makes changes in Government spending or tax to influence growth.

General aspect

It is fair to say that in the decade up to 2008, the demands from all sides were for more public services and less taxation. The typical response to increased level of spending in many quarters was that it wasn't big enough. The outcome was that from 1998 to 2008 inclusive, total Government current and capital spending trebled.

Taxation issues

In the context of the review now being undertaken it is appropriate to briefly mention the tax treatment of property.

Tax incentives for urban and rural development have been introduced over many decades by all Governments. A good example of incentives that clearly led to positive outcomes was the designation of Tallaght for urban incentive purposes for an area that had very few facilities to meet the general needs of that community. Another would be incentives at the early stage of the development of the IFSC. Both of these encouraged development which led to improved economic conditions.

There is however little doubt that tax incentives generally in relation to housing, and the incentives for commercial development did contribute to the pressures in the construction sector. Another main issue driving activity in that sector was reduced interest rates, the availability of loans on easier terms, and unreal expectations that investing in property was always going to be a winning formula.

The Minister for Finance progressively moved from 2005 on to reduce and terminate tax incentives associated with building and tax minimisation by high earners.

Measures were also introduced in Budget 2006 to restrict the capacity of high earners to reduce their income tax liability to very low levels, or to zero, through the cumulative use of various tax incentives, particularly tax incentives on property.

Reductions in the top tax rate band from 48% in 1997/98, to 40% in 2006, increased disposable incomes significantly for middle and higher income groups which also boosted the appetite for fixed assets at the same time as significant interest rate reductions occurred.

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At times of strong revenue flows such as existed from 1997 more or less through to end 2006, the reality was that as revenues increased, the pressures from all sides were for more public services and less taxation.

In general prior to 2008 the annual Budget day packages as a result of the pressures exerted by individual Ministers and the Social Partners, ended up significantly higher than those recommended in the Budget Strategy Memoranda. The fact that revenues were buoyant in that period added to expectations.

Too much focus on the short term by the political system diminished the appetite to look at longer term sustainability issues. While some early Long Term Issues papers produced by the Department were published (leading to the establishment of the National Pensions Reserve Fund) my recollection is that later reports in 2001 and 2003 were not published.

Publication every few years or so by the ESRI on an independent basis of their Medium-Term Economic Review and a Long Term Report should be the subject of presentations to Oireachtas and debate on the picture that emerges.

This could provide a meaningful context to political and public consideration of the sort of choices that have to be made in relation to desirable levels of taxation and public services against the background not just of the short and medium term social and economic considerations but also the longer term pressures arising from demographic realities.

Finally a comment on the role of fiscal policy apart from what is set out above. The accepted analysis after the establishment of the ECB and the transfer of monetary policy from the Irish Central Bank was that the only tool available to Government to control economic activity in the economy was through taxes and spending. Too much store was placed by the Department on this conclusion and more consideration should have been given to the impact of uncontrolled lending. The long standing practice of the Department before 2008 was to regard the Central Bank and Financial Regulator as being completely independent in monetary and regulatory matters. With the benefit of hindsight, the Department should have adopted a more critical stance in the decade ending in 2008.

Monetary policy deals with changes in money supply or changes with the parameters that affects the supply of money in the economy.

The ECB consisting of the Governors of the individual Central Banks regarded monetary policy as dealing mainly with inflation levels. The Treaty on the Functioning of the EU, Article 127.1 provides that "The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union".

Interest levels, when they go up, or down, can discourage or encourage growth in credit in an economy and thus have the potential to slow down excessive economic growth or to boost it.

This one size fits all approach is appropriate to a single economy that has more or less uniform economic activity in its different regions.

However where different regions are exhibiting significantly different levels of growth the level of interest rates that should apply in a very low growth or depressed region within a currency union will inevitably exacerbate the level of economic pressures in a very high growth region.

Faced with an interest rate regime that was not appropriate to the needs of the Irish economy when it was growing too fast, the introduction of appropriate measures by the monetary authorities should have been considered to prevent the banks creating the credit bubble and the resultant crash.

R2c: Adequacy of the assessment and communication of both solvency and liquidity risks to the banking institutions and sector

The Department would always have expected that in the first instance the Board and top Managements in the banks would have been on top of both solvency and liquidity issues and that the Financial Regulator and Central Bank would have kept this under detailed scrutiny.

Both issues are the bread and butter of banking, both for the banks themselves and the relationships with the customers they loan money to.

The banks convinced themselves that their loan books were sound. They felt that the liquidity pressures that emerged during 2008 were a temporary phenomenon that could be addressed as international pressures dissipated and markets returned to normal, or that it was a reflection of concerns about a particular bank which reflected negatively on their standing.

The international financial meltdown in September 2008 put paid to that. When the lid was lifted on their books the bulk of troubles were down to the domestic realities, not to the international financial crisis.

The relevant issue was that they had loaned too much and on poor terms. This was funded largely through international sources which then progressively lost their confidence in the Irish banking system.

The banks failed to appreciate the dangers until it was too late.

R3a: awareness and clarity of roles and accountability amongst the regulatory and supervisory institutions of the State

As regards the context of this matter prior to September 2008, the side of the Central Bank charged with ensuring financial stability placed an unwarranted and undue reliance on the assessment of the banks themselves and the Financial Regulator that individual banks were sound.

At a macro level the Central Bank was concerned about the level of credit and all that implied. However the combination of the financial reports of the individual banks and the conclusions the

Central Bank reached on foot of their stress testing led to the Central Bank not intervening in the credit market by utilising the force majeure authority given to it.

Management of both the Central Bank and the Financial Regulator are best placed to comment on the awareness and clarity of their roles. The writer's view is that they should have had greater concerns about the credit explosion and should have put appropriate measures before their Boards for approval and implementation.

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

As regards the banking institutions, prior to September 2008, the engagement of the Department with them was confined in the main to discussions regarding tax issues. The primary contacts with the Institutions were with the authorities in Dame Street. Post September 2008 the Department did have contact with the banking institutions in relation to the resolution phase.

There would have been ongoing contact by the Central Bank with the Department relating to legislative change, EU affairs through common membership of the Economic and Financial Committee (attended by senior EU Finance Ministry & Central Bank officials) and attendance twice yearly at the ECOFIN Council of EU Finance and Economy Ministers, the Domestic Standing Group and on economic forecasting.

As Secretary General of the Department between July 2006 and January 2010 I was an ex-officio member of the Board of the Central Bank.

It is fair to say that while clearly the pressures in the housing market and the stresses in the money market featured in discussions, I do not recall any proposals being advanced on foot of any identified imminent threat to financial stability or to the solvency of any particular institution. Papers presented to the Board did not foresee an impending tsunami involving an international financial crisis, a precipitous collapse in the construction sector, a severe downturn in the domestic economy, or a solvency problem in the financial institutions.

I was not a member of the Financial Regulator Board.

R3c: Effectiveness of the communication between the Central Bank and the Department of Finance

My impression was that the channels of communication at all levels between the two organisations were open. As noted elsewhere, the standing approach in the Department was to regard the monetary policy and regulation function as completely independent.

In retrospect it is clear that the communications should have been more critical of what was going on in relation to credit growth over the years.

The Governor of the Central Bank, as a matter of standing practice had an open line of communication to me as Secretary General and with other senior officials of the Department and also with the Minister of the day. He would regularly brief the Minister personally on issues of concern on a confidential basis. These were private one-on-one meetings. The Governor would also have occasional meetings with the Taoiseach.

At no stage prior to September 2008 was the Department advised that matters had been raised in either the meetings with the Minister or the Taoiseach that gave rise to particular concern regarding the solvency or viability of individual financial institutions.

The Governor of the Central Bank would, each year, before the annual Budget send a communication to the Minister for Finance setting out his views on behalf of the Board regarding the priorities that should be addressed in the Budget. This was not published.

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

The legal advice of the Attorney General's Office was used through 2008 and beyond.

This was supplemented from September 2008 by specific legal advice on commercial and corporate governance issues. The main expert financial advice secured in the run up to the Guarantee was from Merrill Lynch. The views offered by them formed the context for the decisions reached.

See comment earlier regarding the Guarantee (see C3b).

R4b: impact of the reliance placed upon information and reporting from statutory auditors of the banks

Seeing a "clean" audit opinion would of course have provided comfort to me and my colleagues in the Department and to me as a member of the Board of the Central Bank. These statutory opinions, together with various disclosures in the financial statements made by the directors, would have provided comfort at the time of publication that there was no significant risk of material unprovided losses.

None of the covered banks had any modification to their opinions in the years immediately preceding the Guarantee - "clean" audit opinions were given. I would have read the headlines related to the publicly released annual reports and have reviewed some of them relating to the period.

The external auditors were, in their statutory audit opinions, confirming that the financial statements provided a true and fair view of the state of affairs of each bank.

Statutory auditors play an important role promoting confidence in published financial information.

The financial statements did not indicate a significant credit risk existed that was unprovided for prior to the Guarantee. No significant concerns on liquidity or solvency risks were apparent from reading the financial statements, either in the various disclosures or narratives included by the directors, or in the audit opinions issued by the statutory auditors. An extract from the Allied Irish Banks (AIB) 2007 annual report illustrates the point.

Chairman's Statement

"Enhancements have been made across AIB's credit risk measurement and management processes, the identification of material risks and their alignment with capital requirements and capital planning and in the development of a comprehensive stress testing framework. These enhancements served the organisation well in the difficult market conditions that prevailed in the second half of 2007."

This was typical of what the Department would see, and rely on.

While I understand the accounting standards may not have permitted provisions for expected losses (banks were unable to set assigned provisions for doubtful debts where there was no objective evidence such provisions were required), the financial statements, in my view, had opportunities for the risks to be more clearly set out, e.g. in the principal risks and uncertainties; in the past due, not impaired disclosures; in the concentration of risk disclosures, in the various commentary sections at the front section of the various annual reports.

The financial statements are the responsibility of the directors, but with hindsight they should have engaged more actively with their auditors to enhance the disclosures provided and thus improved the quality of information included in financial statements.

I understand that a new IFRS standard is coming down the road that will move to an "expected loss" model for impairment provisions and hopefully this should present a more relevant picture of the credit risks in place in the financial institutions.

Separate to the statutory audit opinion, the auditors would have had additional regulatory reporting obligations, in particular to the Financial Regulator. I would not have had any involvement in any such regulatory reporting. On only one occasion was I ever informed of an issue reported by an auditor to the Financial Regulator, and that matter was actioned by the Financial Regulator.

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

In relation to external contrarians I was of course aware that a minority of outside commentators had negative views on many fronts. The expert analysis presented to the Board of the Central Bank in relation to housing market dangers did not trigger alarm. The expectation would always have been that the books of the banks contained a wide spectrum of borrowers who had, surely, been carefully scrutinised and that prudent loan to value ratios, on average, and security existed.

The view of the IMF in August 2006 on the regulatory system referred to elsewhere would have had an impact on attitudes too.

In relation to internal contrarians, many people in the Department had concerns about the outlook for housing. The Department was very clearly aware that the level of construction sector output was seriously out of sync with that across Europe and that we were spending the tax revenues from a source that would inevitably slow down to a more sustainable level. However as noted earlier the combined set of circumstances that emerged in 2008 were not envisaged.

As regards internal opinions I would say that staff in the Department would always express a wide and divergent set of views and these would be considered as in any organisation in determining the stance to be adopted on particular issues. This is the normal cut and thrust of arriving at Departmental positions.

R5b: Appropriateness of the advice from the Department of Finance to Government and the use thereof by Government

The Programmes for Government and Social Partnership process heavily influenced policy demands.

The general advice to Government regarding appropriate levels of spending and taxation was included annually in a Budget strategy memorandum. Up to 2008 the outcome would usually have varied against the overall recommendations made. The fiscal policy stance over that decade was, in general pro-cyclical, i.e. the levels of expenditure increases and tax concessions in good times added to demand in the economy.

As regards specific issues brought to Government by individual line Ministers through Government memoranda, the views of the Minister/Department are usually included for Government consideration.

In relation to the particular taxation policy levers available to the Minister for Finance, the Department each year prepared Tax Strategy Group papers analysing the various areas, identifying options for action. The matters are then decided by the Minister and Government and incorporated in the annual Budget.

As regards the run up to events in 2008, the advice of the Department was that legislation needed to be prepared to take appropriate powers to nationalise any particular financial institution.

That legislation was prepared and amended to take account of the decisions in relation to the Guarantee.

In relation to the specific issue of nationalisation/guarantee, I have dealt with that elsewhere (see C3b and C4a).

R5c: Analysis of the key drivers for budget policy

The starting point for the assessment of budgetary policy is an assessment of the situation in the economy and the prospects for it having regard to the views of external forecasters such as the ESRI, the Central Bank, EU, IMF, Organisation for Economic and Cooperation Development and the Department's internal economists.

Assessments were done of how spending and taxation was likely to trend. These taxation and spending levels, combined with estimates of debt service and EU funding costs were used to derive estimates of the fiscal outcome in the absence of policy change.

The need to change policy was then considered having regard to the Stability and Growth Pact, fiscal trends, the economic situation, the Programme for Government agenda and recommendations were prepared for Ministerial consideration and then for Government approval. A Budget strategy memorandum was prepared accordingly around mid-year. The stance would have been reviewed regularly in the run up to the Budget.

Many outside groups submitted views on specific measures including the Irish Congress of Trade Unions, the Irish Business & Employers Confederation, the Irish Farmer's Association, the Irish Creameries and Milk Suppliers Association and tax practitioners, not to mention lobbying by individual Ministers, programme managers etc.

Social Partnership Programmes and Programmes for Government set out major agendas for taxation and public services.

Decisions on spending policies were made by Cabinet.

The Minister made decisions in taxation having considered all the foregoing and the views of the Tax Strategy Group.

R5d: Appropriateness of the relationship between Government the Oireachtas the banking sector and the property sector

I do not consider I should comment on the appropriateness of the relationship between the **Oireachtas** and the banking or property sector.

I would offer some general suggestions in this context.

The Oireachtas Joint Committee on Finance and Public Expenditure and Reform could regularly meet not just with the Irish Banking Federation, but with the Chairpersons and Chief Executives of the systemically important banks to hear their views on the state of the economy, and their assessment of the state of their industry. The views of the ESRI could also be considered.

The Central Bank Governor's pre-Budget submission to the Minister for Finance could usefully be published and presented to the Committee for review.

As far as the relationship between the Government and the property sector is concerned, the Minister for Finance and the Department had regular contact with the Construction Industry Federation and tax practitioners regarding tax policy.

The Department of the Environment, Community and Local Government would have contact with the property sector in relation to housing supply and policy generally and to regional planning and the planning framework.