JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

WITNESS STATEMENT: KEVIN CARDIFF

Introduction

The Joint Committee has directed me, pursuant to section 67(1) of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013, to provide a written statement on 23 separate lines of inquiry which cover a vast array of topics and which span a significant period of time. I am pleased to have this opportunity to discuss the events of the financial crisis in Ireland: I was very involved in many of the key events of this time and I have endeavoured in this short statement to address the relevant lines of inquiry. However, there is no way for me to deal with several years of intense activity in a short statement. Therefore, to help the inquiry, I will simply note that I have already given testimony at a number of Oireachtas committees over recent years, of which I am sure the inquiry is fully aware, and have provided many important documents already (details at Appendix 1). I will try not to go over old ground in this statement and also will try to manage the legal restrictions that have been placed on witnesses here, in relation to ongoing legal cases where I might well be called as a witness. In order to support the work of the Committee as far as I can, I have prepared a lengthy report for the Committee as an appendix to this summary document, dealing with just some of the key periods of the crisis in significant detail (Appendix 2).

I have been asked to address the various lines of inquiry as they relate to my role as Former Secretary General of the Department of Finance ("DoF"), and any other relevant roles that I held within the DoF. I joined the Department of the Public Service, later subsumed into the Department of Finance in 1984. I was appointed as head of the Division with responsibilities encompassing the Department's role in relation to financial services matters in December 2006. I was appointed as Secretary General in February 2010 and remained in that role until February 2012.

I have divided this statement into three parts. Part I addresses the events leading up to and including the bank guarantee decision taken by the Government on 30th September 2008. Part II addresses the domestic and international policy responses following the bank guarantee. Part III provides a more general overview of the role of the Department of Finance during the crisis, and its interaction with other institutions such as the Central Bank ("CB"), Financial Regulator ("FR") and the National Treasury Management Agency ("NTMA").[1]

[1] Lines of Inquiry C1, C2, C3 and R4 are addressed in Part I. Lines of Inquiry C4, C5, C6, C7 and R4 are addressed in Part II. Lines of Inquiry R1, R3, R4 and R5 are addressed in Part III.

Part I – Events Leading up to the Bank Guarantee

Genesis of the broad guarantee

When Northern Rock started to dissolve in the Autumn of 2007, there was a very public run on that bank. There were large queues at its branches, including in Dublin. The crisis was addressed by the UK government initially in two ways – by nationalising the entity, and by providing a guarantee. The extent of that guarantee was – in the course of midnight phone calls with the British authorities – clarified so that Irish depositors would know that they too would be safe.

The lessons of Northern Rock were closely noticed, and perhaps 'over-learnt' in Ireland. While government guarantees carry real risks for taxpayers and citizens, a guarantee of a financial institution is a fast and effective way to stop a bank run and protect savers and the economy. Nationalisation on its own, despite all the reassurance that the involvement of the State might provide, does not stop a bank run.

Towards the end of 2007, the Department of Finance (DoF) and the Central Bank, including the Financial Regulator (CB/FR), engaged in a carefully constructed simulation exercise to see how one might react in the event of a bank crisis. In this simulation exercise – which dealt with a situation of one bank in trouble in isolation – the action recommended by those parties playing the CB/FR was that the Government should provide a guarantee. Those playing the Government were more reluctant to rely on the transfer of risks to Government in this way. One key lesson, therefore, was that one should not jump too quickly for a guarantee approach, and should insist on a broader consideration of options.

This consideration was also discussed and indeed agreed with CB/FR, and as liquidity for the banking system gradually tightened during 2008, crisis management discussions looked also at other intervention options, and there was a real consciousness of the necessity to avoid knee-jerk guarantee responses. For example, during this time the two larger banks, while not involved in any planning exercise, were nonetheless approached by the Governor of the Central Bank, who suggested to them that in the event of a potential failure of any of the smaller institutions, they might need to be part of the solution to such an event. I understood from the Governor that indeed the two larger banks understood that such an event could threaten the system that sustained them and that they had indicated – hypothetically of course, since there was no case in point – that they would engage and try to play their part.[2]

Other intervention approaches were also considered and worked upon, while at the same time there was a lot of effort in CB/FR, the DoF, the NTMA and the banks themselves, with a view to ensuring that ongoing liquidity pressures could be addressed – various key papers outlining the development of various crisis resolution options during 2007 and the first half of 2008 have already been provided to the Oireachtas and published – links at Appendix 1. It was understood that in some other countries banks were being encouraged to repatriate funds so as to provide liquidity in their own domestic markets and the CB/FR was naturally encouraging Irish institutions also to be willing to share their liquidity with each other. This much is well known and I will go no further on this point, for the legal reasons explained earlier.

In the first half of 2008, there was absolutely no serious consideration, which I can now recall, being given in CB/FR, DoF or NTMA to a broad guarantee in respect of a wide range of institutions for a wide range of liabilities, as a discrete policy option, although of course, as I have just noted, there was

[2] I should note at this point that in the first half of September 2008, when it was clear that INBS was in significant difficulty, I told the staff in the FR that Bank of Ireland ("BOI") and Allied Irish Banks ("AIB") would have to be called in to assist in a resolution for INBS. The CB/FR met with the two banks and got a strong refusal – the banks were concerned that INBS' very high property exposure would be difficult for them to digest. Goldman Sachs produced an assessment when asked by the FR– based of course on information from INBS and its executives – as well as from documentary review, of the scale of difficulties with the INBS loan book. The assessment was perhaps a bit more upbeat than we had feared at the time, and in retrospect and with all the benefit of hindsight was hopelessly optimistic. On Sunday 21 September 2008, I heard their assessment in a meeting with Basil Geoghegan from Goldman Sachs and various others: while it might be difficult to get 100% back on some of the loans they had issued, there was nothing to suggest any losses could not be absorbed by INBS' own capital. In other words, they seemed to be in some trouble, would need some help, but were probably solvent.

ongoing work on legislative options which included consideration of how to enable Government to give guarantees in appropriate cases. But at various points in time it seems that a broad Government guarantee did feature in discussions in other quarters. The Governor of the Central Bank, I believe, received approaches in March/April 2008 suggesting that the Government should announce a broad guarantee – though it is possible that what was in mind at this time was a general political undertaking rather than a formal guarantee. While those approaches probably reflected particular pressures around and just after St Patrick's Day 2008, I believe the concept persisted in some form for some time after, and was raised in certain discussions with the Department of Finance, and perhaps also with the Central Bank in Summer 2008, but I am not aware of any extensive discussion between the Department and other parties on this concept at this point in time

The Committee is well aware of the liquidity crisis that gripped the banking sector in September 2008, and I have described in detail the events of that month in Appendix 2. At that point, a range of interventions in the banking sector were being considered, including the nationalisation of INBS as a measure to stem the institution's liquidity drain. However, when Lehmans filed for bankruptcy on 15th September 2008, the liquidity situation became critical and there was widespread panic in the financial markets and among the general public.

The decision taken by the Government on 20th September 2008 to increase the level of protection for bank deposits from €30,000 to €100,000 worked well to assuage the concern among individual depositors and avoided a run on INBS.[3] However, that measure was almost worthless to bigger depositors whose sentiment towards Irish banks could change overnight. Nobody involved with the decision expected anything other than a short respite, a little time to continue working and planning.

[3] Most of INBS' deposits came from smaller depositors and thus the increase in the deposit guarantee eased the liquidity pressure on that institution.

In September 2008, in light of these domestic and international developments, a broad guarantee was discussed extensively, and quite properly, as one of the options available to Government in dealing with the crisis that had by then arisen.

Naturally, the broad guarantee concept, as an option to be considered, was discussed between CB/FR, NTMA and DoF on a number of occasions – Dr Somers, the CEO of NTMA, for example, was personally consulted, informally, in the first half of September 2008 on such an option, and both the Central Bank and the NTMA were asked at various points in time to consider what the implications of such an approach would be. The broad guarantee approach was also discussed in crisis-management meetings including various different formations of the DoF, CB/FR, NTMA, various advisers and Ministers in the days and weeks leading up to the guarantee night.

A broad guarantee approach was also suggested to officials on a number of occasions by individuals/organisations in the private sector, before the guarantee night itself, and my records suggest that this list may have included Bank of Ireland. I do not believe that these external approaches were influential in relation to the crisis preparation work being carried out by various working groups involving the DoF, NTMA, CB/FR and their advisers. So far as I can recall, a broad legal guarantee was never proposed by DoF or NTMA, or any of the professional advisers we dealt with, in the period before the night of 29/30 September 2008 (guarantee night), but it was discussed as an option. CB/FR were also not initially to the fore in pressing for a broad legal guarantee, with the Governor suggesting on 18 September that it might be counterproductive, but by the guarantee night, the Central Bank and the FR representatives were clearly and explicitly in favour of that approach, having regard to the situation at the time.

It will also be recalled that there was a government meeting on 28 September – as I understand it, one, or perhaps two, Government ministers since have said that the decision to opt for a broad guarantee approach was made at that meeting. If that had been the case, it would have been very important to communicate the decision to the technical teams involved. However, there was no such message, no-one said on the guarantee night that the decision had been made the day before, and the disposition of the Minister for Finance that night would not suggest that any final decision had been made. However, it seemed clear that the Taoiseach did have a predisposition in favour of the broad guarantee approach, and I cannot know if this was influenced by the previous day's Government meeting. There had been a short note prepared for use by the Minister for Finance at that Government meeting, which does not suggest that a detailed discussion was expected, or that a broad guarantee would be the outcome. These matters, and the events of the guarantee night itself, are dealt with in considerably more detail in the report I have provided as Appendix 2

The Night of the Guarantee

The inquiry may find it useful for me to set out my recollections of the night of 29/30 September and I will do so in summary here.

I was surprised that the option of giving a broad guarantee for the banking system emerged very early in the discussion which commenced sometime after 6 p.m. that night. I had expected of course that we would discuss guarantees for banks among the options for consideration that evening – indeed, by then I thought that some guarantees were inevitable. But the Taoiseach raised the issue of a broad pre-emptive guarantee quite early in the discussion. It seemed to me that this was going to be the baseline approach against which every other option would be considered.

There was a lengthy discussion of the situation and the options, especially the guarantee option[4]. Tony Grimes of the Central Bank spoke about the funding position of the banks. John Hurley, the Central Bank Governor explained his understanding of the ECB and the European position (outlined below). The Irish central bankers were clear that their own balance sheet was not large enough to make large loans to Irish banks outside the framework of the European System of Central Banks. They had been very insistent on the need to have Government funds available to lend to banks. CB/FR representatives all strongly favoured the broad guarantee approach.

The Minister for Finance and I were more cautious about the broad guarantee option, noting that on its own it could not solve all the problems of the banks, and indicating that other options should be considered, including nationalisation of Anglo.

The financial regulator spoke about the current solvency situation of the banks, maintaining the position that they were solvent, if not without difficulties.

At some stage in the evening, the Minister's views moved more towards the consensus favouring the broad guarantee option. The Minister told me some time later that during a pause in the meeting, when he and the Taoiseach had left the room to speak privately, he agreed with the Taoiseach to follow the broad guarantee approach. He did not use the word 'overruled' but rather indicated that he thought it important that he and the Taoiseach presented a common political position. I was not in that private discussion and had no other insight into itat the time. However, the Taoiseach and the Minister did not actually announce that their decision was made, but rather let the meeting move toward their position.

[4] A document outlining pros and cons of a variety of options had been presented by Merrill Lynch on the previous Friday, and legislation and practical arrangements had been prepared to allow for a variety of intervention options was ready, including nationalisation, special liquidity swap arrangements, direct loans, guarantees etc. This legislation could have been passed in a matter of days. Moreover, practical arrangements had been made (e.g. preparation of contracts, availability of collateral) to ensure that any decision to support the banks by loans or swaps could be implemented more or less immediately. Extensive work had been done on the State Aid implications of the various options, so that a State Aid notification could be made, also immediately.

While all of this had been going on, Dermot Gleeson and Eugene Sheehy, the Chairman and Chief Executive of AIB, and Richard Burrows and Brian Goggin, 'Governor' and CEO of Bank of Ireland, were waiting in a separate conference room. They were asked to join the meeting.

The bankers' message was stark.

We already knew they were in trouble, of course, and it was clear that Anglo was entirely out of cash and that Irish Life would most likely be in the same boat later that week. The two large banks reported that market participants were no longer differentiating between Irish banks - all were being tarred with the same brush, and all would have funding problems. On their estimates, although both had substantial liquidity cushions, the circumstances were so extreme that even these two most substantial Irish banks might run out of funds in a matter of a small number of weeks. They wanted a guarantee from the Government in very broad terms, and they wanted insulation and differentiation from, in particular, Anglo, which they argued could come from a nationalisation of that bank.

While at this stage INBS was draining funds only slowly, it would eventually also have difficulties, and the EBS building society which had not yet been flashing the same warning signals as the others, would presumably also be infected. All the main domestic credit institutions, therefore, were likely to run out of cash in time frames running from days to weeks, assuming that the situation did not worsen. A worrying situation had become a desperate situation in just a few short days.

The bankers came in, discussed, left, and then were invited back into the room for further discussion. I took some notes, scribbled in a hardback notebook and I understand the Committee has a transcript – I have recently, for the first time in some years, seen a pdf of the original manuscript, and have provided a new transcript as a note to the report at Appendix 2, though it should be said that these were never intended to amount to a formal minute. Based on my memory and these notes, the following is clear to me:

- The banks outlined the market position, as I have noted above.[5]
- They asked that Anglo be nationalised.
- They explicitly sought a very broad guarantee, and provided a suggested wording.
- I asked, for the benefit of the room, why we should guarantee existing long-term borrowings of the banks, and they responded in terms of ensuring a consistent message to the market, avoiding market differentiation, the negative reaction that would arise if existing lenders to banks were disadvantaged compared to new, pointing out that addressing the funding situation as it stood would require that existing lenders would also be new lenders.
- Similar arguments arose in relation to subordinated debt, but I do not recall now if the bankers made a distinction between dated and undated subordinated debt.
- There was a discussion of how much the banks ought to pay the Government for a guarantee, and Eugene Sheehy suggested a risk-adjusted system on the model of the American FDIC charging system.[6]

It has emerged in the media and testimony to the inquiry in recent times that Sean Fitzpatrick had been to visit at least one of these two banks that day, and had asked that the larger bank would take over Anglo. I do not recall this rather salient piece of information being passed on in the meeting with the Taoiseach.

[5] even the word "bankruptcy" was used, but this was a reference to the possibility that they would have no cash to meet payments, rather than that they would be insolvent in the sense of the value of their assets failing to match their liabilities.

[6] The FDIC is the Federal Deposit Insurance Corporation. A decision on charging mechanisms was not made that night, and was instead considered in the following days.

While the bankers' interventions had added some additional colour to our understanding of the situation, their information was consistent with that already available, rather than adding much new (apart from confirming their own fears).

In fact, theirs was not even a worst-case scenario. In the absence of significant official intervention, a failure of Anglo to meet any of its obligations would trigger events of default on many of its borrowings, so billions of euro would become payable immediately. Anglo's depositors would lose access to their money, the bank would close its doors. Depositors, large and small, could rush to take funds from the other banks, and international investors would withdraw from Ireland as much as they could. Payment systems, such as international credit card and debit card service providers might withdraw services from their Irish customers abroad and internationally traded businesses would face in many cases impossible demands for upfront payments for goods and services and could no longer rely on their bank guarantees and working capital facilities, as the Irish banks would not have the cash to honour them.

The contagion effect of an Anglo default could be exacerbated by the failure within the same week of ILP, and it was possible that all banks would be told to close their doors for days or weeks while authorities struggled to cope.

In relation to bonds of various types, the meeting accepted the bankers' arguments that it was important to keep the bondholders on board, and covered by the guarantee, so as to encourage the flow of new funds. (This may in retrospect have been a mistake, but not as great a mistake as is sometimes suggested, as only a minority of these bonds would mature in the two year period concerned.)

The term – or length of time applicable – for the guarantee was also discussed, and it was considered that two years ought to be enough, or that if problems persisted for longer, then other mechanisms would have been found to address issues in the meanwhile.

And there was a relatively short discussion, too, about the question of whether to include dated subordinated debt within the guarantee. I was asked whether that issue had been covered in any of the discussions with the Merrill Lynch team, and I reported that at the meeting of 26 September they had advocated – on balance – that dated subordinated debt would have the same protections as senior debt, and so dated subordinate debt was included.

Although one of the more junior people in the room, I spoke a number of times. I can remember in particular a number of interventions I made:

1. I noted, being aware of their views and also having emailed Merrill Lynch as soon as it became clear that a broad guarantee approach would be a key focus of discussion, that Merrills and NTMA, our advisors, would be likely to advise against the broad guarantee option, on balance.
2. I said, in response to a direct question, that I thought that immediate nationalisation of Anglo, with guarantees as required for that institution, but only a strong political declaration in relation to support for the others, was a better option in my opinion.
3. I pointed out, that while the Financial Regulator was happy to say the institutions were solvent, it was clear that once guaranteed they could not in any circumstance be allowed to fail – and so any capital or cash shortfall would have to be addressed: there would be no choice in the matter. We knew that our advisors had concerns about the business models of at least two institutions and that a deterioration in the banks' loan books was possible – however there was no inkling of

the sheer scale of later loan losses and there was no suggestion made at any stage that the banks were, at that moment, insolvent.

4. I stressed, repeatedly, the necessity to make the guarantee as legally watertight as possible and this meant swift legislation and immediate engagement with the European Commission – the guarantee would not work if not accepted in the market and it was therefore important that no market players or significant government or EU authorities would call it into question.[7]
5. After the decision had been made in principle, I was asked to produce drafts of the final announcement, based on the banks' wording – I believed that this wording was broader in a number of respects than had been understood by the official parties and I told the Taoiseach in a side conversation that if we accepted their wording the banks 'would be laughing at us' or words to that effect – the Taoiseach immediately asked me to ensure the draft reflected the understanding of the official parties as to the decision taken, rather than the banks' draft.

My interventions described above got varying amounts of support/rebuff, and of course I was only one of several people making comments on the various options proposed. However, the Taoiseach was clearly in charge, as was quite appropriate.

What is clear is that none of the options available to the Government on the guarantee night were pleasant, or sure to be sufficient to address the immediate crisis. The broad guarantee approach was a legitimate option in the circumstances. Its pros and cons had been laid out in a document prepared on 26 September, and while the 'cons' were substantial, there were important advantages. The various

[7] On one of my later interventions on this point, Minister Lenihan, possibly thinking I was overplaying my concerns, asked who would wish to challenge the guarantee – I replied that any of the market participants who were to be excluded from the protection of the guarantee might decide it was to their advantage to be troublesome: on this I was correct, as we discovered quite quickly.

meetings and considerations that took place in the weeks before the guarantee note are, again, set out in greater detail in the report at Appendix 2.

Contacts with the ECB before the guarantee night

Since it has been a matter of some discussion in the inquiry to date, and since I may be able to add to the Committee's understanding of matters, I will deal briefly with official contacts with the ECB in the days and weeks leading up to the guarantee night. There was a real concern that the ECB should be kept 'in the loop', in part for reasons of good cooperation, but also for the purposes of having some insight into what was going on in Europe. There was a fear that multiple phone calls to member state government or regulatory authorities would not provide much information but might prompt regulatory authorities in other countries to tell their institutions to pull funds out of Ireland.[8] It seemed safer to use the Central Bank's links with the European Central Bank to get information on what was going on – and indeed this approach did provide some useful intelligence on, for example, Fortis, Depfa/HRE and so forth. It was also necessary that the Central Bank should be in touch with the ECB because we needed to know what level of support we could expect from the ECB in the event of difficulties in Irish institutions. It was my understanding that the ECB was therefore aware of increasing difficulties in Ireland and that the ECB and Mr Trichet personally were aware on the 28 September 2008 that the Irish banks had real difficulties that could materialise in a very short number of days – my recollection is that before the guarantee night, the Governor of the Central Bank, John Hurley reported three important points from Frankfurt, after discussions with the President of the ECB:

[8] This was not an empty fear – in months that followed, when it was clear that Ireland did have some problems, we heard through the banks that some of their foreign counterparts had been encouraged to think again before depositing with Irish institutions. Of course, this is not the sort of thing that can be proved, but it seemed credible, and there were some more formal actions that seemed to confirm this threat.

1. There was no European approach to the financial crisis in preparation at that point.
2. The message from the President of the ECB was that each Government should protect its own financial institutions and should not let them fail.
3. The ECB was not preparing any special intervention in relation to liquidity, including in relation to collateral.[9]

The discussions on the guarantee night therefore took place in a situation where there was a vacuum at the European level, not yet filled, and where the message from the ECB was, more or less, save your banks yourselves. Records I have seen recently confirm that Mr Tony Grimes, Director General of the Central Bank, spoke with the ECB about our situation and about collateral rules in or around the 17th of September and that the Governor was expected to make efforts to speak to Mr Trichet in or around the 28th September, and did in fact speak with him, and these records are consistent with my recollection of events. I know that the late Brian Lenihan has given an account of a message left on his telephone from Mr Trichet or his office. I was not aware of that at the time, so far as I can recall, but it seemed clear at the time that the message Mr Trichet had for the Irish Government was the one being passed via the Central Bank Governor: that it was very important that Governments prevent their banks from failing, and that there was no concerted European initiative in prospect.

It is entirely possible that a different approach to the Irish financial sector difficulties might have been taken, and more efforts would have been made to make contact with European partners, if there was any sign of a concerted approach being prepared. That there was not such a concerted approach was not, of course, particularly the fault of the ECB

However, despite there being no special intervention by the ECB aimed at the Irish situation, Irish banks were able to avail of a range of ECB facilities, over the period of the crisis, some of which had indeed

[9] In fact the ECB was moving in the opposite direction, towards tighter collateral rules, having taken some loss on Lehmans

been expanded to help cope with the liquidity crisis which was engulfing the US and Europe, including access to longer term funds in addition to the ECB's usual weekly and overnight facilities. Irish banks were encouraged by CB/FR to prepare as many assets as possible for use as collateral with the ECB, and did so.

Part II – Domestic and International Policy Responses to the Crisis

Although the guarantee was generally received positively by the markets and seemed for quite some time to be effective in supporting bank liquidity, there was no reason for anyone to think that the guarantee had solved any underlying problems. It was best seen as a way to provide additional time for structural solutions to be developed.

Even before the ink was dry on the guarantee, the Government system started to consider the structure and capital position of the banks. There were many ideas as to the possible manner in which banks should be restructured, and it was necessary to have those debates, and at various times institutions were asked to consider how they might be merged with others, so as to start the process of reducing the complexity and scale of the financial system. But all such efforts fell down on the simple basis that this was no longer a situation in which a bank with deep pockets could take over another – none of them had deep pockets, and none of them was well enough regarded in the markets that they could take on a problem institution and maintain market confidence – in some circumstances putting two institutions with complementary balance sheet structures together might make sense, but any 'complementarity' between the Irish institutions was not strong. There were no marriages made in heaven among them.

Various efforts were made to explore whether private capital might be attracted to the institutions, and they were each pressed to make best efforts to find it. At points in late 2008, and in some cases even thereafter, they might have felt they retained some possibility of external capital. There were various private equity houses and other investor groups expressing interest in making or brokering investments, such as, from recollection TPG, the Mallabraca consortium, KKR, a mostly Irish consortium co-ordinated by Deutsche Bank, a small Swiss Bank in which David McWilliams was involved, and so forth. I am sure that a check of records would provide further examples of institutions with a greater or lesser interest in investing in or promoting investments in the Irish banks at that point in time. All of these were engaged with by the Minister, by officials, by NTMA as appropriate, and of course by banks, and in no case was it clear that investment would be made available on reasonable terms, from the State point of view. Why the State? Because in most of the more serious cases the investment proposition was – when finally surfaced - based on the State providing not just a liquidity guarantee but also a guarantee against losses – they wanted, not unreasonably if you can get such a deal – to leave most of the risk with the State and take most of the upside with themselves.

However, it was not just a question of ability to raise capital – as late as the end of November some of the bankers were making strong complaints about the Government's insistence that they should take extra capital at all. One bank put the Government's view that their bank needed capital down to the prejudice of one staff member in Merrill Lynch (who was not as it happens, at all involved in the advice ML were giving us), rather than any underlying problem they might have. But the Government was insistent that capital was required, and after lengthy discussions, the Government announced its proposed approach to recapitalisation on 14 December 2008 and the proposed amounts on 21 December 2008 – up to €3bn each for AIB and Bank of Ireland, and an initial €1.5bn for Anglo. AIB had in fact been offered €4bn but was anxious not to be differentiated in the market from Bank of Ireland.

In February 2009, it was announced that AIB and Bank of Ireland's first recapitalisation would consist of a preference share injection of €7 billion between the two (the initial €3bn amount had become €3.5bn). In April, the NAMA project was announced and a great deal of work was done subsequently in turning this announcement into legislation, which passed in November.

Work on the stabilisation of the banking system and improved banking regulation continued during 2010 and 2011. Over the course of 2010, the former Minister for Finance, the Department, the Central Bank and the National Treasury Management Agency took a number of actions to address the worsening situation in the banking sector, including stress tests, further recapitalisation, and following the agreement of a programme of support with the EU and IMF authorities, legislation to facilitate the reorganisation and restructuring of the banking sector in the form of the Credit Institutions (Stabilisation) Act.

In March 2011, following the completion of the prudential capital assessment review, PCAR, and the prudential liquidity assessment review, PLAR, by the Central Bank, the Minister announced the Government's proposals to restructure the banking sector comprehensively. This restructuring aimed to create two Government supported universal pillar banks that will be smaller and more focused on the Irish economy, with EBS subsumed into AIB.

At around the same time, deleveraging plans have been agreed with all the banks, subject to Government support, providing for the deleveraging in the aggregate of approximately €70 billion of assets, more than 70% of which are assets located outside of Ireland. Each of the pillar banks has moved to establish core and non-core divisions and management teams for each business. Deleveraging committees with involvement of staff from the Department of Finance banking division have been set up in each of AIB, Bank of Ireland, IL&P and Anglo Irish Bank to ensure delivery of the targets.

The PCAR process identified a capital requirement of €24 billion, including a buffer of €5.3 billion (this is discussed in much greater detail in Appendix 2). The impact of this large headline number was significantly reduced by further contributions from subordinated debt holders – in some cases despite resistance - by the sale of assets to generate capital and, where possible, by seeking private sector investors, as well as by the use of contingent capital instruments.

The biggest element in the very large recapitalisation of these banks over the period between 2009 and 2011 was the materialisation of losses and expected losses on their loan books, offset by a shareholder and subordinated bondholder contribution and asset sales and deleveraging. A further, smaller but not insignificant generator of the recapitalisation requirement was the market and regulatory demand for higher levels of capital for the future. I have not quantified this effect, but Basel 3 capital rules and indeed the Irish Central Bank's regulatory demands were considerably higher than those which applied in 2008, before the crisis.

As far as Anglo-Irish banks is concerned, and to go back a little in time for a moment, the initial planned recapitalisation of Anglo announced in December 2008 was deferred temporarily pending further consideration of its future: As part of the programme of recapitalisations announced for the Irish banks in November and December 2008, it had been decided that Anglo would get some Government money to help in underpinning its capital base against losses. In retrospect, the amounts being discussed seem very small, since over time we have come to learn the depths of the loan losses that arose in that institution and the final amount of money put into Anglo (and INBS, which was subsumed into the Anglo structure) amounted to well over €30 billion. But at the time these high figures were not yet known, or perhaps knowable.

By 12 December 2008, Anglo's board had decided to formally indicate to the Government that they would need its assistance in raising capital. But the Government would not be willing to invest in Anglo, or any other bank, without sending in a team to carry out a "due-diligence" exercise. Merrill Lynch and PWC examined banking and loan issues and Arthur Cox examined corporate governance issues.

I am mindful of warnings in correspondence from the inquiry that certain matters connected with ongoing criminal proceedings in relation to Anglo Irish Bank and others must not be dealt with, and accordingly, I cannot properly discuss the decision to nationalise the Bank, which was heavily influenced by such matters. However, I can say that there comes a point when loss of confidence starts to erode a bank's wholesale and retail deposit base and can accelerate into a bank run. Anglo had experienced this to an extent in March 2008. They experienced it again in a nearly disastrous way in September 2008. And they were starting to lose funds again in December 2008, despite the Government guarantee.

And so, the question of fully nationalising Anglo came to the fore again. It was still an unpleasant option. Depositors ought to be reassured by the involvement of the Government, but maybe they would react negatively to such a big change in the status of the bank. It was a reasonable assumption, but there were no certainties that, in fact, the bank would be able to fund itself any better as a nationalised entity than in its current status. But it seemed to be at the very least an option that had to be seriously considered, and by mid-December the legislative provisions that had been ready in September to allow for nationalisations were being re-examined.

Given that the Anglo share price was now so low that the Government would be likely to become a large majority shareholder anyway, some of the arguments that could be made favouring keeping the banks in private hands were less salient in this case.

On 12 December, Merrill Lynch had laid out the pros and cons of an Anglo recapitalisation. They were arguing that Anglo was mostly a property-based bank and that business model was now not going to be sustainable, and that there were going to be losses to be absorbed on its property loans – at least nationalisation would give the Government clearer control of the Anglo situation and might also for technical reasons reduce the amount of capital it had to hold, and therefore the amount that the Government would put in.

In the end, though, the decision to nationalise was not made until mid-January. Even if the authorities had wanted to nationalise Anglo in December, and some of the people concerned clearly did, there were pragmatic reasons for a short delay:

1. The necessary legislation would have to be adopted by the Government and proposed to the Dáil.
2. The second consideration was that the due-diligence reports would not be ready until around the second week of January, and we would by then have more information about flows etc, and greater insight into the bank, which might affect the decision, and the nature of the official response to Anglo's ongoing problems.

Meanwhile preparations continued on the proposal to recapitalise Anglo, which would have led to a majority Government stake in the bank rather than a complete nationalisation. As it was in September, so in January – matters were being brought to a head by liquidity pressures. Anglo had, for a number of weeks, been trading on a narrow liquidity cushion, often of less than a billion euro.

Around the same time all of this was happening, the Fitch rating agency let it be known that they were going to issue a downgrading for Irish banks, including Anglo in particular, and it was believed that Standard and Poors would do something similar – the concern was that this downgrading would lead to an almost automatic reduction, of the order of €8 billion, in liquidity as corporate depositors which as a matter of policy only deposit with higher rated banks pulled out their funds.

Around 14 January, 2009, after a lengthy discussion, a paper was submitted to the Minister for Finance. It said that having regard to the governance issues in Anglo and the continuing liquidity pressures, the Central Bank, Financial Regulator, NTMA, Merrill Lynch and Department of Finance officials were all of the opinion that it was better to nationalise Anglo than to provide it with further capital within the existing structures.

On 15 January 2009, the Minister for Finance announced that Anglo would be nationalised, citing funding difficulties and "unacceptable practices" that had undermined the reputation of the bank, and the legislative provisions for a nationalisation that had been drafted during the previous Summer and early autumn, and worked on further since, finally were put to the Oireachtas and passed.

The Establishment and Operation of NAMA

Peter Bacon was personally selected by the Minister for Finance to study the "bad bank" approach and how it might apply in Ireland, and the NTMA was instructed to take him on. As I understood it at the time, Mr Bacon worked closely on this task with the NTMA staff in consultation with their CEO, before finally presenting their conclusions to the Minister.

When Dr Bacon and the NTMA presented the proposition they had been working on to the Minister, it came as something of a shock to the Minister and to DoF officials – it was very ambitious and DoF officials were concerned about the size of the proposed contingent liability to be adopted by the State. But, perhaps anticipating this, Dr Bacon/NTMA were able to quickly suggest a compromise approach involving a contingent liability of only about two-thirds of the initial proposal. The NAMA proposal was considered in a meeting with a large attendance at which the Taoiseach presided. I recall that the Taoiseach asked each party in the room whether they recommended this proposal and each of them did, notwithstanding some later implied suggestions to the contrary.

The NAMA legislation was worked on very intensively, and as quickly as possible, with extensive resources dedicated to it. State Aid considerations were also very much to the fore, and had to be dealt with in very intricate detail. The legislation had to cope with every possible piece of foreseeable commercial trickery that an under-pressure creditor might seek to utilize, and yet respect constitutional rights and due process.

Many different lobbies wanted their own say in the NAMA process, while some approaches from parties outside the State had to be accommodated or batted away. NAMA was variously seen as being potentially a vehicle for national planning policy, a source of social support, a factor in the north/south relationship, a rescuer of developers and so forth. All of these demands had to be weighed against the principal purpose of the NAMA vehicle, which was to recover value for the State. The NAMA board and certain committees then had to perform the dual function of centre of expertise and reflector of a political balance.

Despite very considerable, genuine and real concerns about the risks involved in the establishment of NAMA, the time and effort put into its design have paid dividends – few legal challenges have been upheld, and the governance rules imposed by the legislation – including rules criminalising inappropriate lobbying – seem to have helped. There continue to be many complaints about NAMA and its operation, where I have had no involvement and cannot comment, except to say that it was always envisaged that this structure, dealing with thousands of loans, and billions of taxpayer euros, in a very uncertain and very commercial environment, would almost certainly be controversial at all stages of its life. With careers, livelihoods, reputations and billions and billions of taxpayer euros at stake, it would be amazing if there were not a multitude of voices pressing one agenda or another, in the media or in the courts. That NAMA's work should be controversial, even now, is no sign of failure.

There were two important pre-conditions for the establishment of NAMA: a favourable statistical treatment and indirect but very real financial support from the ECB. The statistical issues were addressed through a strange corporate structure for NAMA, developed initially by a very small group of people drawing diagrams on a couple of sheets of paper, then significantly refined thereafter. It was to achieve the optimum statistical treatment that NAMA had a small number of initial private investors.

The ECB angle was more important. NAMA assets were to be paid for not with cash, but with NAMA bonds, which the banks would use at the ECB as collateral. In this way, as well as helping to deleverage and derisk the balance sheets of the banks, NAMA would also help to introduce a new source of liquidity – the use of NAMA bonds to get ECB cash. In effect this meant that Ireland was preparing a demand for, perhaps, €50 billion of ECB cash (it worked out smaller in the end). During the course of a visit to the ECB by representatives of the Central Bank, NTMA and DoF, the ECB raised no objections to what amounted to a request for a very large increase in support for Irish banks, subject only to the government paper to be submitted to the ECB being in acceptable form – without this assurance the NAMA project would have been still-born, and ECB cooperation was greatly appreciated, at the time.

Relationships with the ECB and the other Troika parties in the lead up to and after the EU/IMF programme for Ireland

Just as the ECB and its policies were a key consideration in the period around the guarantee night, so their role was very important – and the engagement with them much more complex – in the period running up to the EU/IMF programme for Ireland ('the Programme'). I deal with the period in and around the inception of the EU/IMF programme and the months after it, including the role of the ECB in considerable detail in the report at Appendix 2.

The IMF, European Commission and ECB staff who came to Dublin worked very hard and there was never any doubt about their commitment and their diligence. I believe that many of these individuals were or became true friends of our country. However, they were representing their various organisations each of which had its own different agendas at play. For Ireland, the most difficult relationship was with the ECB, because its agenda was, in part, to reduce its exposure to the Irish banks and Irish economy, at a time when the other parties were increasing their support. The ECB's concerns were understandable, and up to a point Ireland and the ECB shared the same policy goal to reduce Irish reliance on ECB and Central Bank funding and to restructure, reshape and restore the Irish financial system. However, that policy agenda risked being pushed too far too fast, at which point it would lead to unnecessary costs for Ireland. Too fast an adjustment, whether in fiscal matters or in dealing with the financial sector, might cause irreparable damage to our economy and our social fabric, and the ECB was pushing hardest on both of these fronts, but especially on the financial sector.

Rightly or wrongly, there was also a view that the ECB did not fight 'fairly' in all cases – they would ask for actions in a particular direction, and say that in the light of those actions the ECB would most likely act in a particular way. But they would never be bound to any agreement – would in fact say that legally no agreements on anything were possible. 'Do it our way, take it on faith that we will respond as we say', was the best that could be done. And sometimes they seemed to us to fail to make good on the non-promise that had not really been made, or to make good much later than expected.

No doubt the ECB would, in their turn, say that on some matters the Irish authorities were difficult to deal with, and were always holding back on what the ECB viewed as necessary adjustments. And that would be true – we had to have regard to the sustainability of Irish debt, to the management of the Irish economy, and sometimes that meant insisting that the ECB would remain engaged with its Irish debtors to a much greater extent than was comfortable for them.

In Ireland (but not just Ireland), the ECB felt trapped, and for them, things in Ireland got worse before they got better, as the demands of Irish banks for central bank support actually increased in the period after the start of the Programme. While we shared many objectives in common with the ECB, we had other priorities too. In fact, it is a testament to the real and extensive efforts made on all sides that good professional relationships were maintained, and business continued to be conducted in a proper manner, throughout the period (I can speak only up to the start of 2012).[10]

There were points of difficulty also with the IMF and the European Commission, but actually rather few considering the complexity of the situation and the pace of work. With the Commission the most frequent issue of debate was to do with differing expectations about the economy and the extent to which these led to different fiscal expectations. These were, however, managed relatively smoothly. The IMF tended to find itself in the middle of many of the debates – they would happily at times have settled for a less ambitious fiscal adjustment programme – which might have suited Irish negotiators – but it was essential to have a consensus position for the Programme as a whole.

There was never a party which suggested that fiscal adjustments were unnecessary – there was no way to avoid austerity policies. There was also very little discussion about the extent of the adjustment required over time: the deficit had to be substantially eliminated at some stage. The only question was how fast to move – very quickly, to restore credibility to the fiscal situation and minimise the total extent of the adjustment, or more gradually to reduce up-front damage to the underlying structure of the economy and to social cohesion.

A key reason why the Programme worked well in Ireland – and has been relatively successful – was the fact that the National Recovery Plan 2011-2014 was finalised in time to be the main influence on major parts of the Programme. Rather than negotiate separate arrangements, the Troika partners were happy to accept the four-year plan that had been developed in Ireland and to build on it. This meant that, perhaps, the Programme was more coherent and less likely to have entirely unacceptable elements than

[10] The very positive promissory note arrangement came some time after I left the DoF, but Irish authorities had been working towards some such arrangement for years, by the time it was accepted.

if Ireland had been working with an agenda coming entirely from outside. Whether in the DoF or at the political level where the decisions were taken (under either of the Governments concerned), there was a clear acceptance during the programme discussions of the need to make radical economic and financial decisions to put the country back on track, but it helped that we were working with the grain of a programme created internally, rather than constantly dealing with externally generated policy lines.

Mr Trichet's appearance at IIEA

I have reviewed the evidence of Mr Trichet at the IIEA event.

1. **There was one really important truth** in the messages given by Mr Trichet – the ECB, and no doubt Mr Trichet personally, gave very large and very important support to the Irish banking system at particularly difficult moments[11].
2. **There were also a few misleading points** that might be put down to the vagaries of memory, or to the fact that Mr Trichet could not be familiar with every aspect of the ECB's operations.
3. **And there was one big fallacy**.

That fallacy was encapsulated in one word – "simply". "The ECB simply gave advice on this issue" (burden sharing).

There was, in fact, generally nothing simple about the ECB's giving of advice. When the ECB gave advice in relation to joining the EU/IMF programme, the implied 'or else' was very clear from Mr

[11]– and also to the Irish government bond market (though I do not think they ever published numbers, so it is difficult to say how much of this support they gave). ECB support also allowed NAMA to be established. Their support kept the banks going and kept depositors whole. Other practical assistance was of importance also, and although it was some time coming, the ECB acquiescence to the final promissory note arrangement was very positive for Ireland – we should not forget these important and valuable points of support.

Trichet's letter of 19 November 2010: if you don't do this, your banks will lose access to ECB and even national central bank support with disastrous consequences for your country. In many ways this letter was entirely superfluous, since it was already clear by the time of the letter that the Government was going to opt into a programme. But at least this letter has the advantage of making the 'or else' clear and evident. There was no lack of transparency there.

As far as the negotiations with Europe in 2010 regarding the Irish fiscal position and in relation to the negotiations on the Programme itself, the ECB negotiators, acted as and were accepted as a full party to negotiations – their agreement was probably just as important as agreement from the Commission or the IMF, and they acted themselves in the same spirit, notwithstanding that its role in the programme discussions was headlined as being simply advisory[12]. And as will be clear from the exposition of events set out at Appendix 2, the ECB's role in negotiations both before and during the EU/IMF programme discussions extended to discussions of the Irish fiscal position as well as to discussions of the support for and restructuring of the financial system. In many ways, in fact, this was a better arrangement than an alternative in which the ECB were not present at negotiations in which they had a major stake.

The ECB and burden-sharing

While the exchange of letters between the ECB President and the Minister for Finance in relation to joining the Programme creates a high degree of transparency about certain matters, there was no letter in relation to the issue of burden-sharing with senior bondholders. Again, this matter is dealt with in greater detail in the report at Appendix 2.

[12] All of the relevant official documents said that the Commission was acting 'in liaison with' the ECB, implying that the ECB was not a full party

However, we should be clear – in November 2010 the Irish Government, represented by Brian Lenihan, *did* want to insist that senior bank bondholders would share the burden of bank failure, and so were not part of the global consensus that Mr Trichet speaks of against burden-sharing. In this policy position, the government was encouraged by the IMF negotiators in Ireland, who believed such burden-sharing to be appropriate, albeit not without serious broader implications.

In Ireland, official preparations were being made in secret to allow for it. Specialist legal expertise was quietly brought into Ireland to advise on how to make the burden-sharing process work, and our own legal advisers were working on the matter also. It seemed feasible, despite some significant legal obstacles, to impose some losses on senior bondholders, but could not work if the European partners and the Commission were opposed.

At the time, we were led to believe that Dominique Strauss-Kahn, head of the IMF, was not only in favour of this approach but believed he could persuade other major players in world finance, including the major European Governments, the Americans and the ECB to go along. Strauss-Kahn was to, and did, convene a conference call to pursue this arrangement. There had even been early indications of a positive hearing from US Treasury Secretary Geithner[13].

We heard back, however, via the IMF team in Dublin, that instead of a positive response, there had been a strong negative reaction from the ECB and from Geithner and others, and that the programme would not go ahead if senior bond-holder burden sharing was contemplated. This was confirmed by European Commission and ECB negotiators in Dublin and the IMF negotiators despondently confirmed that this

[13] Why would Geithner matter? He represented the biggest shareholder in the IMF, one of the lenders to the Programme. Other countries, the Eurozone countries and some others, were not only indirectly assisting Ireland through the IMF, but also through the European Union's EFSM fund (to which all European member states were a party) and through the EFSF, set up specifically to aid Eurozone countries in difficulty, or by bilateral loans. Some of our partners, therefore, were contributing to our Programme on three different fronts.

was now also the official position of the IMF. So it is not fully true to say that the IMF was in favour but the others were not – after that international phone call, the Troika parties adopted a single position.

So it seems to be a mis-characterisation to say that the ECB 'simply' gave advice – unless all our information was wrong, the ECB actively engaged in an international discussion and was, though not on its own, directly influential in forcing the hand of Ireland in relation to the issue of burden sharing for senior bond holders. Yes of course, it was formally Ireland's decision, but it was far from Ireland's preference.

But just to provide some balance – one should remember that from a European point of view, the burden-sharing was seen as a real and serious risk. A new Lehmans type event, perhaps. 'Havoc', potentially, according to even an IMF negotiator at the time. None of this was a certainty, but even in Ireland the official preference for senior burden-sharing was late in coming – previously we had feared that this type of action might seriously damage our market access (again all discussed in Appendix 2), but by the end of November 2010, we did not have much market access left to lose – the balance of advantage had changed for us, but perhaps not for our partners.

Later on – at the end of March 2011, with the new Government in power and itself intending to engage in some senior burden sharing in relation to Anglo bonds, there seemed to be some shift of opinion within the ECB – the head of the Bundesbank, naturally an influential member of the ECB's Governing Council (but unfortunately apparently not in Frankfurt on the day that the Governing Council considered the issue), seemed in favour of it. ECB negotiators seemed to have mellowed slightly on the point – even Mr Trichet, I understood, seemed less opposed to burden-sharing than might have previously been the case (though there were messages a day or so beforehand from Jürgen Stark who continued to express opposition at that point in time). Interestingly, at this stage there seemed to be no expectation of opposition from the Commission or the IMF.

I will leave it to other witnesses to say what passed in discussions between Ministers and the ECB – I may not have the whole story. But at official level there were firm messages back from the ECB – amounting to a threat to withhold important messages of support for the Irish banking system in the longer term. So important was ECB support and opinion that the Government decided not to take the risk of alienating them. The ECB refusal was relayed orally (and not without regret) by an ECB official, and by email, and the terms were clearly those of an instruction to amend the Government's proposed statement on banking: "the GC[14] meeting was very clear: you need to go back to the old version of the statement and strike out the whole para on Anglo/INBS burden sharing with bond holders".

Mr Trichet has explained the reasons for the ECB views in the context of his presentation at the IIEA, and no doubt his Governing Council was sincere in its concerns. But by March 2011, there was such a strong market expectation of some senior burden-sharing that I doubt the event itself would have turned out to be much of a shock to the market. Probably a few hedge funds celebrated at our expense that week.

[14] Governing Council

Part III - Role of the Department of Finance, the CB/FR, the NTMA and other advisors

The DoF had no market-facing functions in the years leading up to the bank guarantee. Residual bank supervision functions were removed from the Department in the early 90s. Debt management functions were taken over by the NTMA in 1990. Regulatory functions were almost entirely carried out by the CB/FR.

These functions were deliberately placed in independent structures by an Oireachtas which wished to see them dealt with in a segregated and separate manner. Even within the CB/FR, although there was a single legal personality, there was a significant internal segregation driven by a political desire to ensure less, rather than more, Central Banking influence on regulatory matters.

None of this is inappropriate – it is part of the segregation of duties that takes place in all modern states. But it did mean that as the crisis progressed the DoF's first and principal advisor on financial stability and regulatory matters was the CB/FR, as the Department had only very limited direct interaction with the market. The second call for assistance was the NTMA. From December 2007, the NTMA were formally asked by letter from the Minister for Finance to engage with the developing crisis, and did so especially in relation to advice and assistance with bank liquidity issues. Separately from this advisory/assistance role, there was also a deliberate build-up of cash resources, agreed as appropriate between the NTMA and DoF, to ensure that additional funds would be available to meet any unanticipated request for assistance to the banks, or to cope with any temporary 'strike' by bond investors.

While it seemed entirely appropriate that these parties would all be fully engaged in the crisis planning, it was my personal view that, for a time, NTMA held back somewhat on their engagement, perhaps concerned that they would be asked to progressively engage with financing the liquidity gaps of the financial sector, to the detriment of their day job of financing the Government. It was possibly this sense of reluctance that led the Minister for Finance to write the letter to the NTMA in December 2007.

Nonetheless, the NTMA was involved in discussions of bank liquidity throughout 2008, and was informed of crisis resolution approaches being considered, and had regular contacts with the DoF and CB/FR in that period.

When the banking difficulties deepened in early September 2008, the NTMA were again asked by the DoF to participate in discussions with the DoF and CB/FR in relation to the developing problems at Irish Nationwide Building Society (INBS) and to fulfil their role as advisor to the Minister. Three NTMA officials, in particular, were asked by the CEO of NTMA to engage with the other involved parties on this matter – John Corrigan, Brendan McDonagh, and to a lesser extent Oliver Whelan. These gave their advice and assistance wholeheartedly throughout that month and for years afterwards, McDonagh becoming the head of NAMA and Corrigan the CEO of NTMA. Others in the NTMA also were asked to help from time to time. Dr Somers, who was the CEO of NTMA at the time, was kept informed and consulted at various points. In their role as advisors to the Minister for Finance, the NTMA were closely involved in the further development of intervention options for consideration by the Government, including in relation to the broad guarantee option. Various senior NTMA staff discussed this option in telephone calls, meetings or email communications throughout September[15], and of course were involved in the management of the guarantee thereafter. The CEO of NTMA was abroad on the guarantee night, but I personally made a number of efforts to ensure that NTMA advice – and indeed advice from Merrill Lynch – was available to the Government if they required it.

[15] For example, I believe around 9/10th Sept 2008, and certainly on the 18th, 23rd, 24th, 25th, 26th 28th and 29th of that month, at least

Early in the September discussions on the problems of INBS and others, it became clear that there was not a sufficient understanding available from CB/FR of the internal workings of the banks which were apparently in difficulty, and also that there might be important demands for corporate finance and accounting expertise to flesh out the expertise already available among the official parties.

With the encouragement of DoF and NTMA, Goldman Sachs were commissioned to conduct initial work on the loan book of INBS, and also some very initial work on Anglo, PWC were engaged to carry out more detailed work on the various loan books of the banks in general, and Morgan Stanley were approached by DoF, in consultation with the NTMA, to become the external advisor to the Minister for Finance and NTMA – after a couple of days of engagement, these advised that they might have conflicts which would prevent them doing a thorough job, so Merrill Lynch were first consulted, then commissioned by the NTMA as advisors for the NTMA and Minister.

To formalise this arrangement the Minister made a formal direction to the NTMA to make advice available to him, including by the commissioning of external advisors. Separately, Arthur Cox were commissioned as legal advisors to supplement the services available from the Attorney General. Over the years that followed, the external advice arrangements changed, and there was an additional focus in both the DoF and NTMA on taking in external staff with specific expertise relevant to the crisis, while there was a wholesale restructuring and growth in staffing in the CB/FR.

As matters developed, the roles of NTMA in both advisory and executive matters changed. Through the NPRF, NTMA staff were heavily involved in the management of the State stake in the banks and from early 2010, there was a specific delegation of advisory functions from the Minister for Finance. Tendering procedures etc led to changes in external advisors also, Merrill Lynch being replaced by Rothschild's, for example, and of course the set-up of NAMA led to a strong growth in consultancies, while various stress tests and the like meant a big role for external advisers in the CB/FR.

Generally speaking, these advisers were used in an appropriate manner. Being part of the direct remit of the Minister for Finance, the NTMA were not just advisers – they were an integral element of the resources available to the Minister for Finance, being a public body reporting directly to him through the CEO, and much more influential and more directly involved with the policy process than were any of the external advisers. Generally speaking the advice of these external advisors on technical matters was useful and competent. However, as predictors of the future, they tended to be less than accurate – but this puts them probably in the same boat as most others. This meant that expectations of future banking losses, for example, were greatly underestimated by all the advisers.

I have previously given evidence to the Public Accounts Committee in respect of the system of financial regulation in the lead up to the banking crisis and transcripts of that evidence are available to the Committee (see Appendix 1). The FR accepted itself that there were regulatory shortcomings in the banking sector. It is also the case that the FR was not in a position to give the DoF a clear insight into the depth of the problems in the loan books of the individual institutions and it was necessary to engage outside advisors, but in doing so Ireland was no different to most affected jurisdictions.

In general, all parties to the Domestic Standing Group ("DSG") cooperated reasonably well. The DSG had noted in 2007 that an issue was developing in the banking sector, in particular the gradually tightening liquidity situation. By early 2008, the DSG had procedures in place that allowed for greater exchange of information and had already carried out simulations of what the response should be if an institution got in to difficulty. A great deal of preparatory work had been done within the DSG and the participating institutions.

In respect of the DoF staff that were working on the banking sector during the crisis, I am of the view that these individuals were hard-working and talented. The DoF was working with other parties on contingency planning throughout 2007 and 2008 and had drafted legislation to cover a range of possible interventions in the banking sector. For example, draft legislation for nationalisation of a banking institution was prepared long before Anglo was nationalised meaning that when the situation called finally for nationalisation, it was capable of being achieved within a relatively short timeframe. So it was also in relation to legislation required for the bank guarantee.[16]

However, it is certainly true to say that nobody within the DoF or the DSG anticipated the depth of the turmoil in the markets that occurred in the autumn of 2008. The scale of the Irish banking problem was greatly exacerbated by the international liquidity crisis and downturns in the economies in other jurisdictions. While the DoF had concerns over the property sector and the construction sector, and communicated those concerns, the DoF did not predict the severity of the economic crash and I wish that it had done so or been able to do so.

Not long after I became Secretary General in 2010, I asked the Minister to agree to commission a comprehensive review of the DoF, which was undertaken by an independent review panel of experts from Canada, Ireland and the Netherlands. It was extremely important to me, as Secretary General, that any shortcomings of the DoF be comprehensively addressed so that the DoF would function to the highest standards. The findings of the panel were reported to the Minister for Finance in December 2010 in a report entitled "Strengthening the capacity of the Department of Finance", and the Chairman of the Panel, Rob Wright, has given evidence to the Joint Committee during the initial phase of this Inquiry.

I will not address all of the findings of that Report in this statement but I was fully in agreement with the thrust of the recommendations of the Wright group. The Report acknowledges that in general, the

[16] The resources within the DoF were stretched during the crisis. A relatively small group of individuals were engaged in the contingency planning during 2007 and early 2008, but this group had to be kept small for confidentiality reasons. The Department took a lead role in coordinating the response to the crisis, and it was necessary to add an additional 18 – 20 people to the banking team within the Department around October 2008 and to make additional efforts to supplement skills at various times thereafter.

Department's advice to Cabinet on the risks of pro-cyclical budgets was comprehensive, but that the advice should have been adapted in tone and urgency as successive budgets were passed. The Report also identified some gaps in technical proficiency within the Department, and concludes that this fed in to a perceived failure to highlight a broader range of macroeconomic risks. Even before the emergence of the findings of the Wright report I had recruited a number of specialists through various routes, and instituted a formal programme of information exchange with external economic experts. In response to the Report, the DoF also recruited new staff with specific economic, banking and financial services experience, as well as in other specialties. The Report was generally positive in its appraisal of the DoF's response to the crisis.

Conclusion

I hope that this statement, combined with my previous testimony and the documents I have attached as appendices, will make a real contribution to the Banking Inquiry and to the public interest in having a well-documented narrative of these events.

Documentation

The Joint Committee will note that I have provided a small number of copy documents in Appendix 2. The Joint Committee will be aware that as I am no longer in the Department of Finance, I do not have access to all of the original relevant files and documentation. Accordingly, I confirm to the best of my knowledge and ability, that the copy documents that I have included in the Appendix are true and correct. I understand that the Department of Finance has provided a large volume of documentation to the Joint Committee and in those circumstances, the copy documents that I am providing have likely been provided to the Joint Committee already, and in that sense will be in the public domain. In the case of certain of the documents, I have only a scanned image version available to me given that I no longer have full access to the Department files nor access to institutional IT resources, and I have provided the scanned image in PDF format.

APPENDIX 2

Report by Kevin Cardiff to the Committee of Inquiry into the Banking Crisis:

Events around the Guarantee Night, 29 September 2008, and

Events related to the genesis and early development of the EU/IMF programme for Ireland

Kevin Cardiff

This document is prepared without input from any other witness at the Inquiry or any official body – it has not been checked with any of the individuals mentioned in it, and neither the Department of Finance nor any other body has been asked to fact-check it. It might of course be useful to the Inquiry to send it to those individuals and bodies for their comment also

Introduction

This Report is my summary of what happened, to the best of my knowledge and recollection, in certain key periods of Ireland's economic and financial crisis and is designed to give the Committee information to inform their deliberations. It is based on personal recollections, notes and records and is entirely from my own perspective. Events were so complex in these periods that this is necessarily a summary presentation and of course other persons involved would have their own perspective and other information.

On Friday 5th September 2008 I received a telephone call from William Beausang – a colleague who was heading up the secret work we had been doing on banking crisis preparation. He told me that he had heard from the Financial Regulator's office that an incorrect report had been circulated by Reuters about Irish Nationwide Building Society[1] and that as a result, the Regulator feared a run on the building society's deposit base the following week – they were asking about my availability first thing Monday morning.

Mr Beausang and I spoke about that – if there was to be the potential for a 'run' on Monday, then we better get to work straight away. And the planning for such an event envisaged an immediate meeting of the Department of Finance, the Central Bank, the Financial Regulator and the NTMA. I pressed for a meeting the following morning, and a large group of people met around a table the next morning in the Central Bank Building in Dame Street. In the course of the next week or 10 days, the people in the room and their bosses would decide on the plan for responding to the threat of a run on the building society, refine a plan for nationalising it, develop messages for communicating the news to the public, make arrangements for emergency call centres in Dame Street and in the Department of Finance, engage with the larger banks about their potential role in handling the INBS crisis.

In the next month, the same group of people and a few more, would consider the potential for melt-down of the entire Irish financial system – and not just the Irish one – develop a range of options for decision by the Central Bank and by the Government, not a single one of them attractive, refine the draft legislation to allow for the nationalisation of banks and building societies and the provision of guarantees and capital and liquidity supports, then implement a very broad banking guarantee, and present legislation to be passed by the Oireachtas within three days of its being announced.

In the next seven or eight months, the Government and the various official parties would have recapitalised several banks, nationalised one, fought a sometimes almost clandestine public relations battle with people seeking to undermine the bank guarantee, and planned the formation of the National

Asset Management Agency, which would look set to become one of the world's biggest property asset managers.

As tension rose and the stresses of the moment increased, I was proud of many excellent colleagues, who threw themselves wholeheartedly into what we knew was the defence of the economic wellbeing of our country, and disappointed with only a few. Contrary to how they have often been portrayed, the civil servants engaged in this struggle generally behaved well and with competence and skill, assisted by colleagues in other institutions and by various groups of consultants.

They were, as individuals, generally very skilled and competent. But as a group, they were lacking in the broad range of skills required for the occasion, necessitating the acquisition of external advisers. The same could be said for almost every civil service in the world, I think – with the possible exception of those which had been through their own financial crises in the previous two decades. In the UK, in France, in Belgium, in Germany, in the United States, Austria, Luxembourg and other countries and at the highest decision making levels of the European Union, September and October were months in which unprecedented events led to apparently 'last ditch' crisis meetings of ministers, central bankers, regulators and financial institutions' own governors, to create a firewall against the impending disaster.

Crisis point

We met on Saturday 6 September 2008 in a conference room in the Central Bank building in Dame Street. The room was full, and we set about preparing for the possibility that the Irish Nationwide Building Society, or INBS, would be in serious difficulty that Monday. Staff from the Central Bank, from the Financial Regulator, from the Department of Finance and the NTMA met together and in smaller groups to prepare different aspects of a crisis response. We considered the time it would take to bring legislation to the Dáil, the steps that could be taken to get more information on INBS, the manner in which members of the public could be kept informed, the infrastructure that would be required to deal with hundreds or thousands of phone calls – and approaches were prepared in relation to all of these matters.

Of course, this was not the first time any of these issues had been considered – work had been ongoing for months on crisis preparation, on approaches that might be taken, on developing legislation. Officials in the Office of the Parliamentary Counsel and the Attorney General's office had been advising the Department of Finance on legislation and state aids matters, and a Bill was well advanced.

Now we were coming close to being asked to put the theory into practice, and the preparatory work was paying off, although the situation was becoming increasingly complex.

As it turned out, planning continued for days and weeks on end, but the focus for that weekend and the following weekend was heavily on Irish Nationwide as the most immediate problem.

In more normal times, INBS should not have been a big problem to solve. Informally, we knew from his reports that the two big banks had been approached months before by the Governor of the Central Bank. As we understood the situation, he had discussed in general terms the tightening liquidity situation, the problems in other jurisdictions, the necessity to be prepared for eventualities. And he wanted to be reassured that in the event of a problem the two larger banks would play a self-interested role in sorting the problem out. The banks had, we were told, indicated a general willingness to be helpful – Anglo might be too big for them, but the takeover of a smaller player should be manageable.

So in the course of our discussions I told the Financial Regulator's senior staff that I thought the two big players had to be called in and told that their time had come – they seemed a bit reluctant – were we really at that stage? But I pressed – we had always anticipated such a step, if a smaller institution had a problem, and that was clearly the case. To maintain the proper institutional order, and to avoid any indication that the public purse was freely available to solve a banking problem, I sat in a side room (presumably with others, I don't remember now), while the CBFSAI met the two banks. The Central Bankers got a strong refusal – the banks were concerned that INBS' very high property exposure would be too difficult for them to digest.

Here was a warning sign – Bank of Ireland had, we were told, taken a look at the INBS property book many months before when INBS was touting for a buyer to take it over. Even if they were not signalling a specific problem, did we not need to get more and better data on the INBS property book for ourselves? But more than that – were the banks now more worried about their own vulnerability than we had expected? – certainly INBS had a proportionately larger commercial property book than most of the other institutions, but still those others had themselves a very large property exposure.

There was a solution – or at least a partial one – to the data problem in INBS. Goldman Sachs had already been engaged by INBS to examine some of their lending, for another purpose altogether. But they had staff and expertise; they were immediately willing to change the focus of their work and instead to work to answer the Regulator's questions. They very quickly produced an assessment – based of course on information from INBS and its executives – as well as from documentary review, of the scale of difficulties with the INBS loan book. They described the property lending, the very high level of bespoke structures, the unexpected amount of equity participation – the sizeable exposure to particular parts of the London market and the extent to which most of these business relationships relied on only the personal expertise and knowledge of a very small number of people – protecting value in the loan book might therefore be more than usually dependent on keeping and maintaining the focus of the executives concerned. But otherwise the assessment was perhaps a bit more upbeat than we had feared at the time, and in retrospect and with all the benefit of hindsight was hopelessly optimistic. On Sunday 21 September 2008, I heard this assessment in a meeting with Basil Geoghegan from Goldman Sachs and various others. While it might be difficult to get 100% back on some of the loans they had issued, there was nothing to suggest any losses could not be absorbed by INBS' own capital. In other words, they seemed to be in some trouble, would need some help, but were probably solvent.[2]

While the Goldman Sach's work was in train, crisis preparatory work continued. So by the end of the weekend of 13/14 September there was an outline plan for an intervention in Irish Nationwide Building Society (which could of course apply with whatever modifications might be required to other institutions as necessary). The plan, which was never finalised and implemented, because the situation kept changing - provided for the institution to be taken into state 'protection' – in other words, nationalised. If it became clear that the institution's ongoing liquidity drain was not going to be staunched, meetings would be called over a weekend, a new chairman and some new directors would be selected, formal directions from the regulator would be drafted, so that the existing management would, in effect, be under instructions from the regulator to be cooperative for the few short days it was envisaged it would take to bring a Bill to the Oireachtas and have it passed. Lists were made of all the individuals and institutions who would have to be contacted to ensure that all of this could happen. Regulators in other jurisdictions would have to be informed, the ECB would have to be consulted, and arrangements for communications with depositors and shareholders would be put in place, to reassure them. The civil service head of IT and the Department of Finance press officer quietly made contingency arrangements to have a new call centre up and running on very short notice, and messages of the type that would be needed for press and public were drafted. In such an event, bank branch Managers would be contacted over the weekend to allow them to be informed of developments before opening on the Monday. At all costs, the terrible demonstration effect of allowing queues of depositors to develop outside branches – a very public 'run' on the bank – was to be avoided.[a]

Of course, the public were aware of the danger of problems in banks – they were discussed regularly in newspapers, and there had been scarcely a month in the recent past when some major bank or other did not get into difficulty. There was a lot of speculation. The US sub-prime crisis, the Northern Rock events around the same time, in which a bank with an Irish office was saved only by a guarantee (later leading to nationalisation) by the UK Government, and the bailout of the Sachsen Landesbank – a publicly owned German bank with an IFSC subsidiary: these events and more had marked the second half of 2007. And difficulties had continued in the US in 2008, with the collapse and takeover of Bear Sterns in March, Countrywide in difficulty in May, and new difficulties emerging in July, August and early September in the big US mortgage institutions.

In Europe, too, there had been some very public signs of difficulty. In April, the Bank of England had opened a special new liquidity arrangement, indicating the cash pressure most banks were feeling. The ECB was less

[a] INBS had a peculiarity that required some consideration – its branches opened on a Saturday morning. It was hoped that any intervention could be managed over a weekend, but if large teams of staff were known to be working over a Friday night, then there was the added danger of a panic at the branches on a Saturday morning. Branch managers in INBS were already managing queueing at their branches – if a queue was developing just ahead of opening time, they might open a few minutes early, or if the branch was busy, they would ensure that the queue would snake inside the office rather than pass the front door. This was not entirely academic – at one stage in September 2008 I heard from a bank that a camera crew had burst into one of its branches demanding to know where the queue had gone – they had been misinformed that depositors were lining up to withdraw funds.

expansive, but it too was producing increasing amounts of liquidity for the banking system, and developing new instruments for doing so.

Then on 15 September 2008, Lehmans filed for bankruptcy. It was like an earthquake in the financial system – no Government rescue, let the market work it out. The market was not well prepared for this event, and the ability of banks around the developed world to raise funds on money markets, especially markets like the US Commercial Paper market, collapsed.[b]

And of course the public in Ireland, as elsewhere, noticed, and they were worried. George Lee, one of RTE's economic and business journalists, was filmed outside the old Dublin branch office of Northern Rock[c], asking the question whether the queues of depositors (cue file footage from the previous year) that had been seen outside that office would now be repeated at Irish banks. The 'Joe Duffy Show' entertained the worst fears of small depositors, without – it seemed - much attempt at reassurance. Fragile confidence seemed in danger of shattering. Regular technical email messages from INBS to the Central Bank, updating on their liquidity flows, contained more personal messages about counter staff in tears after dealing with customers terrified by the RTE coverage. Brian Lenihan picked up the

[b] Hank Paulson described it thus: "By mid-September, after 13 months of market stress, the financial system essentially seized up and we had a system-wide crisis. Credit markets froze and banks substantially reduced interbank lending. Confidence was seriously compromised throughout our financial system. Our system was on the verge of collapse, a collapse that would have significantly worsened and prolonged the economic downturn that was already underway."

[c] the British Bank that had been rescued by the UK authorities after a very public bank run the previous year

phone to the head of RTE and asked – he told me afterwards, so I did not witness it – that they avoid creating a panic.

Of course, the underlying truth was that there were big and unavoidable problems. And it was clear that the general public would not be reassured just by soothing official words – however many there were. Some action was required. A proposal was prepared for an increase in the level of protection on bank deposits. This protection had applied to the first €30,000 – in line with many European countries but well below the UK. Now it was to increase to €100,000, a level that would protect the deposits of most members of the public, numerically, but which would not of course protect the majority of bank deposits by value. In other words, most people would be protected, because most people did not have large bank deposits. But most of the money, being in large corporate and interbank deposits, would not be protected.

The decision was taken by the Government on a bright Saturday morning, 20 September 2008. There was not a regular meeting that day, so the consultation was done 'incorporeally'. The Secretary General to the Government – Dermot McCarthy - telephoned each Government Minister in turn, explaining the proposal and confirming their consent or dissent. Cabinet confidentiality applies to these meetings, even when done in this manner, so I don't know what was said by any of the Ministers. But when

Mr McCarthy confirmed that the Government was in agreement, we were able to confirm to the Minister's press office– that they could go ahead with work on finalising and issuing the press release.

The measure did work well, as far as assuaging the concerns of the individual depositors. The pressure on small deposits eased greatly. Irish Nationwide, most of whose deposits did come from the smaller depositor, did not later have the same kind of liquidity pressures that were to be felt by the larger banks. Public panic was averted.

But it was no panacea – it was almost worthless to the bigger depositors whose sentiment towards Irish banks could change overnight. No-one involved expected anything other than a moment's respite, perhaps a little time to continue working and planning.

Well before that weekend, however, thoughts had turned to other institutions – if rapidly changing circumstances were such that the INBS loan book was becoming much more troublesome, we had to have better and more up to date information on the other banks than we currently had from the financial regulator. But it was clear that a high-powered corporate finance house was going to be needed.

Nonetheless, we understood that there was a shortage of good teams available, who were not already attached to existing banking relationships and without major conflicts of interest.

By the week ending 20 September, Morgan Stanley had been hovering in the background for a few days – I had received polite phone calls to give me their view on the current market situation and to reassure me that if ever we had need of them, to do some work for us, they could be called on at short notice. So after consultation with my superiors and with the encouragement of the NTMA, we called them.

And for about two days they did some excellent work for us – a very strong analysis based on publicly available information (they were not yet on contract and therefore not getting confidential data) of the Irish Life and Permanent's position. We had very quickly raised our eyes from the immediate INBS problems to the growing problems of the other institutions. Unlike the other banks, ILP had limited commercial property exposures, but it had a very large mortgage book, heavily funded by shorter term borrowings from the wholesale funding market – if that source were to dry up, ILP would become Ireland's Northern Rock.

We also, of course, had to build Anglo and even the two larger banks into our thinking – we needed Morgan Stanley to quickly engage with the situation of all the banks – but they then dropped out. They decided that they had too big a conflict of interest arising from past work – and hoped for future work with Anglo and other institutions. The search for the right advisers had to restart.

Meanwhile, we continued to work, with the NTMA as the Minister's expert advisers, and with the Central Bank and Financial Regulator's staff, to further prepare for whatever was to happen next. The situation was complex, and the environment continued to get worse. Lehman's was not the only casualty – Merrill Lynch had to be taken over by Bank of America and the giant insurer, AIG, had to go to the US authorities seeking short term financing. An update on 17 September 2008 to the Minister for Finance noted that the Irish stock exchange had lost about half of its value since the early part of 2007, that the main Irish bank stocks had each lost more than 70% of their value since their peak and that AIB and Anglo had lost 15% and 20% respectively in just two days. Worse, perhaps, was that the cost of insuring against loss in Irish bank debt had risen 30% or more in just a few days[3] – this meant that some people in the market were losing their faith in the certainty of being repaid on Irish bank debt. The note finished with an understatement "international difficulties are therefore amplifying pressures in the domestic banking system".

Officials were meeting regularly – in the Department of Finance work was continuing with staff in the Attorney General's office on legislation to nationalise a bank or building society, but also to allow for other supports for the banking system, to include guarantees, but we felt that guarantees could never be a whole solution. The Central Bank was monitoring liquidity of the banks very carefully. The NTMA was working with us to identify approaches to dealing with failing banks and, along with us, were pressing the Central Bank to deepen our understanding of the banks' loan books.

During that month a particular pattern developed of organising meetings to move policy along and finalise decisions to be recommended to the Minister or Government, which pattern continued for some months after. Typically the technical work which had been going on over the previous few days via emails, phone calls, meetings in Dame Street or Merrion Street or at the NTMA offices on Grand Canal Street, would culminate in a sort of 'Jumbo' meeting, in which the most senior relevant people of the public institutions concerned would have a focussed discussion based on the information and conclusions of the technical work which had been going on in and between the institutions. Often, these meetings would be immediately preceded by a big technical meeting (in many cases chaired by myself) in which all of the current information and technical discussions could be discussed and summarised in preparation for the higher level meeting to follow. In the higher level meetings, I very often organised the sequence of the discussion, but everyone had their chance to speak and the senior staff present then came to a conclusion.

There was such a high level meeting around the 18th of September, for example, when the Minister for Finance, the Governor of the Central Bank, the Chief Executive of the NTMA, the Chairman of the Financial Regulator and various others met, and it was decided to propose the increase in the Deposit Guarantee limits described already above, as well as to draft a statement for the Minister to use in calming tensions in the markets. Often with these meetings, there was a requirement for immediate action, so some of the people present might be despatched to draft a statement or to organise further technical work, while the meeting continued.

But the circle of people involved was, necessarily, widening. Confidentiality was very important, but no-one was pretending that there was no work ongoing – it would have been impossible to do so. For months we had done our work in secret, with only a very small team of people – afraid that preparation for difficulties in the banking system would be interpreted in public as an expectation of them, and lead to a bank run. It was a relief to have some further support, but while with all that was happening around the world, there was no longer any reason to hide the fact that that we were working on the banking system, there were still many details which were highly confidential.

The widening circle of those involved now included Arthur Cox solicitors, brought in on the recommendation of the Attorney General, and Merrill Lynch, brought in on a €7 million contract by the NTMA. After the 'loss' of Morgan Stanley, Michael Somers of the NTMA very helpfully spoke to Bill McDonagh, the Chairman of Merrill Lynch, whom he apparently knew, and asked for and got a team of advisers from them, to be headed by a lady called Henrietta Baldock, and by her boss, Andreas Orcelli. Her team included market and bank restructuring experts and she had very useful access to the wider resources of their group (notwithstanding that over time they were to be absorbed into Bank of America). Having sourced the team, NTMA then asked that the Minister 'direct' them to contract the external advisers, so as to keep the legal position straight.

Later, many people noted that this was a big fee, for a few days' work. In fact, the team was contracted for a year. It was still a very big fee, but these kinds of companies do command that kind of money. The size of the fees gave us pause for thought – but only for a moment – in truth this was a small cost relative to the size of the problem, however strange a world it was that led to mid-level staff, however highly skilled, being hired out at over a million apiece.

Even at this late stage – in the 10 days before the bank guarantee - it was difficult to say what shape the looming crisis would take. For sure, we had to accept there would be some bank failures, in the sense of banks that could not function properly without some outside help – INBS was in effect already failed, if apparently not insolvent. But INBS was not the most pressing problem – the deposit outflows were reducing in the days following the increase in the threshold for the deposit guarantee scheme, and the sense of immediate crisis in that quarter had thus eased a touch. ILP and Anglo were both losing funding at the wholesale level, as were the two bigger banks, AIB and Bank of Ireland. However, there was a difference that affected, at the very least, the pace at which these institutions might get into difficulty.

Basically, at the end of every day a bank has either a surplus or a deficit of liquidity. That means that either they have more funds than they need to meet that day's liabilities, in which case they have to find a home for those funds, or they are short of liquid funds for that day, in which case they have to find someone to lend them the difference between what they have and what they need. This is not unusual – it is normal banking business and the amounts are generally very small relative to the size of the bank concerned. And the solution is quite simple too – if you have excess funding, you make a deposit with the Central Bank, which will probably pay you less interest than you would have hoped to get on the market – and if you have a shortage of liquid funds, you ask the Central Bank to lend you what you need for the day. Again this is normal.

When the central bank lends to your bank, it does so happily, because it takes collateral for its loan – it knows if your bank did not pay back the short term loan, the collateral would cover the loss, with a bit left over. So normal is this operation that Central Banks maintain lists of 'eligible collateral' - in other words, they have a list of assets they will accept as collateral, and those they will not. Generally government bonds are acceptable on the spot, so are other types of easily traded bonds or securities, maybe some types of inter-institutional loans. But they don't want individual mortgages as collateral, for example – they are too hard to price and not easily traded. And they don't want big bespoke commercial loans, again because they are not readily tradable and priced.

As liquidity pressures on the banking systems increased, more and more of them – not just in Ireland but very widely in Europe and the US – were relying increasingly on Central Bank loans to make up the difference in their liquid funds. But ILP's main assets were those individual mortgages, and Anglo had a lot of those big one-off commercial loans. They were rapidly running out of the type of assets that they could use to get funds from the

Central Bank – and the Central Bank had to follow ECB rules in deciding what collateral was required. A continuation of the difficulties that they were having in getting funds from the public or from other banks would push them to the point where they needed more funds from the Central Bank than the Central Bank could legally lend to them under the normal rules. AIB and Bank of Ireland were much better provided for in terms of eligible collateral.

Worse, for different reasons, Anglo and ILP fell into just the types of bank which lenders had quite recently loved to lend to, but now wished not to do so. Increasingly all of the banks were finding that lenders they had previously relied on would give them less money, or none, or would lend only for increasingly short periods of time – overnight, or for a week for example, instead of for a month or more.

Whatever the longer term solvency of the institutions – and this will be discussed further later – they clearly were moving towards a liquidity cliff. The moment they could not get funds, whether from the Central Bank or elsewhere, to meet all their liabilities on any given day, there would be a major crisis. One could hope that conditions might improve, but there was no immediate let up, especially after Lehmans.

It is hard to describe now the atmosphere at the time. Work was very intensive – late nights and seven days a week. The sense of pressure was also intense, and a big part of my job was keeping all the teams – not just in the Department of Finance but also in Dame Street and Treasury Buildings – on an even keel, working together. I was working most closely with William Beausang and his team in the Department of Finance, with Pat Neary and Con Horan in the Financial Regulator, Tony Grimes, Brian Halpin in the Central Banking arm of the Dame Street system, Henrietta Baldock and her team from Merrill Lynch, and of course with my own bosses: David Doyle, as Secretary General of the Department of Finance and Brian Lenihan, the then Minister. In the NTMA, Brendan McDonagh and John Corrigan were my principal contacts at this stage, and they were briefing their CEO, Michael Somers, on a daily basis. For a part of this time John Hurley was missing while recovering from [redacted] – it was a relief when he came back in, because the Dame street system clearly worked better when there was a single person to co-ordinate. Michael Somers was present and engaged for most of September, but went to New York, with John Corrigan, for an investor conference, I think, at the end of September, and thus was not physically present on the night of 29 September when the Government's guarantee decision was made, although he and his colleagues had been closely involved in the prior discussions.

Both David Doyle and I were speaking to Minister Lenihan every day – sometimes for a moment or two, but often long drawn out discussions of the situation and the options, which were limited. We provided him with regular updates and our understanding was that he was in close touch with the Taoiseach at all times. The Minister was also, of course, speaking to many other people, and the broadcaster David McWilliams has written about one such encounter. The Minister volunteered to me later that this account was inaccurate on one or two points – in particular denying some negative comment in relation to the Department of Finance. But the truth was that the Minister was interested in hearing the comments of persons outside his official advisers (particularly important for a new Minister, perhaps), and there was no obligation for him to tell his civil servants about these discussions.

Throughout the build up to these crisis weeks we had provided the Minister with briefing points that he could use at Government meetings, if required. But it was a matter for his discretion to decide how much of that briefing to use. During his time as Minister for Finance he was concerned that sensitive information could not be trusted to the whole cabinet because – in his view – at least one of his colleagues would not treat the information received with discretion. This had consequences later.

On the evening of 24 September 2008, a further meeting was held to consider the options that were available. Preceded by a meeting of the various technical groups, there were about 15 people in the room in a conference room in Merrion Street, and the atmosphere was tense. The Taoiseach and the Secretary General to the Government, the Attorney General, the Central Bank governor and his Director General, Tony Grimes, Pat Neary and Jim Farrell, CEO and Chair of the Financial Regulator, respectively, and of course the Minister for Finance, with my immediate boss, David Doyle and myself in attendance. Michael Somers and John Corrigan attended from the NTMA. From the various advisory groups, Merrill Lynch, Goldman Sachs (briefly), Arthur Cox and PWC were represented – the latter having at last been commissioned by the Financial Regulator to do more in-depth analysis on the funding and loan books of the banks[d4].

Various possibilities for intervention in the banking system were considered, including lending to the banks to help their funding position, providing them with government bonds which they could use to access Central Bank funding, giving them guarantees to allow them to access funds from the public and on the money markets, and the nationalisation of one or more banks was also very much on the agenda. I made clear that the situation was very urgent –stating the obvious. The discussion also made clear that there was a lot of uncertainty about the underlying future of the banks – the Financial

[d] The commission had to come from the independent Central Bank and financial regulator, as they had access rights to the banks that the Department of Finance and NTMA never enjoyed, but my NTMA colleagues and I had strongly encouraged the regulator to take this initiative. The results were shared among the authorities and the Dame Street people were pragmatic in ensuring that everyone who needed access to the data could get it. A few months before, this would have been anathema.

Regulator remained of the view that there was no evidence of insolvency, for example at Anglo Irish bank. But of course, that situation could change. It was agreed that further work would be done to examine the various intervention mechanisms being considered, and on enabling legislation.

That work continued into the night and the next day, with involvement at various levels by the official bodies and advisors engaged in this effort, in preparation for a further meeting with the Minister for Finance on Friday the 26th. David Doyle asked that the NTMA prepare an assessment of the impact of guarantees from the State to banks on the State's own creditworthiness – they suggested in response that at least there would be a significant increase in the State's borrowing costs and some damage to our credit rating.

The external environment was not helping – in the US, Washington Mutual was the latest bank to get into difficulties – by US standards it was relatively small, but still much larger than any of the Irish institutions, and the manner in which it was resolved (without protections for bondholders and some depositors) was controversial and regretted later by many commentators, who felt it should have been treated as "too big to fail".

In Europe there were problems too. Ireland's representative at the EFC (the Economic and Financial Committee at which senior officials from Finance

Ministries, as well as representatives of the ECB and Commission, met to discuss important developments) relayed back that there was a lot of 'coded talk', but that it seemed there was an expectation of the failure of a large European Bank over the weekend.

There was a scheduled meeting of the Central Bank Board on the 25th so some of the Dame Street people were not in attendance at the meeting with the Minister for Finance, but they were represented, and Oliver Whelan and Brendan McDonagh from the NTMA were also on hand. Arthur Cox were present too. Work continued again on the following day, as discussions began to centre around a set of options put together into a presentation by Merrill Lynch (by now joined by Baldock's boss, Andrea Orcelli). The set of options, together with pros and cons, included the option of providing broad guarantees for all the main banks, but also noted that there were downsides with this approach. The meetings on the 26th finished with instructions for further work and my notes indicated this group planned to gather again at the NTMA offices in Treasury Buildings on Sunday 28 September, although work was of course to continue in each of the institutions concerned on the Saturday.

It was only three days between this meeting of 26th September and the meeting on the night of 29 September and early morning of 30 September at which the bank guarantee was discussed, and then recommended to the

Government, but in retrospect it seemed like a long time. Legal teams, officials, advisors all fitted a lot of work into that small space of time – the legislation in preparation had to be refined and adjusted, further study was required on the European state aid rules, about which more later, advisors and central bankers monitored and inquired into the developing liquidity position of the banks.

And there were new considerations to be addressed – over that weekend it became clear that Hypo Real Estate (HRE) – a big German bank, with an important Irish subsidiary – was running into trouble. So too was Fortis Bank. In the UK, there were signals that Bradford and Bingley, a former building society which had demutualised, was in trouble – it announced big job losses on 25 September and its nationalisation was announced, if memory serves me correctly, on the following Monday, 29 September. The Americans were still under huge pressure, and had announced a big rescue plan, known as TARP, which was being discussed, and was clearly controversial.

The HRE problem was the more immediately important of these for us – a couple of years before, HRE had taken over a bank based in the Dublin docklands called DEPFA bank. DEPFA was on the face of it a relatively low risk operation – the bulk of its lending was to public sector entities and it raised money in part using relatively safe pfandbrief-type instruments – or asset covered securities, as they were called in Ireland. But they were also accessing a lot of funds on a short term basis through wholesale money markets – the same money markets that had been increasingly reluctant to lend to banks, even before the Lehman Brothers shock, and then got a lot worse. So now DEPFA was in need of help, which was a big complication for its parent HRE.

The question then was whether Ireland was willing to expend any resources to help DEPFA, for example, by providing guarantees to its lenders. The Central Bank Governor, John Hurley, was asked whether Ireland would want to participate in a big German effort to save HRE. Mr. Hurley replied that he thought this unlikely: DEPFA was a big enough bank in asset terms, but its assets and its liabilities mostly lay abroad – it could not be regarded as having 'systemic importance' for the Irish banking system or economy. Besides, we needed to hold our firepower for the increasingly immediate threat to the domestic banking system[e].

There were lengthy discussions at the NTMA headquarters on Grand Canal Street at Treasury buildings on Sunday 28 September, at which many of the ongoing issues were discussed. And there was also an informal meeting that

[e] It may have been that weekend, but more likely the following weekend that I received a telephone call from DEPFA staff – they had been told that they would be closing their doors the next day, and would be allowed to go bankrupt, in effect – Lehman-like – and that hundreds of them would be out of employment immediately. They needed to know immediately if there was any possibility of support from the Irish Government. I knew the answer, but I promised to double-check my understanding of the situation, and rang them back some time later after I had with confirmation of the bad news, for them, that no Government support would be available.

afternoon or evening in Dame Street. There was a gathering there in the Governor's office, to talk informally over the current position, including DEPFA and the liquidity of the banks. Anglo was close to zero in terms of available cash: a few more days at the current run rate was all they could expect, and we had to be prepared for the contingency that they might not even have that – on balance though, the Central Bank thought they could last a week, before running out of funds to meet day-to-day obligations, which would mean that big decisions would be needed the following weekend at the latest. Others were also very tight on liquidity, but Anglo's position was worst.

It had been noted at the meeting that morning in Grand Canal Street that John Hurley was going to speak that day to Jean-Claude Trichet at the ECB. At some stage in the day there must have been some debriefing on the call with Trichet (perhaps I spoke to John by telephone, I don't recall), and I scribbled down some points.[5]

Hurley's discussions with the ECB and privately with Mr Trichet were not very encouraging. First, there were growing problems in other parts of Europe: the Fortis situation was discussed, as was the ongoing problems with HRE and DEPFA – there seems to have been a suggestion that the German Government was going to make a statement "as Sarkozy on deposits". This would have been taken to mean, in other words, that the German

Government was going to give a guarantee to all depositors, but not in legal form – it would be a sort of morally binding public statement.

Second, any suggestion that the ECB would accept a wider range of collateral in return for funding for banks was apparently dismissed: my notes say “no support for widening collateral – not going there at the moment – issue for Govt & taxpayers”

Third, Hurley appears to have described to Trichet the depth of Irish problems and the fact that major decisions might be required “in days”. The message back, was that the German and Belgian Governments had faced their issues and the Irish Government must do the same.[f]

[f] My main statement sets out some further details and views in regard to the contacts with the ECB that day and previously

29 September

Monday 29 September 2008.

PWC staff engaged by the financial regulator had been analysing the funding position of the three worst case banks going into the new week. All had been losing deposits, so the funding position was worsening: we knew that. Ironically, Irish Nationwide, where our troubles had started, was not in the worst position, while they had lost significant deposits in the three weeks that had passed since 8 September, but they had a lot of cash, and since the increase in the deposit guarantee limits for small depositors their rate of loss had eased. They were due to make big payments on medium term borrowings which would mature in December, but even with a steady loss of deposits they would not be in immediate cash flow difficulties.[6]

ILP was in a much worse position – if they had a very bad week, they could be out of cash before the end of the week, perhaps on the Thursday, with no assets suitable to use as collateral for central bank borrowings. They had some hopes of producing collateralisable assets[g] in the coming weeks, however, if they could last until then.

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[g] In other words of packaging loans into a legal structure that could be acceptable under central banking rules as collateral, thus allowing ILP to borrow more from the ECB

Worst was Anglo – they might be able to manage a small positive balance at the end of the week, but there were many reasons to be concerned that things could be much worse.

First, even if things went relatively well, there were big deposits due to be repaid on Tuesday 30th, which could create a small shortfall in their cash position that day (remembering that we are talking about a world where 'small' is measured in hundreds of millions of euros).

Second, the benign scenario was contingent on being able to package certain commercial mortgages into a type of security that they could use as collateral to obtain central bank loans – called a commercial mortgage backed security, or CMBS. This was due to happen mid-week, and while this kind of thing is relatively routine for banks, it is not usually done with such limited room for manoeuvre in terms of time, and such potentially dire consequences if the deadline was missed. Theoretically, if they were a day late Anglo could have a position that would see them cash positive, if only just, at the end of the week, but to no avail, because without any cash they would have had to close their doors mid-week. Obviously, they would be hoping for official help to bridge the gap, if this sort of scenario arose.

But all of that was the benign scenario for Anglo – their own worst case scenario was much worse, here described by PWC:

> “under management's "worst case" scenario the shortfall increases to E2,449m on 3 October. If the CMBS is not completed this increases to E4.6 billion. To avoid this the withdrawal of deposits needs to cease, assuming that the interbank and capital markets remain effectively closed for the immediate future”[7]

Clearly, deposit and interbank flows that Monday would tell a lot about the future of the Irish banking system.

On 29th September banks were falling over and having to be supported by Governments around the US and Europe. In the morning it was announced that HRE would be supported by a consortium of German lenders by arrangement with the German authorities. In the US, Wachovia Bank was in need of support with information that it was likely to be taken over. In the UK, the Bradford and Bingley Building Society was to be nationalised. The night before, the Belgian, Dutch and Luxembourgish governments had announced an €11 billion bailout of Fortis Bank – which only a year or so before was heralded as the model of a new style of European bank, truly international, now evidenced by the international nature of its bailout.

There was trouble too for the Franco-Belgian bank, Dexia, whose shares were collapsing, and Belgian authorities were making protective statements. In fact, it also required a bailout not too many hours later. Dexia had lost money on US subprime investments, it appeared, and on Lehmans, and while the French Government appeared to be distancing itself from a potential rescue of Dexia, which it said was a Belgian concern, the Market was aware of its position as a lender to a large number of French local authorities. In Iceland, there was a rescue too, for Glitnir bank - their third biggest lender.[8]

It was clear early on that the Irish banks' shares were also going to take a hammering that day, reflecting their weak position and the desperate situation in Europe.

In a rough first draft I made that day of speaking points for possible use by Minister Brian Lenihan, the international position was summed up as follows:

> "However, the international situation has been getting increasingly bad, and in three weeks there have been at least twelve major financial institutions filing for bankruptcy, rescued by the State or acquired by rivals while under stress, culminating this weekend in the situations at Fortis and HypoBank – the latter having a very large (in asset terms) Irish subsidiary. Interbank, commercial paper and corporate deposit markets have been drying up or funds have been available (sic). As a result, the Irish financial sector is under extreme pressure"[9]

That afternoon, Matt Pass, one of the Merrill Lynch team informed us that Standard and Poor's, an important credit rating agency was likely to issue a statement downgrading the credit rating of the main Irish banks – in effect they were in a vicious cycle: their inability to raise funds made them less creditworthy, which in turn made fundraising more difficult, and the credit rating downgrade would accelerate the downward cycle.[10]

By close of business that day, it would be clear that Anglo could not sustain the pressure on their funding position – they lost deposits, they were out of cash, had no more collateral available to allow them to borrow from the normal central bank facilities, and the central bank had had to put a special facility in place to cover them overnight – but next day they could expect to be another two billion or so in the red, perhaps 8 or 10 billion within a short few days, and trapped in a downward cycle with no exit.

The Night of the Guarantee

It was inevitable that there would be a meeting that evening. My boss, David Doyle, told me to be over at the Taoiseach's office by 6 p.m. Figures from the the Central Bank. Financial Regulator, Arthur Cox and others were in attendance. Some of the Taoiseach's own advisors were there too – Joe Lennon and Peter Clinch. William Beausang was there from the Department of Finance, and he told me that he had our small crisis team on stand-by across the courtyard to do whatever might be necessary. At some point I became aware that the heads of the two biggest banks were to be in attendance in the building – I never had the understanding that the meeting was called at their request, as has been suggested in some media outlets, but as I indicated already, it was clear that there would have to be a meeting that evening, in any event.

There was to be a group of senior officials to meet the Taoiseach, Brian Cowen, and others were to remain outside in support. I was anxious to be in the room with the Taoiseach – albeit for much of the night just about the most 'junior' person in there – because it was important that someone be there who had participated in many of the working meetings that had been taking place over that past few days and would be able to update the meeting on the latest state of play. My bosses, David Doyle and Minister Brian Lenihan were there. Jim Farrell and Pat Neary from the Regulator and John Hurley and Tony Grimes from the Central Bank represented the Dame Street system. The Attorney General, Paul Gallagher was present for the whole discussion, and a solicitor from Arthur Cox, Eugene McCague, and my colleague William Beausang were also in the room at certain points, according to my notes. And of course the Taoiseach attended himself. Others came in and out as required, and indeed I was not present for every moment of the meeting myself, because there were occasions when I would have to step out on some errand or other or to make a call.[11]

I was confident that my team, with the attorney General's office, could deliver any legislation required very quickly indeed, as we already had prepared draft legislation which could allow for guarantees, special liquidity swap arrangements, nationalisation (bank or building society – the technicalities differed but the principles were much the same), direct loans and so forth. Courtesy of our various meetings and brainstorming sessions, some of which the Minister was involved in, we had a range of options to describe, with pros and cons for each.

Moreover, if there was a need to apply Government money directly, the authorities had a 'fighting fund' of sorts arranged, so that taking cash and fungible securities together, as well as some limited scope to apply the Central Bank balance sheet, we could have many billions of euro ready at very short notice: perhaps as much as €20 billion.

The meeting – or rather the series of meetings – that took place that evening were surprisingly business-like, and professional. The then Taoiseach was in charge and calm, and his calmness helped to ease tension and allow the business to move along.

But he did surprise me quite early on. I had expected of course that we would discuss guarantees for banks among the options for consideration that evening – indeed, by then I thought that some guarantees were inevitable. But the Taoiseach raised the issue of a broad pre-emptive guarantee very early in the discussion. It seemed to me that he already had a preference for this approach going into the meeting, or at least that it was the baseline approach against which every other option would be considered.

This was not the preferred approach of our advisers in Merrill Lynch, I was sure, and I stepped out of the room to send a quick email message to Merrill: "in meet with taoiseach - need note on pros and cons of guarantee a sap" (sic). Of course I already knew the pros and cons – they were listed out in a document prepared the previous Friday[12], but I felt it was important that the meeting would have confirmation of Merrill's position. Moreover, events had moved on quite a bit in the previous 24 hours, so the balance of advantage might have changed somewhat in even that short period, and I wanted to be certain that I understood their position clearly.

There was a lengthy discussion of the situation and the options, especially the guarantee option. Tony Grimes spoke about the funding position of the banks. John Hurley explained his understanding of the ECB and the European position. He noted that the ECB President, Jean-Claude Trichet, had stressed that it was essential for European and Irish Financial Stability that there be no bank failures in Europe. But more worryingly, Trichet had also confirmed that there was no European initiative in the making which might ameliorate the situation: it was always possible that a number of larger countries would get together to design an initiative without consultation with the relative minnows like Ireland, but most unlikely that Trichet would be out of the loop on any such initiative. The Irish central bankers were also clear that their own balance sheet was not large enough to make large loans to Irish banks outside the framework of the European System of Central Banks. They had been very insistent on the need to have Government funds available to lend to banks.

The financial regulator spoke about the current solvency situation of the banks, maintaining the position that they were solvent, if not without difficulties.

It seems to me in retrospect that only the Department of Finance representatives, including the Minister, were cautious about the dangers of a broad bank guarantee. However, it is definitely the case that the Dame Street representatives all strongly favoured the broad guarantee approach, on balance at least.

Minister Lenihan and I seemed to be the most concerned about possible downsides to this approach, but at some stage in the evening, the Minister's views moved more towards the consensus favouring the broad guarantee option.

I heard the explanation of this a couple of years later. The Minister reminded me that the meeting had been suspended for a time so that he and the Taoiseach could have a private discussion. According to the Minister, during that private discussion they decided to present a united front around the broad guarantee option. But so far as I can recall, they did not actually announce that, but rather let the meeting move toward that position.

I have also read since, in comments from the then Minister for the Environment that there had been a discussion the previous day (Sunday) favouring a broad guarantee option at Governmental level.[13] If this was the case, it was not made clear to Department of Finance officials at the time, and makes the outcome of the meeting on 29th September seem in retrospect much more predetermined than it seemed at the time. But if the Government had already made a decision, without the benefit of official advice, why were we now meeting to make precisely that decision? And why was the Minister for Finance now, just one day later, seeming sceptical about that approach?

I can only reconcile these accounts by thinking that Ministers may have had a preliminary round of discussions, but were awaiting developments and further information and advice before proceeding. Even a few hours' notice of a Ministerial or Government preference for any particular option would have made for better and more targeted preparations for the meeting, which might have had some impact on the final outcome. It is not the norm, of course, for cabinet discussions to be formally disclosed, but formal decisions are disclosed, usually. So we can take it that any decision on the Sunday was not a formal or a final one.

While all of this had been going on, Dermot Gleeson and Eugene Sheehy, the Chairman and Chief Executive of AIB, and the Richard Burrows and Brian Goggin, 'Governor' and CEO of Bank of Ireland, had arrived and were waiting outside –they were in one of several conference rooms on the same floor. They were asked to join the meeting. They sat along one side of the table, the Taoiseach at the head of the table on their left, the Attorney General, Minister Lenihan, myself, David Doyle opposite them, others filling the rest of their side of the table and the table end opposite the Taoiseach.

These bankers' message was stark. They knew well how vulnerable were the weaker banks, like Anglo, and were very careful to distance themselves from the Anglo position. Sheehy described the market experience of that day. Both banks were finding it harder to attract funds in the market – the willingness of market participants to make deposits or lend to Irish banks for longer periods, such as for one of three months, was greatly reduced, and the two banks were increasingly reliant on shorter term funding – monies made available only for a day or a week. Soon, they would find themselves in breach of regulatory guidelines governing the average 'duration' of these types of deposits. Sheehy said that, for example, on one unsuccessful phone call seeking funds from an international bank, the AIB employee on the call had overheard a comment between two traders at the other end of the line: "no quote for Ireland". In other words, he argued, there would be no market differentiation between the Irish banks, all were being tarred with the same brush, and all would have funding problems – on their estimates, although both had substantial liquidity cushions, the circumstances were so extreme that even these two most substantial Irish banks might run out of funds in a matter of weeks. They wanted a guarantee from the Government in very broad terms, and they wanted insulation and differentiation from, in particular, Anglo, which they argued could only come from a nationalisation of that bank.

Taking these two banks at face value on their funding position, the position now was that Anglo was already out of cash, ILP could be in a similar position by the end of the week, INBS was draining funds only slowly, but would eventually run out. The EBS building society had not yet been flashing the same warning signals, but would presumably also be infected. A worrying situation had become a desperate situation in just a few short days.

The bankers came in, discussed, left, and then were invited back into the room for further discussion. But (and despite some suggestions contradicting some aspects, which I have heard since), the following is clear to me:

- They outlined the market position, as I have noted above,
- They explicitly sought a very broad guarantee, providing a suggested wording

- They asked that Anglo be nationalised
- I asked, for the benefit of the room, why we should guarantee existing long-term borrowings of the banks, and they responded in terms of ensuring a consistent message to the market, avoiding market differentiation, the negative reaction that would arise if existing lenders to banks were disadvantaged compared to new, pointing out that addressing the funding situation as it stood would require that existing lenders would also be new lenders.
- Similar arguments arose in relation to subordinated debt, but I do not recall now if the bankers made a distinction between dated and undated subordinate debt. I do not recall any suggestion from any of the official parties at any stage that undated subordinated debt would be covered.
- There was a discussion of how much the banks ought to pay the Government for a guarantee, and Eugene Sheehy suggested a risk-adjusted model on the model of the American FDIC[h] charging system. This of course would have made the guarantee a very cheap arrangement from a banking perspective and certainly would not be anything like a 'commercial rate' in the circumstances.

[h] Federal Deposit Insurance Corporation

It has emerged in the media in recent times that Sean Fitzpatrick had been to visit at least one of these two banks that day, and had asked that the larger bank would take over Anglo. If true, it is difficult to explain in retrospect why this rather salient piece of information was not passed on in the meeting with the Taoiseach.

The bankers left the room, and the meeting continued in the light of their comments. In some ways their interventions had only added colour to the picture of the situation that had already been available to us. Their suggestion that on current trends even the two big banks would run out of funds was in fact more or less self-evident, but their description of that day's market activity was useful, and their pessimism added to the conviction that decisive steps were required.

In fact, theirs was not even a worst-case scenario. In the absence of significant official intervention, a failure of Anglo to meet any of its obligations would trigger events of default on many of its borrowings, so billions of euro would become payable immediately. Anglo's depositors would lose access to their money, the bank would close its doors. Depositors, large and small, could rush to take funds from the other banks, and international investors would withdraw from Ireland as much as they could. Payment systems, such as international credit card and debit card service providers might withdraw services from their Irish customers abroad and internationally traded businesses would face in many cases impossible demands for upfront payments for goods and services and could no longer rely on their bank guarantees and working capital facilities, as the Irish banks would not have the cash to honour them. The effect of an Anglo default could be exacerbated by the failure within the same week of ILP, and probably all banks would be told to close their doors for days or weeks while authorities struggled to cope. The resulting recession would be unprecedented and the damage to the Irish economy and people would be long term and devastating.

So of course, there was never a sensible option for the authorities to step back from the situation and 'let the banks take the hit'. A decision was required and the approach most favoured in the meeting was turning out to be that of granting broad guarantees to all of the significant Irish banks.

How was the guarantee framed? Well, first, there was indeed a discussion on whether to include existing borrowings of the banks and existing deposits within the framework of the guarantee. The question was simple enough in relation to deposits – most of those were relatively short term, and as soon as they matured would have to be replaced with guaranteed deposits, so a restriction on deposits was not likely to be advantageous. In relation to bonds of various types, the meeting accepted the bankers' arguments that it was important to keep the bondholders on board, so as to encourage the flow of new borrowings.

The term – or length of time applicable – for the guarantee was also discussed, and it was decided that two years ought to be enough, or that if problems persisted for longer, then other mechanisms would have been found to address issues in the meanwhile. I do not recall anyone arguing for a shorter period, although my notes suggest that the financial regulator originally had a shorter certain minimum period in mind, and indeed given that the tone of the meeting was to make a decisive demonstration of support for the banking system, a very short term guarantee might have been counterproductive.

And there was a relatively short discussion, too, about the question of whether to include dated subordinated debt within the guarantee. Earlier, I referred briefly to a meeting on 26 September, at which the available range of options was discussed, and a paper was presented by the Merrill Lynch team. There had been a discussion on precisely this question at that meeting, and some of the Merrill team had felt – though on balance – that inclusion of dated subordinated debt in any broad guarantee was warranted. When asked at the meeting on 29/30 September about what the advice had been on this issue, I was able to recall the 26 September discussion, – and so dated subordinate debt was in. I do not know, of course, what the decision would have been if I had reported a different view from the 26 September meeting.

At some stage later in the evening, David Doyle, seeing my unease, asked me directly what was my view on the appropriate approach to be taken overall. I did not know then, and do not know now, what was the best approach – indeed, there are so many counterfactual possibilities to be considered that I think that question can never be answered. The broad guarantee as granted, or with adjustments, might well have been the best decision to take. However, that was not my recommendation on the night in question.

I addressed the Taoiseach directly (I am not sure if Minister Lenihan was in the room or not at the time, I certainly don't remember any reaction from him on this point). I said that in my view we should 'take Anglo out' – explaining that I meant that in my view, Anglo should be taken over by the State, that there would have to be guarantees granted to Anglo to keep it funded – and that we should make soft guarantees in relation to the other banks. By soft guarantee, I meant that we should make solemn assurances to the market about the support the Government was prepared to give to the banking system, but not to make them legally binding.

The Taoiseach was not disposed to entertain my view on this, either then, or later when I reminded him that if there were to be a nationalisation, it would take some hours to organise, so that any such decision would have to be taken as quickly as possible. It is not possible to say now whether the approach I spoke of would have been any better than that which was in the end followed. What was sure, was that there were huge risks, which had to be addressed in a decisive way – my recommendation, which I think more or less mirrored the views of Merrill Lynch and the NTMA, might have provided a better outcome if it bought some time for Ireland, while a European approach to the crisis was developed (and there was no way of knowing how likely that might be at the time), and if the market was sufficiently reassured by the 'soft' guarantee to provide funding to the other Irish banks in the meanwhile. In that case, the less comprehensive 'soft' guarantees involved might have allowed more freedom for manoeuvre at a later stage in negotiating with bondholders for bail-ins, for example, and the lesser guarantees might have excited less negative comment in other European states – the UK in particular.

On the other hand, if my approach had been adopted, and deposit withdrawals from the other banks had continued, we would probably have had to announce the nationalisation of Anglo on the Tuesday, then consider doing the same again for ILP on the Thursday or Friday – or adopt the broad guarantee approach at that stage.

But it is important to remember that the question for the meeting at that stage was not which options might on balance be the best and least costly: so long as there was a risk – and there certainly was one – of a real economic disaster in the following days, the question became which approach had the best chance of staving that off. We were, I am sure, each of us concerned that a mis-step that night could lead to closed ATM machines, lost cash, lost jobs, huge disruption to the lives of our community in a matter of hours or days.

The question of how the State would charge the banks for its guarantee was also discussed. There was a quick agreement that this could not be decided until later, and that the banks would simply have to accept that the guarantee would come with a 'yet to be quantified' cost.

But even if a broad guarantee for all the significant institutions was to be agreed, as was by late evening more or less clearly going to be the case, there were huge potential obstacles in making it 'stick', and much discussion that evening focussed on this point.

Guarantees entail a 'credit' enhancement: the lenders' belief, or 'credit' that they will be repaid is enhanced by the attachment to the loan of a guarantee from a more creditworthy party. For a guarantee to be effective, the lender must believe it to be valid or legally granted, they must believe in the intent and ability of the guarantor to deliver on it – at least within the range of likely circumstances in which it could be called upon. It is not a confidence 'trick', but a real commitment, but its effectiveness in allowing the banks to raise funds and protect against further losses of deposits is entirely dependent on the confidence that depositors and money and bond market participants would place in it.

So it would be quite possible to give a guarantee, and see it fail immediately, if some circumstance arose which would undermine that market confidence. This was especially the case since there would be a short period – even if only a day or two – when the guarantee would really only be a statement of the Government's intent, because it could not come into law until the Oireachtas had enacted the necessary legislation, and it had been passed and signed by the President. Any serious challenge to the validity of the proposed guarantee, especially in that period, could leave the Government in the dreadful position of having bound itself to back the banks' funding, but without actually improving their funding position.

The biggest likely danger to the validity of the guarantee came from within the State Aid rules of the European Union, which prevent Governments from supporting businesses to the detriment of competitors from other countries, thus ensuring a more level playing field and a fairer commercial market place. So support to banks was normally illegal, and a guarantee given illegally would not attract market confidence.

To be accepted in the market, the Irish guarantee had to clearly fit within the exceptions to the normal rules, the most important being the exception which applies in circumstances of grave economic disturbance and even then cannot be regarded as giving a carte blanche. Moreover, the guardian of the State Aid rules was the European Commission, and it has very wide powers to circumscribe state aid activities by governments, even in emergencies. Worse, it would not be possible to arrange a state aid 'clearance' from the Commission in the time required, so we would have to rely on making the correct legal judgments, then working with the Commission to ensure retrospectively that we stayed within the rules.[i]

So it would be essential that neither the Commission, nor any senior European official, or indeed any other Government would seriously question the validity of the guarantee. Even serious speculation about its validity could render it ineffective, if that speculation was treated seriously in the

[i] Much study had been done of the Commission's approach to the Northern Rock case, which suggested they might, relatively speaking, 'go easy' on a liquidity guarantee with a charge to the institution concerned.

market. More than that, any serious danger, at least as perceived by the markets, that the Guarantee legislation would not be passed, would also render it ineffective.

Finally, the market had to believe that Ireland would do everything possible to protect its banking system, to avoid calls on the guarantee: since it was clearly not possible for Ireland to pay out on every possible obligation in the event that all the banks would fail at once. The confidence inspired by the guarantee was as much a product of the perceived willingness to avoid bank defaults, as it was a product of the insurance granted to the lenders and depositors in the event of default. The guarantee, therefore, was a fragile thing, especially in the first few days.

I recall expressing these concerns, with the strong support of Paul Gallagher, the Attorney General, several times that evening. He would have the task of making sure all our actions were legally as watertight as possible, and of preparing our legal position for the discussions with the Commission, and he was steering the discussion to ensure the legalities were addressed. But effort would also have to be expended not only on ensuring the actual legal validity, but also the perceived validity among market participants. On one of my later interventions on this point, Minister Lenihan, possibly thinking I was overplaying my concerns, asked who would wish to challenge the guarantee – I replied that any of the market participants who were to be excluded from the protection of the guarantee might decide it was to their advantage to be troublesome: on this I was correct, as we discovered quite quickly.

Putting the decision into action

I think it is sometimes imagined that on the night of 29 September that year there was a single meeting, with certain bankers present, at which the fateful decision to guarantee large parts of the banking system was made. In fact, as I hope I have made clear, there was a rolling series of discussions, with some changing personae, in the meeting room occupied by the Taoiseach; of course the people outside in the corridors and waiting rooms, and indeed in other buildings in Merrion Street and Dame Street, were engaged in their own discussions and preparations. There were breaks, side discussions, interruptions and so forth.

One such interruption, to give an example, came when Joe Lennon, one of the Taoiseach's advisers, came in to the meeting room to break the news that in the US Congress the TARP plan – the plan that was intended to save their banking system and economy, and by the way also reduce the contagion effects for Europe –had failed to pass the Congress. It had some real implications for the process in Government Buildings. The first was that the money markets were likely to be even more unsettled the next few days, adding to the pressure for really decisive action in Ireland that night. The other was that markets which had been, quite literally, banking on a Government announced initiative passing a parliamentary process had been disappointed, and that might leave them less inclined to accept an announcement by the Irish Government at face value, until all the parliamentary processes had been completed.

Joe's interruption was not the only one – there were stops while the bankers were moved in and out, twice, and probably for other purposes too, throughout the night. There was a side meeting at some point between the Taoiseach and the Minister for Finance, and I have noted that I left the room myself once or twice to consult the Merrills team, William Beausang and, later I think, but am not sure, Brendan MacDonagh of the NTMA. As it happens, I had made a number of attempts to contact Brendan that evening, and he arrived sometime between 9 and 10 p.m.

But once the main decision to grant the broad guarantee had been made, the level of movement in and out of rooms and corridors went up considerably. There was a lot to be arranged:

- The press release, in which the key elements of the decision would be formulated and presented, had to be drafted.
- Preparations had to be made for an incorporeal Government Meeting – a consultation of Government members and decision to be taken by telephone.
- Work had to commence on adapting the legislation already drafted to the specifics of the new decision.
- Arrangements had to be made for the contingency that the guarantee announcement would not be immediately effective, and therefore to have other processes in place to ensure that Anglo in particular, but also ILP, could be provided with funds when they opened for business a few hours later.[j]
- Question and answer points and press briefing had to be developed for the next morning.
- Preparations had to be made for breaking the news to our international partners first thing the next morning, especially to forestall any statements from them that might undermine the acceptability of the guarantee in the market.

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[j] This required a discussion with the AIB and Bank of Ireland people present in the building about the contribution they could make, now that Anglo was to be guaranteed, to ensuring any shortfall the next day could be met. (It is clear from my notes that Bank of Ireland in particular was very reluctant to provide any liquidity to Anglo for more than a very short period, if even that). It also entailed further arrangements among the authorities.

- All the institutions concerned had to be contacted and told to put their own contingency arrangements into place.
- There was paperwork to be done – for example, the Central Bank lending to Anglo, which might be required at opening of business the coming morning, required a letter of comfort from the Minister for Finance to the Central Bank, and the form of words had to be agreed and the letter signed by Lenihan.

One particular concern to me was the instructions I had received for the drafting of the press statement and government decision – as I was sent out to start drafting, I was told to stick as closely as possible to the drafting suggested by the banks, since this was their area of expertise, and we wished to avoid any misinterpretations or legal/definitional problems.

I thought, however, that the wording suggested by the bankers was at best likely to be less clear, and at worst would have a different meaning, to that which we intended. After a few minutes at the keyboard, I was sure that I could not reconcile my understanding of the decision the authorities intended to take with the wording that was suggested.

I went looking for the Taoiseach (I think, but am not sure at this stage, that the Minister for Finance had already left to make his own preparations for the next morning). I told the Taoiseach that I thought the bankers' wording was inappropriate, even disingenuous, and I said to him that if we used it, 'the bankers will be in there laughing at us' or words very close to that. I explained that I felt that without changes we would be committed to guarantees still broader and longer lasting than we intended. The Taoiseach took the point, and the drafting from that point was our own.

In fact, the decision/press release went through, probably, a dozen drafts, each one mostly only a little different to the previous, before it was finalised. Not only did the wording of the guarantee have to be precise enough for financial markets, but the decision had to be properly framed to reflect the need to justify the action within the EU state-aid rules that I have discussed above.[14]

Morning, 30 September 2008

The various forces dispersed to do their work. For my part, I went back to Government Buildings and scribbled out a list of people whom I would have to telephone next morning, and I think a list for the Secretary General and Minister also, though I am sure they had their own. The Finance team went straight to work on adapting the legislation, working through the night.

Quite a few people have by now written or spoken about their immediate reactions to Brian Lenihan's telephone calls that morning: Joan Burton, Enda Kenny, Christine Lagarde, Neelie Kroes, Alistair Darling. There is little point in my adding to that, except to say that Lenihan's descriptions of these phone calls at the time was a little more upbeat than their recollections. It was a success to get through those phone calls without anyone attempting actually to call a halt to the guarantee decision, for the reason explained earlier, that even a hint of a legal challenge from any of these big players might scupper the whole thing.

I would though make one comment about Alistair Darling's later comments, along the lines that he or others ought to have been consulted beforehand.

When he was in a similar position himself not so many days later, with RBS going down the tubes, no-one from Darling's office picked up the telephone to consult Ireland, even though the fate of RBS' subsidiary, Ulster Bank, would be of huge importance to us (more on this later). The fact was that in the absence of a European System for dealing with these issues, each country was pretty much on its own. Just as Darling did not have time for consulting Ireland on RBS some days later – he was too busy rescuing his banking system – Ireland could not realistically have consulted everyone else that might afterwards have liked to be included in the decision making on that night.[k]

My own series of telephone calls went more or less as expected. One of my first calls was to the chef de cabinet in Neelie Kroes' office, Anthony Whelan. Kroes in her role as competition commissioner at the time, would make or break the chances of the guarantee 'sticking'. Kroes was said to be "hopping mad" in an email I saw that day from a colleague in the Department of the Taoiseach, but the official position of the Commission was simply that they expected to get details of our intervention shortly, and

[k] The Irish and UK authorities later instituted a 'Cross Border Stability Group' which met regularly by teleconference to ensure coordination and information flow. While we on the Irish side sometimes thought the information flow was a bit one-sided (maybe the UK felt the same), we did manage to avoid subsequent bust-ups and had a much more positive and cooperative approach to mutual issues than might otherwise have been the case. The prior existence of such a forum might, but only might, have been helpful in September 08.

would study it for adherence to state aid rules. Thankfully, there was no attempt to stop us in our tracks.

I also made contact very early on with a senior commission official working on state aids. That afternoon, I think, I received an email from the person who had been appointed to formally open a state aid case for Ireland's banks – the opening correspondence for many years of close engagement between the Commission state aids teams and Ireland's banking issues – these people were to be very important in shaping our crisis responses, and their opening salvoes were professional and understanding, if concerned.

Of more concern were my contacts that day with the UK Treasury. It did not take long for them to form the view that any decision favouring Irish banks, should also apply to UK banks' subsidiaries in Ireland. They were now asking whether the 'subsidiaries' mentioned in our press release as also to be covered by the guarantee was a reference to the Irish subsidiaries of UK banks.[15]

Also that day, or the next, I took a call at the suggestion of my colleague, Jim O'Brien, our representative on the important Economic and Financial Committee, with two senior Commission officials. They asked me why there were no phone calls to the Commission or other member states from Ireland before the guarantee decision was made. I simply noted that banks and banking systems were falling over throughout the EU, but that Ireland had received no phone calls about any one of them.[l] Of course, at many different levels Irish politicians and officials busied themselves calming and explaining to their counterparts in Brussels and in European capitals. The guarantee's success was dependent on, at least, the acquiescence of these people. Also about then, I briefed David Wright, a key and influential player in the Commission in matters of financial regulation. I gave him a pretty honest assessment of our situation, and of the pressures leading to the guarantee decision.

Meanwhile, of course, everyone was worried about whether the guarantee would actually work or not – would the outward flow of funds dry up or even reverse. There was no certainty about this, and the various teams of

[l] This too was addressed later with the institution of a 'cellule de crise' – a group of grandees available to deal with imminent crises, supported by a central phone line that one would call when big events were likely to happen. We used that line religiously over the next year or so, when making significant banking announcements, but I suspect it fell into disuse as more informal arrangements arose.

officials had continued to work on the assumption that it might not. There were a number of strands of possible intervention in preparation:

- Even before the bankers had left Government buildings in the early hours of that morning – Tuesday 30 September, 2008 – they had been asked to participate in liquidity support for Anglo if required.
- At 4 a.m. that morning, a final version or near final version of a 'collateralised liquidity swap' arrangement was produced: a CLS arrangement – similar to some arrangements used in the UK and elsewhere – would swap government bonds, which could easily be submitted as collateral for Central Bank funds, and which would therefore have given the banks access to funding from that source, in return for valuable but non-eligible assets which could not be used directly at the Central Bank.
- The NTMA was also ready to make direct loans if directed to do so: all the paperwork was ready to go.
- The Central Bank was standing ready to make a direct loan to Anglo if necessary.

So, there was no doubt that the authorities had the resources and the systems ready to make huge interventions that day to support the banking system, quite apart from the guarantee, and indeed the legislation being put in place was drafted so as to allow for a wide range of different types of supports, not just guarantees.

Banks, however, are not normal businesses: they are the repository of the cash resources of most of the economy, and for that reason, and sometimes also because they are overexposed to short term money markets, they have huge liabilities that they can be called upon to repay with only short periods of notice, or none. Even depositors whose money is on term deposit may be able to retrieve their funds with only a small interest penalty. So in the face of an all-out run on a banking system the size of Ireland's, it could well be the case that even a very large contingency fund would last only for a few days or a couple of weeks. So it was very important that the guarantee should work.

Meanwhile, there was a frenzy of legislative drafting and other activity in the Department of Finance and in the Attorney General's Office. The plan was to have the Bill presented to the Houses of the Oireachtas by, if I recall correctly, Wednesday afternoon, to allow for legal effect to be given to the decision taken early on the Tuesday morning.

But actually, it was possible that we could save a day on this process, and second stage was taken that day – speed was of the essence, as the faster the legislation could be passed, the less likely was the guarantee to be questioned in the market.

In fact, market participants and advisers took the guarantee more or less at face value on the day of its announcement.

- Credit rating agencies made positive assessments about the impact of the guarantee on the banking system
- Ireland's AAA credit rating was left unchanged
- Credit default swap markets showed a clear improvement as far as bank credits were concerned, and only a relatively small, but significant, negative effect for Irish sovereign credit
- Most commentators were relatively positive, some noting that the guarantee had yet to be checked against the state aids rules, but not challenging the validity of the scheme in general.[16]

Most importantly of all, monies did start to return to the banks that day. Our report from Anglo that evening said that they had raised a net €2.8 billion in funds that day from a fairly wide variety of sources[17]. In the short term, at least, the guarantee was working.

After an emergency passage through both Houses of the Oireachtas, the Bill became law on Friday, 3 October 2008.

That was exactly four weeks after that first phone call about trouble at Irish Nationwide.

Competitors demand access to the guarantee

I have already indicated that the UK authorities were very quick to suggest that subsidiaries in Ireland of UK banks should be able to avail of the guarantee. In fact, there was quite broad international pressure both to extend the guarantee to other banks and to ensure that Irish banks using the guarantee would not siphon away liquidity from banks in other places which had no formal guarantee. All we could do was explain the depth of our problems, noting that if we had not addressed them decisively, the impact on the rest of Europe would have been a lot worse – a point which was almost certainly true.

Of course, the Irish guarantee initiative was not the only one. On the far side of the EU, Slovenian banks were losing funds to Austrian banks, after the Austrian Government had promised to make sure that depositors were fully covered (though this was a promise, not a legal guarantee, so far as I recall) and in France, Germany and other places similar solemn promises had been given by Governments. While the Irish guarantee was not the cause of their difficulties, some of the authorities of these countries resented it as being 'unfair'. But nor had they consulted us before entering into their own less formal arrangements. Still, no new friends had been made that week, and the Irish Government was on the back foot in terms of its relations with its neighbours. This was especially the case, of course, as far as the UK was concerned, where the Chief Executives of two big Scottish-based banks were no doubt spending a great deal of effort in decrying the Irish efforts to the Chancellor and Prime Minister. It seems clear, now, that their very substantial market problems – especially those of RBS – were being blamed on the Irish guarantee, even though the depths of their own problems were to become clear very shortly.

Discussions with Neelie Kroes[18], advice on the guarantee legislation received from the ECB, ongoing contacts with the UK and other countries, all made plain that a flat refusal to allow, especially, UK bank subsidiaries into the scheme would be very difficult to make. In fact, a formal decision was indeed made to allow certain of these subsidiaries to apply to join the scheme, but there would have to be extra conditionality to ensure that the guarantee could be properly policed and maintained in such cases.[19]

The situation came to a head somewhat at the ECOFIN meeting in early October 2008. As I noted, the UK had been piling on the pressure for the

Irish guarantee to include the Irish subsidiaries of UK banks. Their legal position was probably strong in this regard – one could not discriminate against these subsidiaries on grounds of nationality. However, the guarantee was already covering a huge range of liabilities, and there was a concern that each addition made it more difficult to maintain the integrity of the guarantee offered in the eyes of the market. More importantly, a guarantee from the Irish Government to these subsidiaries might be used by the banks concerned to support their headquarters' liquidity requirements, or might provide an incentive for those headquarters to provide less intergroup funding to the Irish operations – the incentives were all wrong, in other words. Worse, however poor was the information available on Irish banks' asset positions, we had no way of checking on the soundness of the UK banks, other than to rely on the UK authorities.

But there seemed to Lenihan to be no choice but to at least go some way down the route of allowing the guarantee in some cases, but he could not do so without some reassurance that it would not be called upon. The plan was to speak to the Chancellor at the ECOFIN that day and extract from him a political commitment in that regard.[m]

[m] The other important business of the day was to ensure that no statements were made which would undermine Irish efforts and to reach out to Commissioners Kroes and Almunia – in that regard the day was not without its hiccoughs

In fact[n20] that day the RBS share price was plunging and the UK Government was having to make supportive statements to the media. Lenihan and I eventually caught up with the Chancellor in a corridor, and spoke for a few minutes. Darling gave a formulaic reassurance – "no-one need worry about the security of RBS" or words to that effect.

Coming away, Lenihan asked me what I thought. I said, "I think RBS is in very big trouble but he can't say so – but they intend to protect it". Lenihan said "That's what I think, too". Political reassurance or not, the Minister was not in a hurry to guarantee RBS subsidiaries after that.

Eventually, this situation resolved itself, because the Irish side would not relent on the strength of the conditionality that would apply to banks covered by the guarantee, and the banking groups to which they belonged. In the end, the UK banks (and indeed the Irish subsidiary of Belgian bank KBC), did not want to, or were not allowed to, accept the types of conditions that accompanied the guarantee as it applied to Irish banks,

[n] Darling's own memoir on this period gives an account of this very difficult day for the UK authorities (see endnote)

including cross-guarantees within the groups and an entitlement of the Irish authorities to intervene in the management of the groups concerned. We heard from one of these banks, for example, that their financial regulator would not countenance the level of Irish control that would be entailed. Presumably, too, the steps the UK took to rescue their banks made access to the Irish guarantee much less important.

The Danish-headquartered National Irish Bank had also raised concerns about its position almost immediately (before 9 a.m. on the morning the guarantee was announced) as the availability of Government guarantees to all of its main Irish competitors put it in a very difficult spot *vis a vis* its deposit base. However, as a subsidiary of Danske Bank, it was shortly to be covered by the wide guarantees offered by the Danish Government to its banks, and it did not seek Irish protection after that.[o]

For a few weeks, though, I had a small pile of letters on my desk from various IFSC and other banks not among those initially covered by the guarantee, asking to be covered by the guarantee scheme.

[o] One addition – Postbank – a new joint venture between the Post Office and a foreign bank was agreed.

Europe acts

It was 12 October 2008: the first ever Eurozone Heads of State and Government Meeting had been called. This was to be a meeting of the presidents or prime ministers of each of the countries who were members of the single currency, together with the President of the European Commission and of the European Central Bank. The meeting had been called by President Sarkozy of France, apparently after some pushing from Spanish Prime Minister Zapatero, and the agenda was to deal with the still unravelling mess that was the banking crisis. It was not an easy meeting.

The meeting in Paris was taking place on a Sunday, less than two weeks since the European banking system had begun unravelling with the various bank rescues, including Fortis, Dexia, HRE, and the Irish guarantee. In the meanwhile, the UK had had to announce the rescue of RBS and other parts of the UK banking system and Iceland had started to disintegrate in economic and financial terms.

Irish officials and Irish ambassadors had had a lot of explaining to do around Europe, but the Irish guarantee was, so far, well accepted in the market, and even grudgingly admired in one or two places. But it was also evident that some governments had provided background briefings to journalists denigrating the Irish decision and its lack of community spirit. Worse than that, some of those briefings appeared to be deliberately seeking to question the validity and reliability of the guarantee.

By then, I think, I had already spoken to an official in one finance ministry in Europe and was reassured that they were not behind any of this activity, and yet journalists in Brussels had shown an Irish Government press officer a negative briefing document which purported to come from the same country's official system. It could well have been that different parts of a government system were giving different messages, or that some press-briefers were not following the official line. Or journalists were spinning yarns in the hopes of creating a reaction.

On the other hand, matters had been going well with the state aid experts in the European Commission. William Beausang had been negotiating intensively with them, in close liaison with the legal experts and the Attorney General, and while we had inserted into the draft guarantee scheme various safeguards on which the Commission was insistent, it seemed likely that the Commission would accept the most important elements of the Irish initiative, thus making it much more secure from a legal point of view. (In fact, the Commission's positive decision was announced on Monday 13 October.)[21]

Moreover, having been outwardly relatively quiet only a couple of weeks before, the European Commission and the European Union more generally was erupting with new initiatives and new responses to the crisis.[22] In the first 10 days of October, the Commission had proposed new rules on bank capital requirements, and the ECOFIN council had launched a new initiative to protect economic growth in Europe. Central Banks had cut interest rates on a co-ordinated basis. Barroso had launched a new group to examine the future of the supervision structure for banks in Europe and globally, and by mid-month arrangements were well under way for further proposals in a range of areas, from accounting standards to minimum deposit protections to crisis co-ordination arrangements[p]. But in at least some of these initiatives the aim was to accelerate the pace of plans for the future. Quite appropriate, but it was also necessary to deal with the crisis of today.

That was what the Paris Summit was for. There was a need for real European approach to the immediate crisis, and Sarkozy to his credit was determined to deliver it. Also to his credit, he invited Gordon Brown to the meeting, because Brown and his team of UK Ministers and officials were the ones who had a plan.

Until then, the Eurogroup discussions had been overseen by Finance Ministers: this meeting of national leaders, prime ministers and presidents,

[p] The cellule de crise, discussed previously

was unprecedented. Even more unprecedented was inviting the UK to play a speaking role. As a non-member of the Euro area, the UK had no right of attendance, and there was a protocol difficulty in inviting Brown but not the other non-Euro area leaders. Equally there were protocol, and no doubt practical, difficulties if they were all to be invited. So, Brown would have the most important role in the first act, but no speaking part afterwards: he would introduce his ideas, give a short presentation, then leave the room to the Euro area leaders for their discussion.

Brown outlined the seriousness of the situation in Europe and globally, even noting that a certain significant bank would probably be next to require a rescue, indicating the need also for a concerted European approach to the crisis situation and he then outlined his suggestions as to what that approach should be.

Brown in effect was proposing that the mixed approach of providing capital to banks, together with the provision of extensive state guarantees for medium term bond issues, as already being put in place for UK institutions, would be adopted as the European standard approach, and that there would be a common expression of the intention to proceed on this basis.

Finally, there was a European initiative that really could address the banking problems. It was two weeks too late to be of use in the Irish case (and perhaps it would not even have been sufficient for Ireland), and was far from being a joint initiative with European level financing and implementation, but this was a real step forward. At that stage, Ireland needed three things from this meeting

- First, steps had to be taken to underpin stability in the European banking system
- Second, whatever the outcome for other countries, the approach taken by Ireland in relation to its banking problems should not be undermined by other initiatives
- Third, Ireland being already highly stretched, should not be obliged to enter into new initiatives for which it had not got the resources

Incomplete and imperfect as it was, the new European initiative had to be regarded as positive in relation to the first of these requirements, the underpinning of broader stability. But the second two were more problematic. On the one hand, the new initiative took quite a different shape to the Irish broad guarantee approach – and we needed to be sure that the broad guarantee was not being called into question. On the other, the proposal seemed to commit countries to rescuing their banks, yet Ireland had already stretched itself to guarantee six banks based in Ireland, in theory still with the potential addition of a number of Irish subsidiaries of banks based in other European countries. There had to be some limit to our obligations. Perhaps the proposal should refer to the rescue only of systemically important banks.

The Taoiseach made these points, but got no comfort – body language and tone from other leaders was very negative.

He tried again – explaining why these issues were important for Ireland, and why an unravelling of the Irish situation would be bad for Europe. Again, the tone and content of responses and the body language, were negative. The ECB, from whom we had hoped for some support, did not help, as he underlined that in order to give the ECB the freedom of movement it wanted for the operation of monetary policy, the guarantees provided under the new initiative should never cover short term paper.[q] The Irish guarantee was already covering short term deposits and bills of all kinds. The Danes would have been useful allies, having recently announced a broad guarantee of their own, but Denmark was not in the Euro area, so they were not in attendance.

Cowen kept battling on, insisting that Irish points be heard, despite an apparently deaf ear from some of Europe's most powerful people, ranged around the room.

[q] This issue was to come up again later – the final 'deeds of guarantee' for the banks contained a clause to address ECB concerns that to the extent possible from a financial stability point of view, guarantees for short term borrowings would be minimised. Of course in practice our banks were so reliant on the guarantees that these short term borrowings were more or less essential and the restriction therefore had no real 'bite'

At the lunch break, I found one of Sarkozy's economic advisors and asked him why he thought the discussion was so difficult – we were only trying to protect our position and it seemed as if it would be easy to accommodate us. On the issue of not undermining our existing guarantee, he was reassuring. The language had to speak of a common approach, but no-one, certainly not Sarkozy, was suggesting any unwinding of the Irish guarantee.

On the question of our request, though, to limit interventions to more important institutions, he expressed his surprise at our stance – "but you have already guaranteed all of your banks". I explained that no, we had not; there were plenty of small credit institutions and, more importantly, medium sized international banks, which we could not afford to support and which had not been covered by our guarantee. Why should it be a problem for anyone else to say that only significant banks should be covered, I wondered.

Because at least one big country had lots of small banks which it might wish to rescue, if it came to it, but which might not be regarded as meeting the threshold of systemically important, was the answer.

Just as the chairman was trying to wind up the meeting, Cowen came in again – he had to be clear that no-one was going to suggest, even by implication, any change in the Irish guarantee arrangement. The response was impatient but helpful – what has gone before is unaffected, this initiative is in relation to new situations, and no one would say differently.

Looking beyond Liquidity – the capital needs of the banks

That was a Sunday. All the Irish authorities were still very busy putting the scaffolding around the guarantee. The guarantee legislation required that support of credit institutions would take place in accordance with a scheme or schemes which itself had to be presented to the Oireachtas, and each institution would have to be covered by a deed of guarantee, which would not only provide for the guarantee, but give extensive rights of oversight to the authorities, as well as providing obligations and limits which would apply to the banks. The hectic pace of work that had continued since early September had not abated and indeed the requirements of administering the guarantee were adding considerably to the workload. In the Department of Finance a new team of around about 18 people, including some of the Department's brightest young graduates, would shortly be assigned to provide additional support, and a new Assistant Secretary, Ann Nolan, would also be assigned to help.

But there was no reason for anyone to think that the guarantee had solved any underlying problems. It was best seen as a way to provide additional time for structural solutions to be developed. On that Wednesday, 15

October 2008, I sent the following message to my own team, the NTMA, the financial regulator and the central bank, as well as the Attorney General's Office and Arthur Cox:

> "Some thoughts – we have all been so busy doing the guarantee/Oireachtas processes etc. that there is a danger we will be distracted from preparations for further difficulties. We still have some imbalances out there. I think we need to think about
>
> A. What recapitalisations might be required
>
> B. What consolidations might be required
>
> C. Whether any nationalisations might be required
>
> To leave our system in a stronger position"

I went on to suggest some preparations that might be commenced and suggested a teleconference a couple of days later. I finished with "To be clear – there is no Govt policy to recap or to nationalise anything, we are brainstorming scenarios here", because I did not have any policy direction to follow, it was simply clear that the guarantee would need to be supplemented by other efforts and we may as well get started, or restarted, since these issues had been discussed to some extent already. Now they would come to the fore.[23]

Nationalisation of Anglo

I have prepared a lengthy descriptive chapter dealing with the nationalisation of Anglo, but the Inquiry has made me aware of areas of inquiry on which I am not to comment for legal reasons, and for this reason I have deleted this material. I have addressed, in a limited way, the nationalisation of Anglo and other events during this period in my written statement to the Committee.

However, at the time of finalising this Report to the Joint Committee, I have been made aware that the Joint Committee intends to issue a direction to individuals formerly employed at Anglo, Irish Life & Permanent, and Irish Nationwide Building Society to give evidence at the Inquiry. In those circumstances, I reserve my right to provide supplemental evidence to the Joint Committee to respond to the evidence that may be given by those individuals.

TRICHET'S WORRIES

During September 2010, Brian Lenihan took a call from Jean-Claude Trichet, president of the ECB. Trichet was demanding to know what Ireland was doing about the continuing pressure on the fiscal and banking position. Lenihan explained the actions that were under way – bringing transparency to the banking losses and restructuring the banking system was a priority, a new four-year plan was being developed to be published in November, to be followed by a Budget for 2011 which Lenihan was already publicly saying would be a lot harsher than had been predicted before the Summer. Every action was being taken that reasonably could be taken, but big and apparently intractable problems remained.

Trichet demanded that the European Commission be allowed to come to Ireland to examine the situation. However, the request seemed a bit redundant, since a Commission team would in fact be in town on the following Tuesday, but on foot of Mr Trichet's intervention, they arrived on the Monday instead.

The team was led by Istvan Szekely, formerly an IMF official, now working in the Commission. When I had a chance to speak to him privately he outlined some concerns he had –he thought our growth expectations weretoo optimistic. And he was concerned that if the economy performed less well than expected, we could overshoot our deficit targets. And we also discussed the dangers to access to sovereign credit markets.

And, while it was not the purpose of the Commission mission, it was clear that Mr Szekely would be expected to make an initial precautionary assessment of the potential for an EU/IMF programme, in his reports back to his bosses in the Commission (to include, I supposed, Ollie Rehn, the Commissioner and Marco Buti, the Director General of the relevant part of the Commission). So this mission – pre-planned and whose principal purpose was entirely different – nonetheless became an early opportunity for the potential parties to a negotiation to meet each other at a technical level.

Somehow, however, this short opening mission managed to get exaggerated in media discussion, with suggestions that there was a permanent team of ECB advisors operating in the Department of Finance from September 2010.

Even if there was no 'permanent team' there were considerably more contacts between Irish authorities and the European Commission, ECB and IMF than in a typical year, reflecting the difficulty of Ireland's position, and also the implications for the broader European system. In addition to a range of more 'normal' contacts with the Commission and other institutions, there was a series of additional discussions throughout the autumn. For example, in September there was an evening meeting in Brussels, with Olli Rehn representing the Commission and Jürgen Stark the ECB. On 19/20 October there was a meeting at official level in Brussels. There was a detailed meeting between Rehn, Stark and Lenihan, with accompanying officials, on 25 October to hammer out an agreement on the fiscal tightening to be expected over the following years. On 8 November, Olli Rehn came to Dublin. There were various other contacts in the meanwhile, and finally, on the weekend when two Ministers said there were no negotiations ongoing on a bail-out, a group of 15 or more Irish officials flew out to Brussels for a two day sequence of meetings on Sunday and Monday, 14 & 15 November 2010, with a similarly large group of IMF, ECB and European Commission officials in Brussels. More about all of these below.

AN IRISH TEAM GOES TO BRUSSELS

On 22 September 2010, a small team accompanied Minister Lenihan to Brussels for what was to be a confidential discussion. It included myself, Ann Nolan, Alan Ahearne, Michael McGrath and Cathy Herbert. The discussion quickly settled into what was becoming a familiar pattern: a discussion of recent events, a run over the current political considerations, a restatement of the very real efforts Ireland was making to correct its position, a request from the Commission to consider how we would react if fiscal pressures worsened, and a very clear and distinct demand for greater effort, from the ECB. But there was not a conclusion, and at this stage no-one present was actively advocating a bailout – in fact most of those present wanted to avoid it. Certainly, after spending some time with him alone, Lenihan told me that Commissioner Rehn thought it was still on balance more likely than not that a bailout could be avoided – though it had to be considered a possibility – even, according to Lenihan, suggesting that the Portuguese were a more likely candidate for bail-out at that stage than was Ireland. But Marco Buti, who reported directly to Rehn, told me separately that it was his personal view that a bailout would probably on balance be required. He was not advocating it, at this stage, merely giving an opinion on the likely turn of events. However, while neither the European nor the Irish political systems were yet prepared for a bailout, it could certainly be seen as starting to feature in discussions as at least a "Plan B", from then on.

For Ireland, however, it was considered too soon to contemplate. First, an EU/IMF bailout would provide funding for the Government, not for banks. At the time, the Government had lots of cash, having made a conscious effort through the NTMA to beef up cash balances. And although the yields on Irish Government paper were getting much too high for comfort, the last NTMA bond auction had actually gone alright – the target amount of money had been raised. Worryingly, however, there was plenty of speculation about an Irish "need" for a bailout, and this kind of talk could easily become a self-fulfilling prophecy. When the IMF lends money to a country, it takes for itself a priority over other creditors. Why does this matter? Well, if I am about to lend to Ireland, I would normally expect to be paid on the same basis as other creditors. So if 'Country A' owes €100 billion, and can only pay back €75 billion, I would expect to get paid back three quarters of my loan. On the other hand, if half of that €100 billion comes from the IMF, the IMF takes the first €50 billion and the rest of the creditors, who are owed €50 billion in total have to settle for the remaining €25 billion – they get only half. The presence of the IMF in the mix has devalued the other loans, and for atime at least the private sector is less willing to make a loan to Country A.

Moreover, if there is increasing speculation about an IMF bailout of Country A, the potential private sector lenders will be concerned that there is information about Country A that they do not have – in other words that the prospects for Country A are disimproving, and the probability of a default by Country A may seem to have increased.

So for the investor, a key measure of risk is the product of the probability of a default on their loan and the likely size of the loss in the event of a default. And apparently credible speculation about IMF involvement in a country changes the investors' view of each of these numbers, making it less likely they will want to lend, closing down the access that the country concerned has to the market, and increasing the interest rate that the country has to pay to borrow. At a certain point, the increased interest rate becomes unsustainable – the country concerned cannot be expected to be able to pay that interest rate on a large portion of its debt, and when investors believe that point has been reached, they will simply cease to lend to the country concerned at almost any reasonable interest rate.

The irony is, therefore, that the availability of a rescue for a country in trouble can accelerate the need for one. For that reason, no Irish official would be likely to speculate in public on an IMF bailout. But lots of other people seemed to want to pretend to speak on our behalf, or to make their own guesses seem like fact, in briefings and 'leaks' to newspapers and others. So there were regular denials or rebuttals of one story or another suggesting that there was any Irish Government plan to seek a bailout.

But if a bailout were to be avoided, Irish efforts to convince markets had to be successful, and the signs on this were not good. During September, a real effort had been made to get to the bottom of the problem of Anglo-Irish Bank. Anglo's situation had continued to worsen, in particular because the expected discounts on NAMA purchases of its loan book were turning out to be much worse than had originally been expected. Of course, property prices had been continually worsening so creating losses on Anglo's loans to property developers, and in the absence of any willing buyers it was hard for valuers to say what the value of any asset would be. Moreover, there was a real problem that the assets that NAMA was purchasing in the banking market were not turning out to have the characteristics that NAMA had been led to expect – on various measures, the loans were not as good as they should have been. All of this was reflected in NAMA's payment of a lower price for the assets than might have been expected, then in turn greater losses and a greater capital need for the banks.

The announcement of a 'definitive' indication of the losses in Anglo at end-September 2010, accompanied by an announcement also of a need for additional capital for AIB, created some stir in the market, and was met with mixed reviews. Some commentators were happier with a big number for losses in banks, which might be seen as getting all the remaining bad news out at once, and allowing a firmer platform for policy thereafter. Others worried that the newly announced losses, which would add to the Irish national debt, would not be easily managed by the sovereign, in the midst of what was a fast developing sovereign debt crisis. Since the previous May, led by the difficulties in Greece, markets were taking increasingly sceptical views of a number of countries and were less and less willing to lend to them. Interest rates on their bonds had to rise to provide a sufficient reward for investors willing to invest in these countries' "risky" sovereign bonds. For Ireland, this trend had continued throughout September, and towards the end of September the cost of borrowing reached the point that, in tandem with the announcement on the capital requirements of Anglo, the Government also announced that it would not borrow any further funds for a period, and in the meanwhile would draw down on the large cash pile it then held, precisely for this type of eventuality.[24]

There is no particular 'magic number' level at which interest rates become unsustainably high for a sovereign borrower: it depends on all sorts of factors. But some commentators had decided that a 7% yield might be seen as a 'cut-off' point, after which a country should be seen as being in trouble. Irish yields were heading for that point. On 28 September David McWilliams posted this on his Twitter account: "Irish bond yields touching 7%, 6.99% actually. Once they break 7, its curtains." Some of my colleagues interpreted that comment as being a bit too gleeful for comfort, but there was at least reason to hope that the announcements to be made [the next day] on the banking outlook would be sufficiently realistic to allow the markets to be reassured that the costs were still manageable.[25]

In fact, market reaction to the Banking announcements were neutral to positive, with a real fall off in interest rates on Irish bonds. But there was no great sigh of relief – the debt burden might now be better estimated, but it was still very high (and would be higher still, later) and in the context of a very negative trend for European periphery bonds, it presented only a short term relief. For a while, this trend ameliorated, and by mid-October the interest rate on an Irish ten year bond was around 6.2%. This reduction in bond interest rates may have been assisted by activity by the ECB in bond markets, but was despite the fact that rating agencies Moody's and DBRS announced they were considering a downgrade of Ireland.

Banking outflows continued, however, and the ECB concerns that had led to the phone call from Trichet to Lenihan in September had not abated. Indeed, as many of the bonds issued by Irish banks under the original guarantee programme (now replaced by a second version) matured in September 2010, the overall reliance of the Irish banking system on central bank funding had increased considerably. This was inevitable, and to some extent expected[r], but combined with the pattern of outflows, it left the ECB anxious and frustrated[s]. They wanted Ireland to have a 'Plan B' but the only one of those available might be to seek assistance from the IMF and EU partners, which would not directly address bank liquidity. An alternative (or indeed complement) might be a much bigger frontloading of fiscal adjustments – in other words a very big set of cutbacks in Budget 2011. But this would risk further slowdown in the economy: the major adjustments already made had been more or less accepted by the people, but it was not clear what would be the consequences, economic and political, of a further very large adjustment in the coming year.

[r] There was a quite lengthy delay in receiving European Commission approval for a limited extension of the bank guarantee system, which may have exacerbated the situation, however.

[s] At this precise time ECB officials were talking about reducing the extraordinary size and nature of central bank support to the banking system, prompting markets to think they were likely to be less willing to provide funds to peripheral banking systems – see the interesting paper 'Did the ECB Cause a Run on Irish Banks?' by Gary O'Callaghan, February 2011

BACK TO BRUSSELS

It was against this background that Lenihan, myself, Michael McGrath and others flew out to Brussels on 25 October 2010 to see European Commissioner Olli Rehn and ECB vice-president Jürgen Stark.

The first part of the meeting was with the European Commission only – maintaining for a brief moment the fiction that the ECB was present to deal mostly with banking matters. Commissioner Rehn greeted us with his usual courtesy and we quickly got down to business. Economic figures and expectations are regularly shared between member states and the European Commission, so they had a good idea of what our projections for 2011 looked like. Irish authorities had concluded that some increase in the originally proposed adjustments for 2011 would be required, so that the adjustments planned ought to be in the €4.5 billion to €5 billion region. Rehn's staff – he was accompanied by Marco Buti and Istvan Szekely – were convinced on the basis of their different nominal growth projections that a greater adjustment still would be required, and while they were not in the room for the start of the discussion, we knew that the ECB were likely to be very hawkish, and probably thinking in terms of €7 billion or more of tax increases and expenditure cuts in the coming year. Indeed, the opening position of the Commission was that reaching that 10% figure might actually require more than that. There were also technical points to do with interest on promissory notes given to Anglo-Irish bank which affected the figures – in particular how those might be treated in the calculation of the deficit. All were convinced that getting the deficit down below 10% of GDP in the following year would be essential to maintaining confidence and in being able to fund the activities of the Government.

Rehn's main points were that

(a) Frontloading the fiscal adjustments now would lead to less pain later, because the strong political commitment shown would be more convincing to the markets – he quickly came down to a figure of €6 billion as his bottom line

(b) The different macroeconomic assumptions of the two sides were a problem

(c) Politically difficult longer term measures were necessary to underpin the credibility of the adjustment – he talked about pension cuts and social benefits

(d) The public and the markets needed early indications not just about plans for 2011 but also for a number of years out – to allow them to see the structure of the planned adjustments and plan accordingly

(e) There needed to be a strengthening of the legal framework governing the budgetary cycle – more 'rules' about budgetary discipline, in other words.

(f) There needed to be a new strategic plan in place for the banking system, complete with timelines.

Lenihan had no issue with some of these suggestions – they were along the lines of the Government's plans and expectations. But there were problems with others. The differences in macro-economic assumptions led to a technical difference between us in reaching the target of a 3% deficit by 2014. (The IMF already believed this was an unrealistic target, but the Commission was not ready for that discussion at that stage). But even allowing for that difference there was some real space between us on what the 2011 adjustment should be. Lenihan, in the course of the discussion had already drifted towards his limit of €5 billion and Rehn had come down to €6 billion, but there the room for manoeuvre seemed to stop. The technical issue around the promissory notes could be further discussed by technical experts, including in Eurostat (the European Union's central statistics office) – but the Eurostat view would of course be independent of the Commissioners.

We got into details. An adjustment of €5 billion in 2011 would probably break down as around about €3.8 billion in spending cuts and €1.2 billion in tax increases. We preferred to emphasise spending cuts over tax increases, as they were regarded as less damaging to the overall economy than generalised tax increases. Some of the spending cuts could come from the capital programme, but a large amount would have to come from current spending, and Lenihan explained that this would probably mean big reductions in health, education and welfare. Education, he explained, is harder to cut because we had a rising school age population. The technical matters could continue to be discussed, but the bottom line for Lenihan was that the scale of cuts being suggested by the Commission would mean further cuts in pay and social welfare, which would be deflationary for the economy, as well as big tax increases for the low paid.

To deal with the final point of the discussion – banking – Jürgen Stark and Klaus Masuch of the ECB joined the discussion. Mr Stark outlined some 'facts'. The ECB was owed €116 billion by Irish banks and the situation was getting worse – this was not sustainable. A large amount of money was owed to the Eurosystem via the Irish Central Bank in the form of Emergency Liquidity Assistance – in particular by Anglo. 'Emergency', Stark noted, was supposed to mean short-term and there was unease in the ECB about the ongoing nature of this lending, which had to be re-approved every two weeks. There was therefore an urgent need to consider a restructuring plan for the banking system, which should be part of an "overarching programme" also involving fiscal adjustments. He noted that the Greeks were able to continue accessing ECB funds only because they were in an EU/IMF programme, which gave the ECB some confidence in getting its money back. He again talked about the danger that access to funding would not be available and that there had to be some consideration of the other possibilities.

At one stage in the discussion, it was suggested that one-off measures be used to bridge some part of the gap between the €5 billion limit of the Irish side and the €6 billion minimum of the European side. One off measures are measures that can generate revenue or reduce spending in a single year, without having a knock-on effect into other years. For example, a 2% tax increase will generate income in the year it is introduced and every year afterwards, unless it is reversed, and so it is not a one-off measure. By contrast, a one-year levy, or the sale of a licence for a lump sum only impact the budget in the year that they happen. So if you need to reduce your deficit by €10 billion in two years, and in the first year you achieve a €5 billion adjustment, but they are all in one off measures, the deficit reduction in the second year is still €10 billion. For that reason one-off measures are a sort of second-class adjustment – they save some money, always a good thing, but they don't help to make progress towards the longer-term goal. For that reason, they might tend to be dismissed somewhat in fiscal planning terms.

The full meeting broke up, but Rehn, Stark and Lenihan had a private discussion. Lenihan came out of that meeting. He thought that the Commission and ECB would accept a slightly lesser multi-annual adjustment than they had envisaged, if we could achieve 2011 fiscal measures totalling €6 billion. Moreover, Lenihan reported that they would accept several hundred million of one-off adjustments in that €6 billion: the question was, did we have a way to find those one-off measures? I said yes, we probably could, and asked the Minister to give us a few minutes to make some calls. I called the Secretary General of a Department: can we advance the sale of some licences that were otherwise planned for the following year? Someone called the public expenditure experts in Dublin – they proposed a couple more measures. Was there any property we could sell? (It had to be physical property, land or buildings, as sales of shares and stocks don't count towards the deficit in European accounting terms). We thought too that there was probably some room for manoeuvre hidden away in the debt service estimate prepared by the NTMA, and a conversation with John Corrigan at the NTMA indicated that they could indeed make a contribution[t].

So very quickly we were able to confirm to the Minister that yes, we could generate a significant number of one-off adjustments for 2011, mostly using measures already envisaged but perhaps not for 2011. It seemed we had, if not a deal, a route to a solution that could be worked out in the following days, which would probably be acceptable to all sides, and when the Department's Economic Review and Outlook was published in the first week of November this adjustment package of €6 billion in year 1, and €15 billion over four years, formed the basis of the fiscal programme.

[t] He was able to confirm again by email the following day.

But by the end of that month, October, there were still problems: the sovereign debt position was not going to right itself any time soon. The decision of the NTMA at the end of September to step out of the market temporarily was the right one – there was no point in borrowing large amounts of money in the market at interest rates that were so high they would themselves start to create fiscal imbalances, especially when we had a significant pile of cash in the bank. But that cash would be gone in a few months: unless there was some reason to expect that the market access of the Irish Government at reasonable interest rates could be restored, we could expect to see that cash pile eroded month by month, until in about 3 or 4 months, the markets would decide that our funding difficulty was now becoming a funding crisis. And the Irish sovereign debt problems were unlikely to ease unless the broader international sovereign position also eased. But there was no sign of that, as pressures continued on Portugal and even Spain, though to a lesser extent. And just as the developments in Greece had had a devastating effect on willingness to lend to Ireland's government or banking system, the combination of circumstances in Ireland risked creating a contagion effect in other parts of Europe.

This situation had been made worse by events at Deauville around the middle of October.[26] There, among a range of other suggestions for future European policy, the French President and German Chancellor decided to support a package of measures for European economic governance, several of which were controversial. To much of Europe it seemed rude and high-handed. Discussions were going on in other fora, in particular at an ECOFIN meeting, that same weekend, and the joint announcement seemed designed to make those ECOFIN discussions redundant.

But for Ireland, and other countries in more immediate danger, these economic governance issues were important, but not the main issue arising from Deauville. Because amidst all of the other matters dealt with at Deauville was a declaration that in the case of sovereign debt crises there would in future be "un traitement ordonné des crises dans le futur, comprenant les arrangements nécessaires pour une participation adéquate du secteur privé". An orderly treatment of future crises, to include the necessary arrangements for an appropriate participation of the private sector. It was taken to mean, and it did mean, that there would in future be a mandatory system of orderly defaults on sovereign debts. There was uproar.[u]

The problem was this: if investors believed that instead of being able to rely on the determination of a country to repay them, whatever their difficulties, they could now expect that the same countries might be *required* to default on the same bonds, in certain circumstances, then one would have to place a lower value on those bonds. Moreover, and worryingly, speculators had a very strong incentive to 'short' the bonds of countries in difficulty because if the pressure on the market created by the shorting activity led to a request for a bail-out, then they (the speculators) could not lose. The same kind of speculative activity that had burst apart the

[u] Mr Trichet described it thus: "the so-called Deauville doctrine embodied the idea of compulsory private-sector involvement: Any government having recourse to the European financial help would have to obtain debt relief from its private-sector creditors as well. Since any country in potential difficulty was subject to this rule, it frightened traditional investors and excited speculators, who saw the move as guaranteeing profits for short sellers"

exchange rate mechanism in the early 90s might drive a wedge through the Eurozone.

Very quickly indeed, press officers rushed to make clear that this was not about the current situation of Greece or Ireland or any of the countries in difficulty at that moment. Rather, this was about how new crises would be dealt with. But the damage was done. Now, market participants must consider that the policy position of the two most important Eurozone countries, and therefore shortly of the Eurozone itself, was that sovereign defaults might not just be acceptable, but might actually be mandatory, before external public sector assistance would be made available to a country in trouble. These comments from an investment analysis produced by RBS in early November makes the point:

> "This private sector participation risk has always been a nightmare scenario for EMU in our view - and has all the hallmarks of making tensions a self-fulfilling prophecy. As we relayed earlier this week ... this changes the very nature of EMU and the risk taking in sovereigns and their banks. In short, this would mean an assessment of EMU sovereigns on much more standalone basis and a basis where the usual adjustment cushions of FX and central bank rates are not available."

It should be said, however, that there are some who do not regard the effect of Deauville as having been so negative, and it is hard to separate the Deauville factor from everything else that was happening, but it is certainly the case that very many people with an interest in the issues regarded the Deauville announcement as damaging to confidence.

Nor was there any improvement in the banking situation. Funds continued to flow out of the banks over the month[v], and the exposure of the Irish banks to the ECB – a good proxy indicator for the liquidity strain on the system – continued to mount.

At every point of contact between Irish authorities and the ECB it was clear that the tone and content of ECB comment on Ireland was becoming more strident and more panicky. In this period started what I regard as an increasingly hectoring tone on the part of the ECB. They would make assertions of their policy position that seemed to be more based on their own assertions of how the world should operate than on the Treaty and the law.

Over the following months I heard more often than I care to remember assertions like "ELA is supposed to be short-term, and cannot continue" or "funding to a Government owned bank is monetary financing and monetary financing is contrary to the Treaty". Worse, there might be talk of penal interest rates being charged to banks which were relying regularly on access to ECB funds and we would be reminded regularly that the funding of Irish banks relied on the acceptance of different types of assets as collateral by the ECB – and the collateral rules or their interpretation in the Irish case

[v] about €4 billion net for the four weeks to 29 October, for the banks being supported by the Irish Government

could be changed. So amidst the massive support and genuinely helpful assistance of the ECB in maintaining some stability in the financial system, there was this heightening of tension and increasingly strident rhetoric.

And although all of this seemed unpleasant and less helpful than we might have liked, to a significant extent the ECB was correct – things were definitely getting worse, and they were right to worry that Ireland was not doing enough to address the problems. But this was not for want of effort, but rather because the scale of the problems was overwhelming the resources available to deal with them. The ECB worried that they would be expected to finance Irish solutions, but without finance there were no solutions. And without solutions, the ECB's exposure in Ireland would get worse.

THINKING ABOUT THE ECB

I thought there were two main flaws in the ECB's thinking at this point. The first flaw was a belief that if only Ireland would do enough frontloading on the fiscal front – more austerity – that the whole position would stabilise. This was based on an assumption that greater deficit reduction would be seen by the market as very positive, that funding for the sovereign would improve, leading to greater scope for the Government to address banking problems. But the problem was that at that moment – with a generalised weakening trend in the market not just for Irish but for all peripheral (and some less peripheral) countries' bonds, it was unlikely that any reasonable fiscal effort by the Irish authorities would be likely to turn the trend around. There was a better chance that a credible four year plan would help to alleviate the situation, but if the ECB's panicky state of mind became known in the market, this too would tend to lead to market weakness rather than strength. The only way to achieve a turnaround in market sentiment would be if the Irish banks' liquidity continued to be supported, and the Irish government's credibility was underpinned by planned actions over a period of months, not days or weeks – a turnaround was going to take time.

A second key flaw was based in the design of the ECB's central banking functions, and their interaction with the other national central banks within the Euro area. One of the functions of a central bank is to act as a lender of last resort (LOLR). This means that in cases where a bank has not enough cash or deposits to meet all its obligations on any given day, it can go to the Central Bank for funds, and this is a perfectly normal element of banking systems (I have explained this earlier). In the case of the ESCB – the system of the euro areas national central banks and the ECB itself – this system is supplemented by national central banks being in a position to offer emergency liquidity. So, if a bank is in big trouble, but still solvent (or being kept solvent by a Government) it can go to the national central bank for funds. In this case, though, any losses arising if the bank eventually went bust would be a loss for the national central bank.

Moreover, during the crisis period, the ECB insisted that every country in Europe would promise to make good, immediately, any loss incurred by a national central bank in giving ELA. This means that when a bank is in trouble, it is a burden on the national fiscal position, unless the State and the national central bank are prepared to see it go bust, with all the damage that might do. Moreover, as the ELA has to be approved every two weeks by the ECB Council, and as the ECB's view is that this type of funding must be seen as short-term, there is a real pressure to find a way to put the bank in trouble onto an even keel, or to wind it up in some way.

In a case where a single bank is in trouble, in an otherwise stable system, this approach makes a lot of sense. But when a whole banking system is in difficulty at the same time as national level fiscal difficulties, it is a recipe for exacerbating the overall problem:

First, the greater the strain in the system, the more the burden of supporting it is passed from the collective ECB level, to the much weaker national level. In other words, at the very moment when the national systems are weakest, they are asked to take on the heaviest loads.

Second, the insistence that Governments back the national central banks means that there is a growing (and potentially truly enormous) contingent liability for the State at precisely the moment when the State is least able to accept such a burden. And in such circumstances, asking a State to give more support to its banks, or to take over the task of liquidity provision from the central banking system, is to ask it to do the impossible.

Third, the ECB's 'insistence that a bank which has been nationalised by the State precisely because it is in difficulty, should then be seen as an arm of the State, and therefore that any funding to that bank should be seen as being a potential breach of the Treaty prohibition on monetary financing, means that any Government trying to cope with the confused and frightening mix of circumstances that characterises a financial crisis cannot rely on a stable policy position and ongoing support from the ECB. At any time, the ECB can block ELA at national level or change the rules under which the banks can access funds at the ECB level. Worse, because it sees itself as independent of Governments, the ECB will not 'do a deal' – they will demand action on a particular by a national government on a particular basis, but any reassuring noises they are prepared to make in private about the ECB's response to this action will in many cases not be accompanied by firm confirmation to the market that support will continue. So it is very difficult to plan any action under these circumstances.

It should be said that these design elements of the European System of Central Banks are not an absolute requirement of the European Treaties. The Treaty does not provide any significant guidance on how central banks should respond in a crisis, it does not require that Governments promise to make good any losses of national central banks, it does not require that the ECB avoids taking losses itself in all circumstances, and it does not include a prohibition on lending by the central banking system to a bank which has been nationalised and is in difficulty.

The Treaty does make the maintenance of price stability the principal function of the ECB, which means that even in the middle of a financial crisis that is threatening the very existence of the currency, it does not have financial stability as its principal purpose.

The irony is that despite its apparent reluctance, the ECB did provide enormous support to Ireland and other countries over a medium term horizon, and allowed the continuing support of nationalised banks by ELA and ECB funding. They acted in many ways which were very supportive, even while their communications were sometimes undermining of the Government and its efforts. It was a strange mix, and it would have to be said that this led to there being at times a more emotional tone to business discussions than seemed useful. But perhaps they could say the same about us?

A LETTER FROM MR TRICHET

Many of the elements of the characterisation above of the ECB's policy position can be seen in the letter sent by Mr Trichet to Brian Lenihan on 15 October 2010.[27]

The letter is, naturally enough, couched in the usual official language, but it's interpretation seemed to us to be clear enough: The ECB was saying, in effect, "okay, we are glad you engaged in discussions with the Commission as suggested by us and that the ECB was involved in those discussions (as in the meeting with Stark) and we are glad too that we have agreed between us an appropriate level of fiscal consolidation over time."

But in the second paragraph Trichet points out that the banks are still in trouble and the ECB does not like that, reminding Ireland that the ECB is not obliged to keep supporting them, especially if conditions worsen and Ireland does not play its part in dealing with the situation. Then, in the third paragraph he could be interpreted to be saying "and by the way, we can also block the provision of ELA, so again Ireland needs to be doing its part". But he does say in the fourth paragraph that Ireland cannot expect this level of ECB funding "permanently" – so at least he is not pretending the situation can be fixed overnight. Finally, in the last paragraph he is in effect underlining that the fiscal package that has been agreed has to be stuck to or the consequences could be dire.

Lenihan did write back to Trichet in early November, although most of Trichet's previous letter had not demanded a reply, but instead was setting down a position, and Lenihan's letter was not a direct reply to Trichet.

Lenihan's letter, which I am sure I had a hand in drafting (but no longer remember the details of who drafted what parts) points out in different words that "yes, we in Ireland are in a very tough spot, but we are doing all we can, witness our recent fiscal announcements. But we are not being helped by interventions such as the Deauville declaration, and indeed other pronouncements by senior politicians in Europe. Maybe you, as President of the ECB, could help calm things down?"

At this stage, the possibility of a bail-out being required is of course on the minds of both men: how could it not be? By the date of Lenihan's letter, the yield, or effective interest rate, on Irish 10 year bonds had climbed to nearly 8%, compared to less than 5% three months beforehand, indicating the growing strain on the State's potential to fund itself, and there had been no let up on the banking front, with fund outflows of around €2 billion, in just four days[w]. But neither was calling for a bailout yet – give the fiscal plan some time to be absorbed and see if that helps to stabilise matters.

[w] There were of course days and weeks when there were inflows also, but the net trend had been consistently negative

REHN VISIT OF 8 NOVEMBER 2010

A few days after Lenihan sent that letter to Trichet, Olli Rehn came to Dublin. He and his team, including Istvan Szekely and Stephanie Riso from his private office, were met by Minister Lenihan, myself, Alan Ahearne and Cathy Herbert.

Some of the discussions were more or less technical, but important just the same. There were differences between Irish Government and European Commission economic forecasts, for example, which had to be resolved or explained. Rehn was accepting of the proposed €6 billion fiscal adjustment for 2011, but he wanted to see real and convincing adjustments to the structure of the economy in the Government's 4 year plan, then under construction.

Rehn also wanted there to be some provision in the plan for additional fiscal adjustment if the economy underperformed the forecasts. Lenihan agreed to this, given that he was not willing to put into the plan a €17 billion adjustment over four years, which would be what was implied by the Commission forecasts. All cuts hurt, he said, so he did not want to cut harder than he had to. But there was discussion of a wide range of structural and fiscal adjustments. Social Welfare, public sector pensions, the tax base, the difficulties of making cuts in the hospital services, even water charges, came into the discussion of what might be done over the next four years.

There was a good deal of consensus, but not total agreement. VAT increases were a problem for Lenihan, because of the danger of driving trade across the border into Northern Ireland. Rehn was suggesting earlier publication of the 4 year plan, with very specific measures. Lenihan was concerned that publishing as early as 15 November would leave too big a gap between the plan and the Budget in early December.

And there was a discussion about a bailout programme as a real possibility. Rehn was in favour of a programme – perhaps to be announced around the same time as the four year plan. Lenihan was noting still that Ireland was well funded – it was not entirely clear that funding by a programme would be required, but he could countenance some sort of precautionary facility, and an associated economic and fiscal programme. Moreover, there was some level of agreement that technical work in relation to the funding and banking situation in Ireland could go ahead. The day after Rehn departed from Ireland that work started, but at that stage even the Commission was talking about a programme of work over "the next couple of weeks" that could identify and resolve differences of understanding between the potential programme parties.

But there was no decision at that stage, and Rehn was not pushing for an immediate commitment to enter a programme. Instead, the target seemed to be to be well prepared for a potential decision, perhaps on a precautionary basis and around the time of publication of the 4 year plan, which was not for two or three weeks yet. There seemed to be time for an orderly discussion and proper democratic decision-making.

That changed.

Suddenly, strange things started to happen. Lenihan heard from Korea, where the G20 summit was in train, that Ireland was apparently becoming a feature of important discussions among world and European leaders.

This was not surprising, but what was more surprising was that it was being suggested in Korea that Ireland had already decided to seek a bailout. . Someone over there, at a forum where Ireland was not represented, was apparently taking it upon themselves to announce a decision Ireland had not made. Messages came from all around. Parliamentary Questions were put down – is it true that Ireland is currently negotiating a bail-out? Dan Mulhall, the Irish ambassador in Berlin, spoke to a high ranking German official, later a senior figure in the Brussels system, who had been given the same story.

Meanwhile, I got a phone call from a contact in the US Treasury – he had heard we were in bailout discussions with the IMF, also from sources in Korea. I emailed the IMF – could it be that our precautionary discussions up to now were being misrepresented deliberately? They replied that all internal discussions in the IMF were highly restricted and they were going to tell Smart that there were no programme discussions ongoing.

An Irish contact in the IMF sent a message to Michael McGrath, in the Department of Finance, to let us know the kind of material that was swirling around among IMF executive directors; he included material apparently from a global financial firm, saying that intensive discussions were under way, with a view to final decisions in the Eurogroup on 16 November.[28]

All of this was interfering with the proper conduct of business: because of the messages emanating from Korea, my colleague in the Department of Finance, Jim O'Brien, indicated to the chair of the Euro Working Group – a gathering of very senior officials, which often led policy discussions on serious difficulties within the Euro area – that the Minister did not feel a discussion of Ireland's situation should be on the next Eurogroup Ministers' meeting.

There was so much momentum, and specificity, behind these rumours that it seemed to us that there was a serious attempt being made by high level individuals, either in the European institutions or in the member states to force Ireland's hand. It did not seem to have emanated from French colleagues, even though the Germans seemed to have got it from the French, the Americans said 'from Korea', Rehn's staff were of the same opinion as us as to the outcome of the 8 November meeting, so presumably the rumours were not coming from them, and the IMF officials we were dealing with had also seemed puzzled by the rumours. The market rumours were capped by a persistent Reuters story on 12 November 2010, quoting "Eurozone sources" as indicating Ireland was already in discussions for an

EU/IMF programme, even going so far as to indicate some of the terms apparently being negotiated.[29]

And of course, all of these rumours had real impacts. Not only did we have to worry that market confidence in Ireland would be damaged, but there was a real damage being done, here, to the democratic process. At this stage, it seemed unlikely that we would avoid a bailout package. And in fact, at this stage it seemed unwise to seek to avoid it. Bond yields heading for 9%[x], flows continuing from the banks, and insufficient national resources to deal with the scale of the problems: getting some help from elsewhere seemed like the logical thing to do. But this was not a decision for officials, or for a single minister, this was something that should be decided by a cabinet, considered properly, debated in the Oireachtas, and someone was trying to rob us of the time and space to do all of that.

If it is the case that hidden 'sources' were using leaks of inaccurate information to bounce Ireland into a bailout (which was sadly by then inevitable anyway), then the people concerned were not just undemocratic, but anti-democratic – they ought to be asked to explain their actions, but they would first have to admit them. Who was in Korea, pretending to announce that the Irish Government had decided to seek a bailout? Who, in Korea or elsewhere, was taking these false rumours and putting them into the hands of press and financial commentators? Were any of these leaks being made direct to Irish journalists – what can they tell us? And why did

[x] Although ironically there was an initial reduction in bond yields on the putative news of the bailout

journalists not challenge the source of these leaks – they know that behind every leak is an agenda, so why were these 'stories' pushed so uncritically into the public media with little explanation of their source or of the driving agendas at play?

A FURTHER MEETING IN BRUSSELS

That weekend a bunch of civil servants – as well as people from the NTMA and Central Bank – travelled to Brussels.

We had an important but limited mandate and certainly had no mandate to arrive at any agreements. We were in particular to discuss the banking situation to see what common conclusions could be arrived at in relation to how we might start to repair it, and we were to engage with the European Commission, the IMF and the ECB about what type of terms might be available if there was a decision to seek the assistance of an EU/IMF programme.

The meetings in Brussels lasted for two days, and much of the discussion in which I was involved went around in interesting circles – neither side wishing to show their hand too early. I was in a room, for most of the time, with Patrick Honohan and John Corrigan on the Irish side (sometimes others joined). In separate rooms, various teams were ploughing through an agenda of work on more technical matters (especially on the banking system and on fiscal expectations) and reporting back to us occasionally. In the same room as me were Istvan Szekely, Ajai Chopra of the IMF and Klaus Masuch of the ECB: these were the some of the senior faces of the Troika we would find ourselves dealing with most closely in the coming years.

By the end of the first day of discussions a few things were becoming clear.

- It was clear, for example, that neither the IMF nor the European emergency financing facilities could provide bank liquidity – that would have to come from the ECB[y]: the ECB would hint, go close to a promise, that if we joined an EU/IMF programme, the ECB would continue to fund the Irish banks, but they would not make this part of any explicit agreement.
- It was clear too that the people in the room had no mandate to discuss the interest rates to be paid – the IMF rules were fixed and the EU and EFSF facility rates would be a matter for the member states to decide together
- There would be important obstacles to agreement. It seemed likely that demands to change our corporation tax rates would be made by some countries. Others might seek collateral for their loans, which could create enormous practical, political and legal obstacles.
- There were limits to the scale of the programme – about €65 billion was the number in mind – based on a combination of an assessment of how much funding Ireland might need for a three year programme and the amount that EU officials believed might be raised, after discussion with some of the member states concerned.

[y] This was not a great surprise. The sheer scale of the liquidity needs of the banks were so large that one really needed the ability to print money to meet that demand – only the ECB could do this and the other EU support facilities and the IMF each had limits – they had to conserve some firepower for other potential troubled cases.

While on the one hand, the EU/IMF staff were pressing for greater certainty about Irish intentions, we were anxious to be able to report back to Dublin on the likely shape of any package. In other words, if the Irish Government decided to request a bailout, what type of conditions would apply? This was very important, because once the request had been made, Ireland would lose much of its bargaining power.

Towards the end of that afternoon, the IMF produced a note on the elements of a programme[30] - it lacked detail, but these could be fleshed out the following day. There were no highly objectionable elements, and everything envisaged by the IMF's 'elements' would equally be built into any sensible plan that we might design ourselves. The Minister was checking in from time to time and I was able to say so.

I had been very clear in the discussions about our views on the corporate tax issue. We were not able to concede anything on that point and it could not be a condition of any programme: how could we put the Irish economy back into a stable situation if we were to undermine the export sector from which the necessary growth would probably come. And why would partners who wish to help us think that this would help – it seemed more like using our temporary weakness to extract long-term competitive advantage.

The Commission was also clear – this was not their demand, they were simply indicating that this point was likely to be pressed by some countries who might insist on its becoming part of the conditionality of a programme. On that basis I indicated that there might be no agreement on a programme any time soon. Helpfully, the IMF were not interested in the tax issue and I knew that at least one major country had indicated that its representatives at the IMF would resist any attempt to make corporation tax concessions part of the deal, and I hoped that the message might have been passed on.

Later that evening, myself and Honohan had dinner with Mr. Szekely and his boss, Marco Buti. We went over the day's events and the prospects for Ireland and Europe. Walking through narrow side streets on the way back to our hotel, Honohan told me that while I was washing my hands, Buti had taken the opportunity to tell Honohan that I was unrealistic and that we would have to concede on the corporation tax issue.

Discussions continued the next day, and we fleshed out more detail – not of the programme, since there was none at that stage – but of the likely demands of the EU/IMF parties in the event of a programme. What kind of structural measures, for example, would they be looking for? I don't remember the full list now but none of the discussions suggested that they would be likely to seek unreasonable concessions. The fiscal pathway they had in mind was in line with that which had already been outlined by the Irish Government and the structural measures were not out of line with those we were already considering in the drafting of our 4 year plan. I was able to tell Lenihan as much and he was reassured.

The problem issues were clearly going to be in the banking area. Matthew Elderfield reported that after two days of intensive discussion, questioning and debate, the EU/ECB/IMF team, who it seemed to us had expected to be able to find flaws in the capital exercises already carried out on the Irish banks, were in fact somewhat satisfied with the information they were being given. There were no big obvious flaws in the work done to date on which we had based existing capital calculations.

But in some ways that left the situation even more complicated – even if these potential new partners could be persuaded about the appropriateness of our methodologies, the simple fact was that the market was acting as if the banking system remained fundamentally broken. There would have to be considerable further discussion, including in relation to reducing the size of the sector, fixing the loan to deposit ratios so that the Irish banks had a much more balanced mix of assets and liabilities, and indeed more discussion about the level of capital in the banks and how it could be addressed in a way that helped to provide stability.

Overall, though, these two days of discussions had achieved quite a bit. There was one point of disagreement, though, towards the end of day two, I think. Mr. Masuch said that his bosses in the ECB would now hope and expect that the Minister for Finance would immediately announce a decision to enter a bailout. I think everyone in the room at that stage believed a bailout was inevitable, and in some ways this was not a strange request, suggestion or whatever it was. But I felt obliged to explain that they had been talking to an official, working for a Minister – there were others to be consulted and reassured – the Government would have to decide on this, not just a Minister. I knew from Lenihan that I could tell Masuch that we were committed to work towards a very quick decision, and I did so, but there were questions unresolved at the end of this two day discussion, which could only be resolved at the level of the Eurozone and ECOFIN. Mr. Masuch was reassured, a little, by our promise to work quickly, but I remained a little surprised by the expectation that I would have been able to convey definite decisions that day.

MINISTERIAL DISCUSSIONS

I knew from emails over the weekend that the speculation about Ireland's entry to a bailout package was extraordinarily intense. The Department of Finance Press Officer had indicated he received no fewer than 25 calls from journalists before 11.30 on that Sunday morning, 14 November, for example.

But I had been working or travelling non-stop for two days and I was not aware that two Ministers had denied in quite a stark way that there were any negotiations going on. So I was surprised to be asked by a Minister very shortly after those weekend discussions, whether our discussions had amounted to a negotiation. I responded, so far as I remember, by noting that I had no mandate to decide anything, but that I was discussing possibilities and asking questions and the other side was doing the same. None of us could make commitments, but it did have the characteristics of a negotiation. I understood the context better later, and felt sorry for the two ministers concerned. Clearly, the communication at Ministerial level over the weekend had not been clear enough to prevent them walking into trouble. I wondered if there had been a misunderstanding.

I simply don't know the answer to that question, but I do know that the situation was extremely difficult for everyone concerned – announce or agree with journalists' queries that we were negotiating for a bailout, and parties which wanted to seek concessions from us in return for the bailout would be at an advantage, because once we had announced it, there would be little bargaining power left. Be too coy, and the public would later feel misled. Tell too many people about the discussions in Brussels and risk a leak and further market disruptions. No good options.

The fact is that there were talks going on about the potential for a bailout – but they were preliminary at that stage and aimed at outlining an agenda, and some limits, for further discussions that could then lead to a decision. It was, at that stage, still just talks about talks. But the direction was very clear.

Matters moved even more quickly from then. Minister Lenihan reported to the Cabinet on Tuesday the outcome of the Sunday/Monday discussions. Unusually (it arose only a few times in my career), I was asked to participate in a short part of the meeting. The purpose of the meeting was to give the Minister clearance to negotiate at the Eurogroup and ECOFIN meetings that week. Immediately after the Government meeting, the Minister, myself, Jim O'Brien and a small team headed back to Brussels to be in place for the Eurogroup discussions that evening.

These were tough. There was great pressure on Lenihan to agree immediately to request an EU/IMF programme. From the point of view of other Ministers, there seemed little point in a delay. What was Ireland waiting for?[31]

Well, the answer to that question was simple enough: he was not yet in a position to do a deal. At the same time as they were planning to be supportive and to put great resources behind the Irish Government's efforts to restore the Irish economy and fiscal position, some of the member states were adopting a threatening stance in relation to key elements of our business model – they had been demanding changes in corporation tax structures, for example. In addition, there were parties in the discussion who had been most anxious to require Ireland to adopt much tougher fiscal targets - perhaps tougher than the economy and the people could withstand. Others wanted to impose collateral requirements on Ireland: the pledging of specific assets against loans, a process which would have been enormously disruptive and counterproductive. There was also a need to see if the ECB could be persuaded to be more helpful still.

There were no indications that the ECB or any of the other parties could be persuaded to make a general long-term bank liquidity facility available as part of the programme, but that left a big gap in the programme – up to now, the fiscal crisis was driven only in part by the banking crisis: the reversal in the fortunes of the banks had led to big capital requirements that imposed large one-off additions to the National Debt. However, the deficit reduction effort was mostly arising from increased social spending arising from the recession and hugely decreased revenues arising from the same economic circumstances – just as the demands on the Exchequer had risen, its resources had plummeted.

However, the banking situation posed huge risks that had to be addressed before lenders would come back into the market for Irish Government paper. Even if the deficit could be stabilised over time, we needed to address the banks' ongoing problems, including their funding. If a programme was to work, Lenihan at least needed to be persuaded that the ECB would continue to fund the banking system. If this was not to be the case, a very different set of decisions would be required.

Moreover, Lenihan did not have the Government's permission at that stage to agree to request a programme. It was clear that such a request would have to be made, but Lenihan did not have a *carte blanche* and the democratic process could not be entirely set aside – he would have to report back to the Government.

There was one concession he could make, however, especially since the demands for corporation tax changes seemed to have been set aside for the moment at least, and since the demands for collateral appeared to be coming only from a small minority. Up to now, the discussions had mostly been taking place in Brussels, and the IMF had not been involved in on the ground discussions. Lenihan could reassure the Eurogroup ministers that we were moving in the 'right' direction by allowing the symbolically important step of meetings taking place in Dublin, where they could be better informed and more extensively serviced, which would include all of the Troika parties, including the IMF. And he could promise that the Irish Government would make its decision very quickly. Thus it was that the parties announced that there would be a series of 'short and focussed consultations', aimed at determining the correct next steps for Ireland.[32] Crucially, these were to take place in Dublin.

The agreed statement of the Eurogroup included some important language from an Irish point of view. First there was a general statement that Ireland is working hard to address the crisis, intended to reassure markets about future direction, but also to acknowledge real efforts made already. Then there is a welcome for the fiscal outline of the forthcoming four year plan:

> "The Eurogroup welcomes in particular the announcement by the Irish authorities that their four-year budgetary strategy will be frontloaded by € 6 billion in 2011 on a total consolidation effort of €15 billion."

This indicated the Eurogroup's acceptance of the broad outlines of the fiscal consolidation – no additional austerity beyond that already planned.

However, they would expect that the four year plan would also include significant structural adjustments to the Irish economy. This was also in line with what the Minister already had in mind, so was not a threat to Ireland's position. However, although they were accepting the Irish fiscal plan, there remained some doubts about whether it would be sufficient over time, so they wanted there to be annual reviews which, reading between the lines, would also allow for further fiscal measures if required:

> "Together with the structural reforms that will be announced in the strategy, this budgetary adjustment should allow Ireland to return to a strong and sustainable growth path while safeguarding the economic and social position of its citizens.
>
> We nevertheless invite the Irish authorities to include an annual review in their strategy that will allow them to cope with the implications of less favourable macro-economic developments were they to arise."

As far as the banks are concerned, the statement notes that market conditions have not stabilised and more efforts will be needed. In other words, any programme will have to deal in detail with the banking sector.

Overall, this was not too bad for Lenihan – he got a day or two of space to consult, consent that the main fiscal and economic plan would be on the lines he was already planning, and other potentially difficult demands, including on tax, were set aside at least for the moment (though some were to come back a few months later).

<u>SHORT AND FOCUSSED CONSULTATIONS</u>

That was a Tuesday – very quickly IMF staff and staff from the European Commission and the ECB started to arrive in Dublin for discussions that were to commence on the Thursday: some visa arrangements had been made on a contingency basis in advance to ensure there were no entry obstacles to an IMF team, in the event that the Government would decide to hold such discussions in Dublin.

There was a huge amount of work to be done, and a lot of people to be involved in doing it – each of the IMF, Commission and ECB had a substantial team, so there were probably close enough to 30 Troika people in the city at a time. And of course, there were dozens of Irish officials involved also.

Each day a complicated programme of work would determine which teams would meet which Irish officials, often with several meetings running in parallel, and at the end of the day the senior staff would meet in my room in the Department of Finance, and run through the events of the day, discuss any major issues arising and the general direction of the discussions, before breaking up to have further discussions with our own teams and to arrange events for the following day. There were occasional bilateral discussions with individual members or small subgroups of the Troika teams, and all of the senior Irish officials – and the Minister – were on constant standby for that kind of discussion.[z]

While the discussions were due to get under way, there was some surprise news. Patrick Honohan, the Central Bank Governor, telephoned RTE from Frankfurt. He announced to the Irish public that he expected these discussions to lead to a very substantial EU/IMF bailout package, without notice to the Minister for Finance or the Government. Exercising his own discretion and the independence of his office, he decided to make a more explicit statement than the Government had been able to make up to then[33]. It seemed to take the public by surprise. Despite all the speculation and the announcement two days previously that the Troika would be coming to town, there was a real surprise for many people in Honohan's declaration that the negotiations to take place would lead to a loan of tens of billions to Ireland, which the Government would have to accept.

This put the Government very much on the back foot as far as public relations were concerned, but it also provided some clarity to the situation.

Another surprise was the arrival on Saturday 20th November of a further letter from Mr Trichet[34]. This letter was a bit of a puzzle. It was an explicit threat to withdraw funding from Irish banks – even through ELA, from the Irish central bank – unless four conditions were met:

- Ireland had to request assistance from the EU/IMF

[z] A key event happened at one of those bilateral meetings, a few days later. I will deal with this further below.

- There had to be decisive fiscal, economic structural and financial sector measures
- The package had to provide for capitalising banks that needed capital, and
- The Government had to guarantee to repay any losses of the Irish central bank on ELA.

Why was this a puzzle? Quite simply because the ECB was deeply involved in all the ongoing discussions and was fully aware that these four conditions were about to be met. In retrospect it is easy to attribute a 'bullying' attitude and behaviour to the ECB, and yet there seemed to be little to gain from sending a letter that contained nothing new. Maybe it had been decided to send the letter earlier in the week and by the time all the Departments of the ECB had struggled through the legal and political nuances, it had become less relevant, but still had to be sent. I just don't know.

And certainly the letter – especially if it had been sent a few days earlier, would have had real relevance and some cause. Since Trichet's previous correspondence, banking outflows had continued and the week just past had witnessed some very large movements of funds out of Irish banks. The ECB had a right to be concerned. But as a party to the discussions, it was not in the final analysis necessary to send this correspondence.

However, it can at least be said that this was a clear and open piece of communication: a very direct warning/threat, based in the ECB's own understanding of its rules and role. If pressure is to be exerted, it was much better that it come in this form, than in the form of non-transparent leaks to newspapers by persons unknown, of the type I discussed earlier. Moreover, it could have been that the ECB was concerned that the Irish government might yet withdraw from the idea of a programme at this late stage. In practical terms, this was by then very unlikely, but it would explain the letter. It also has to be remembered that at this stage, Portugal was still in play, Spain and Italy might be next to feel the effects of the sudden risk-averseness of the bond markets, in which case the challenge to Europe's resources might have become overwhelming. Europe had good reason to want to see quick decisions in Ireland.

In any event, Trichet did not have to wait long. The Government met on Sunday 21 November and decided to request EU/IMF assistance. That meant that the talks which had been taking place already to decide whether there would be a programme now would now formally become talks about the basis of the assistance.

TERMS OF ENGAGEMENT

We had to decide how to deal with our visitors. On the one hand they could be welcomed with open arms, as the bringers of huge amounts of money to keep the Irish State from going bankrupt. Or one could deal with them suspiciously as people here to rob us of our sovereignty. Work with them, or treat the whole process as a cunning game? Share information more or less freely or guard it with proprietorial zeal?

To me, the answer was clear enough. We were entering into a business relationship – indeed this was to be our most important business relationship, and the basis of this relationship was that a bunch of people representing countries from all over the world were going to come to Ireland to help us out. Yes, there would be problems and some of the demands of the visitors would be unpalatable – perhaps even inappropriate. But we had to consider what would be a success for us, but also what would be a success for them?

Actually, for the EU/IMF people on the ground in Dublin, their interests were quite closely aligned with ours. They wanted to be associated with a successful support programme that led to Ireland being back on its feet as quickly as possible. If we dealt with them professionally, explained our situation, demonstrated our competence, they could be expected to engage positively with us. Moreover, they could become our best ambassadors in their various head-offices, fighting our corner in Washington, Brussels and Frankfurt.

Moreover, if we developed some good will, when we had a disagreement with any one of the parties to the Troika, we could potentially enlist the help of the others in persuading the people concerned.

So basically, we needed the money, we needed the programme to work, and this was much more likely to happen with an open cooperative approach, albeit that within that framework we would certainly have to assert ourselves and be tough about what was important for us.

Minister Lenihan was entirely in agreement with this approach, and was ever-present in the Department for consultation and direction. And of course to rein us in if he felt we were being either too difficult or too accommodating to the other side in the discussions. As the days of negotiation rolled on, I spoke to him daily, usually, and sometimes for hours, about developments, our strategy and tactics.[aa]

On the 18th of November, as we were about to start negotiations, I prepared some comments for my senior management colleagues, that reflected my

[aa] One member of the Oireachtas said closer to the time that it would have been better to have Silvio Berlusconi negotiating for Ireland than Cardiff, because Berlusconi was a wild card and thus a greater threat to the parties on the other side of the table. Since then, however, the Irish programme, for all its unpleasantness, has come to be seen as a success in allowing the country to turn around. Could a different negotiating stance have been even more successful? We will never know, for sure. Although the Greek Government has, at the time I am writing this, been experimenting with the 'wild card' approach, their situation is quite different. Just as 'Ireland is not Greece', I am no Berlusconi. I am okay with that.

views on this. My notes had five main points in relation to the new relationship, which I now summarise:

- Deal with them openly – we need them to understand our position
- But commit to nothing – the key decisions to be taken were so important that the Government would have to take them, not civil servants
- Find flaws in the visitors' thinking, politely and tactfully. After all we needed their plans to be good plans, but
- Also find solutions, and be open to the expertise and experience of these people
- Work hard and avoid letting personality get in the way of this work problem.

In other words, I was committing the Department of Finance to working with the programme partners to make an appropriate programme work, rather than to accepting it on paper while seeking to subvert elements of it behind the scenes, which might have been an alternative route. In this, I had the full support of the Minister – but before we could commit to a programme, we had to design one, and negotiations on that were ongoing.

The negotiations were very intensive. Teams of staff worked in the Department of Finance in Merrion Street and the Central Bank building in Dame Street to feed the Troika machine with the information it required.

The Troika teams worked through their programme of questions and queries at a technical level. It was not an audit, but it was a close interrogation of our policy positions, of our figures, of our ability to deliver. But it was also a very significant process of negotiation.

And for the most part it was negotiation between people with a more or less common view of the world. We might have differences of view, for example, on fiscal policy or on economic adjustments, but in truth the differences were small enough. There was a significant pressure on us to abandon our fiscal forecasts in favour of somewhat more pessimistic IMF or European Commission forecasts. For the IMF, this would simply mean that the programme partners were operating from a common forecasting base, but since they were happy, even on their own figures, with the proposed pace of adjustment in the deficit, this would not imply any change in the amount of austerity to be demanded of Irish people in the coming years. However, European rules were more 'automatic' in their operation. If we adopted new forecasts, and these forecasts did not show us reaching a 3% deficit level by 2014, it might be more difficult for us to resist the pressure to commit to 'do more' austerity in future years. But there was no disagreement between the parties that a significant adjustment would be required each year for some years to come – the only discussion was about the pace of adjustment, and were able to hold the Commission and the ECB to the 'deal' done some weeks before in Brussels on the pace of change adjustment.

There were also discussions ongoing on appropriate structural adjustments in the economy. I don't recall any great debate in this area at this point, but we were being just a little coy. These discussions coincided closely with the planned finalisation of the Government's four year plan, and that work was going on in parallel. We would later come under a little pressure to merge the two processes, so that the 'plan' would in effect be the EU/IMF programme – I will deal with this further below.

The issue of the rate of interest to be paid on loans was also a significant one, though in part these discussions were for the Eurogroup level, rather than the technical level. The Irish side was unhappy with the rate of interest being suggested. The IMF's rate was fixed in the IMF rules – there was very little discretion, and apart from some technical adjustments that might be possible at a later stage, absolutely no willingness to adjust these rates, on the part of the IMF.

There ought to have been more scope at EU level. There the interest rate was determined by the cost of borrowing of the European Union and the European Financial Stability Facility, from which we would borrow, plus a margin that was to be decided on a more 'political' basis. Much smaller loans had been made to certain countries under the EU's Balance of Payment support mechanism at close to the cost of funds (i.e. the loans from the EU to the member states concerned were made with little margin over the rate that the EU itself had to pay in order to borrow the money in the first place). But the loans to Greece had been made at the higher rate, and any concession to Ireland would probably give rise to concessions also to Greece – not politically palatable at the time. So for the moment it seemed we might have to accept that we were 'price-takers' as far as the interest rates were concerned, but we could aim to go back to the issue later.

The most difficult area of discussion, of course, was in relation to the banking sector. This was always going to be the case. In this it was more difficult to find a consensus. There were a number of key areas for consideration, but the most important for us were liquidity and affordability. To be successful, the programme had to ensure directly or indirectly that the banks would have enough liquidity – available money in other words – to meet their ongoing obligations. At the same time, the banks had to have enough capital – loss absorbing capacity in other words – to allow them to continue to trade and to be put back into a position where they could contribute to the economy. Moreover, the continuing dysfunctions of the banking system had to be addressed by an appropriate restructuring of the sector.

But every additional penny that the Government gave to the banks by way of capital was an additional penny that would have to be borrowed, either from the EU/IMF programme or from the market, if we could get access to it, and repaid with interest over time: the danger was that while we could not afford to lose the banking system, we could not afford to save it either. So, while it seemed we would have to put more money into the banks, we had to keep the amount as low as possible while still allowing the system to be repaired.

The ECB, in particular, had a different agenda. They regarded it as so important to fix the banks that they were inclined to want a much bigger intervention in the banking system than had been shown to be necessary.

Moreover, they wanted us to take a large chunk of the money available from the EU/IMF programme at a high interest rate, and hand it to Anglo, so that Anglo could pay off monies owed to the Central Banking system, on which they were paying a quite low interest rate. Whatever about putting more money into bank capital, the demand that Anglo repay low interest loans with money borrowed by Ireland at a high interest rate was a purely selfish one on the part of the ECB – not unreasonable in its logic, from their point of view, but of no benefit at all to the Irish situation.

A similar sort of thing was debated in relation to bank deleveraging. It was clear that there was a huge shortage of people willing to fund the Irish banking system, so the cumulative loans issued by the banks far exceeded the deposit base available to the banks to fund those loans. In the past this imbalance had been rectified by the banks by borrowing money from the wholesale money markets and by issuing bonds to bridge the gap. But those wholesale loans and bond investments simply weren't available any more, and in any event, they had proved to be very unstable funding sources at a time of crisis. As all of these wholesale funds had been withdrawn, the Central Banking system had filled the gap, but this was not a sustainable way to manage a banking system for the longer term. So banks needed to 'deleverage' – simply put, to reduce their loans to customers and other assets so as to put themselves in a more sustainable position. The problem with this was that customers do not repay loans at nearly the speed that would be needed to quickly deleverage the system, so the banks needed to sell subsidiaries to bring in cash and reduce the scale of their operations, as well as to sell some of their customer loans to other parties.

And there was the problem – who wants to buy loans and banking subsidiaries in the middle of a banking crisis? Only people who can buy them very cheaply indeed! And if the banks sell their assets cheaply they make a loss – and that loss reduces their capital, leading them to turn again to the State for even more help. In this way, a fast pace of deleveraging would lead directly to additional demands for State money, in the circumstances of the time. But the ECB was very anxious to have a fast pace of deleveraging, because that would reduce the ECB exposure to the Irish banking system. Moreover, the competition experts in the European Commission were also anxious to have a relatively fast deleveraging, because state aid rules required that entities that had received state aid would normally be required to downsize and restructure.

This tension, between a natural tendency for the ECB, in particular, but also others, to press for a high level of recapitalisation, and swifter deleveraging, and a natural tendency for the Irish authorities (the Department of Finance in particular) to be more cautious and more protective of Irish funds was to last the whole period of the EU/IMF programme and elements of the same pressures are still evident today. But back then, there were a number of ways in which we in the Department were able to work with the Central Bank to minimise the risks for Ireland, during the discussions, in ways that were acceptable to the other parties.

The first strategy was to agree that more capital would be required – it was clear that the markets were not capable of being comfortable with the current capital plans, so more was clearly needed. But we did not need to decide exactly how much more immediately. There could be a more or less objective process for further analysing the situation of the banks to decide how much capital they would require.

Secondly, to the extent that there was uncertainty about the necessary level of capital, some of the capital made available to the banks could be on a contingent basis: we could make loans to them that would be turned into ordinary capital if required, but if not required, the loans would be repaid in the ordinary way. These 'contingent capital' instruments were also known as 'CoCos', and early in the discussions Matthew Elderfield – the head of financial regulation – put forward a paper to the other side of the discussions proposing that CoCos might be part of the mix of solutions to bank capital.

Thirdly, we could resist some of the proposals – the more unreasonable suggestions that were sometimes mooted as a way of sounding us out in relation to the pace of deleveraging or the use of programme funding to allow Anglo to reduce its ECB exposures could be quietly but assertively resisted. It helped that, objectively, we could point to the size of the overall programme. It was not big enough to meet all the potential demands on it.

GOVERNMENT FORMALLY DECIDES TO APPLY FOR HELP

Although a lot of discussions had by now already taken place, these had still been, in principle, 'preliminary' discussions. Before there could be a programme the Government would have to decide to formally launch the negotiations for a programme – in other words to formally say 'we want some help here' – and then the programme would have to be discussed and agreed. The first of these events happened after a Government meeting on 21 November 2010.

Most Government decisions are based on a 'Memorandum for Government'. Generally speaking the Government then discusses the issues with no civil servants in the room other than the Secretary General of the Department of the Taoiseach, or his deputy. There can be exceptions to this practice – and had been a few such exceptions during the financial crisis, when officials were asked to provide a briefing to the Cabinet and answer questions, but even then the officials would be ushered out so that the Government can have a private discussion. Such meetings are supposedly entirely confidential, so as to allow the Government to have a free and open debate and to take a common decision for which they would all be responsible.

The Memorandum for Government for that Sunday set out recent developments[bb] giving rise to the need to consider EU/IMF support and the

[bb] Some of the information was stark – the memo noted that the banking system had lost €133 billion of market and deposit funding since the beginning of 2010, of which €85 billion had arisen in 2010. The banks were now relying on central bank funding to the

likely basis for a deal with the EU/IMF while noting that various elements were still to be decided[35].

The likely size of the funding package would be €85 billion. However, €17.5 billion of that would come from the Government's own cash, which had been stockpiled in one form or another to allow the Government some flexibility in the markets[cc], so the external package would be €67.5 billion.

Of this, €22.5 billion – one third would come from the IMF, and the rest would come from European sources, the EFSF, EFSM. By now it seemed the UK would be a willing volunteer to contribute to the European effort also.

The EFSF was a fund put together by Euro area governments the previous summer as a contingency against this kind of situation. Legally, it was a Luxembourg based company formed by the various Governments concerned with a supervisory Board representing each of the countries. The EFSM was a European Union support mechanism. The IMF is a worldwide body. So in practice the world in General was supporting us via the IMF, the EU as a whole via the EFSM, and the Euro area member states via the EFSF, each time more or less in proportion to the economic importance of the country concerned. So Germany, France, Italy, Spain and the other Euro area

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tune of €118 billion, €35 billion of which was emergency liquidity assistance. Bank of Ireland and AIB had both had to rely on ELA.

[cc] It was the existence of this cash stockpile that had allowed the Government to take some time over its decision to seek outside support.

countries would be providing support on the triple, by their membership of the IMF, the EU and the EFSF arrangements. The UK volunteered to add more of its support to the mix, but would not do so as part of a Euro area facility – its loan had to be kept separate for domestic political and legal reasons.

That day it became clear that Sweden would also provide bilateral loan support and Denmark followed suit soon after. These were not members of the Euro area, but would nonetheless make their own separate loans available as a welcome gesture of support. Not widely known, however, is that others were willing to help also. Norway made an informal but concrete offer to help, in solidarity with European and Irish difficulties. The European authorities at the time were for some reason not anxious to take this up – perhaps a simple matter of management practicality, but those of us in Ireland who knew about it were very appreciative. There was lots of tough talking and sometimes even threatening behaviour in the negotiations on the programme, but the basic fact was that for most of the partner countries this package was also a genuine show of solidarity.

There was, perhaps, a little less solidarity in the proposed interest rate – details were still being worked on, but it appeared to be working out at around 7%[dd] - perhaps not high relative to the then perceived risk of lending

[dd] Working out the likely interest rate was complicated enough – there were different regimes for each of the facilities concerned, so that the mix of funding as between the various facilities made some difference, and any funds received at variable interest rates would be 'swapped' in financial markets for fixed rate funds. The EFSF had to borrow more than it would lend, to maintain its credit rating, so the interest cost to Ireland would actually be based on a bigger loan amount than was actually given.

to Ireland, but sustaining a large volume of debt at that interest rate over time would be very difficult, and could be counterproductive if the interest rate made it more difficult for the Irish economy and State to get back on its feet.

As expected, the plan for a four-year fiscal adjustment of €15 billion – agreed with the EU and ECB some weeks before, was likely to be accepted and the calls for a shift in our corporation tax rules were dropped – but not with any commitment that they could not be raised again in the future. At least, they were not to be part of the package.

Banks would be required to have more capital, but to guard against the problems for the State of overcapitalising, described above, the amount of extra capital would be limited initially, and a further stress testing exercise would then take place to determine the final position.

The programme would not provide any bank liquidity (beyond the amount of the capital to be injected), it seemed. We would still have to rely on the ECB for that – but it seemed on the basis of our discussions that at least the ECB would continue to fund the Irish system and would make appropriate supportive statements.

The questions of a requirement to provide collateral and the demand to spend programme funds on paying down Anglo's debt to the central banking system were still in play at this stage, but it was noted that the Minister would be arguing strongly against any collateral requirement and that there was no money in the arithmetic for the Anglo issue. One could imply that the Minister viewed it as probable that these would not form part of the programme, even if there was still work to be done. It was 'agreed' that Anglo's customer deposits would be moved to other banks, which would reduce the need for official support for those other banks, but increase the need for support for Anglo.

The Government agreed the package on that basis and Lenihan went off to a Eurogroup meeting in Brussels where he would update his colleagues and also try to get the less palatable issues off the table. The Eurogroup and ECOFIN ministers[36] and the IMF[37] issued statements welcoming the Irish application for assistance in relatively generous terms, as did Finance Ministers in various member states[38]. The ECB also welcomed it, but was less effusive and certainly did not make any strong additional gestures of support at that point.[39]

THE FOUR YEAR PLAN

The previous days' work had been characterised at the outset as "short and focussed consultations". According to the IMF, the next few days were to be characterised by "swift discussions", but this time with no ambiguity as to the objective of finalising an EU/IMF programme for Ireland.

Much work was already done, as was evident from the detail in the Memorandum for Government on Sunday 21 November, but there was a good deal more to be done. One of the key items on the agenda for discussion was fleshing out the Irish Government's Four Year Plan. The Eurogroup statement on 21 November had indicated that the proposed EU/IMF programme would build on the fiscal adjustment and structural reforms that will be put forward by the Irish authorities in the four year plan, but although the scale of the planned fiscal adjustment had been known since October, the public had not actually seen the Plan, which was very close to completion.

The plan was finally published on 24 November 2010. There had been a number of discussions on draft chapters in Government meetings on 16 and 18 November and the Minister for Finance was, as I remember it, approved to publish the document with whatever minor amendments and so forth as might be necessary on the following Wednesday, 24 November.

As it became clear that the document was soon to be finalised, the question was raised at one of the early Troika meetings whether it would be possible for the Troika partners to see the document before it was agreed by the Government. They argued that since we were in discussions, any document to be published should be agreed by the parties. I resisted this suggestion – first of all, there needed to be some democratic legitimacy around the process – it would not be appropriate for me to discuss a plan in advance of the Government having finalised it – especially as it was already before the Government. But more importantly, I was sure that it would be better for Ireland to have its own plan – fair enough, then, if the other parties wanted to discuss the details, but let them leave it to our Government to decide what it wanted to do, before throwing it open to discussion.

This seemed risky to the Troika parties – a great deal had been made of the four year plan, and if it did not 'fit the bill' for markets and politicians, there could be a dangerous fall-out, but by this time we knew a lot about the desires of the Troika parties, and we did not think there would be any surprises for them in the document. So we stuck to our guns.

When the Government finally agreed the text we handed it then to the Troika; one of the IMF team was told to work through the night to produce a report on the Plan by the next morning. As we expected, the Troika were not dissatisfied with the Plan – in some ways it was more ambitious than they might have expected in regard to structural reform. Of course there remained differences arising from differences in the economic forecasts, but the basic thrust was generally acceptable to them[40].

The Plan aimed to raise taxes, reduce expenditure relative to what it would otherwise have been, and to make the economy more competitive and better able to provide employment prospects for its people. But it was a very unpleasant recipe, and was immediately condemned widely.

BONDHOLDERS AND BURDEN-SHARING

During this period there was also a very important discussion in relation to the idea of 'burning' bank bondholders – also known as 'burden-sharing': in other words ensuring that the bondholders received less than the face value, of their loans to the Irish banks, thus ensuring an improvement in the balance sheet position of the banks (if they don't have to repay so much, their liabilities are reduced) and in turn reducing the cost to the Irish taxpayer of saving the banks. So the idea is that some of the losses of the banks are forced back onto the investors in bank bonds.

It was clear that we could and would expect investors in the banks' subordinated bonds to take losses. This was already planned. However, the question arose whether also to do so in relation to senior unsecured bonds. These are bonds which are ordinary debts of a bank, just like any of its other ordinary debts. As the bailout discussions got underway formally after 21 November 2010, we thought the IMF might be open to the idea of having some of the senior bank bondholders take losses on their investments in the banks. We were pretty sure the ECB would be dead set against and the Commission too was likely to be against the idea, but maybe not so strongly.

There were arguments for and against this burden-sharing approach, but the Irish parties to the discussions, whether in the Central Bank and Financial Regulator or in the Department of Finance, or the NTMA were in favour of the idea, by this point in time. But this had not always been the case. Until the Autumn of 2010, NTMA advice – accepted by the Minister for Finance - was that to seek to impose losses on senior bank bondholders in Irish banks could be massively counterproductive[41]. The Central Bank had also previously been cautious on the idea of forced burning of senior bank bondholders[ee]. The NTMA argument was that

- any damage to the position of senior bondholders in any of the banks would lead to a situation where bondholders would not invest in Irish banks at all without Government guarantees, and the credit rating of the banks' bonds would be 'irreparably damaged'[ff].
- Moreover, as the same type of investors as invest in the banks also were the investors to whom we looked for investment in Irish Government bonds – they were among the lenders whose loans kept

[ee] This quote, from a speech by Matthew Elderfield in early October 2010 gives a flavour of official views at the time: "The Government has made its position clear on this matter and it does not intend to impose losses on senior bond holders. However, this does not rule out the possibility of some negotiations or a liquidity management exercise agreed by consent. Reflecting on actions by other authorities during the crisis, using resolution powers to impose losses on senior bond holders has, as far as I am aware, taken place only extremely rarely. The current difficult funding position for both the Irish government and the banking system means one should be very cautious about contemplating such a step in the present crisis, never mind whatever legal and constitutional obstacles would need to be resolved."

[ff] There had been a small experiment in senior bond burden-sharing earlier in the crisis period. Irish Nationwide offered at one stage to buy back senior bonds from the market at the reduced price at which they were then trading. The amounts were small and no bondholder was going to be forced to take the deal, but the reaction from Moodys credit rating agency was very swift. They came very close to downgrading the whole Irish banking system, on the basis that any wavering in the Government's support to the banking system and its creditors, even on such a voluntary basis, would be tantamount to a declaration that all bondholders could expect to make losses. That the initiative was the building society's not the Government's made no difference. This position was somewhat surprising, but indicated the extent to which any burden-sharing with senior bondholders might be expected to 'shock' the market.

the Government functioning – the prospect of a default on bank debt obligations would also seriously damage the Government's ability to borrow.

- As the access of the Government to bond markets was already impaired, it would be a dangerous move to impose losses on the bank bondholders, with all the potential damage that might involve.

By the time of the EU/IMF talks, however, the fiscal economic and market situation had changed so much that the NTMA's views were changing.

- First of all, by this time, bond market conditions were such that we had temporarily ceased to try to borrow on the bond markets, and assuming successful completion of the negotiations with the EU/IMF we would not need to access the bond markets for some time. So the danger of a negative market reaction were reduced.
- Secondly, the combined weight of accumulating deficits and bank capitalisation costs were making the debt much less sustainable, and imposed losses on bank bondholders would alleviate this problem. In other words, the balance of advantage had changed.

Against this background, Ireland was now very much open to the idea of forcing losses on senior as well as subordinated bank bondholders. We already had had indications that the IMF would be likely to favour, even press for, the imposition of losses on senior bank bondholders. This was confirmed during a bilateral discussion between the Minister and at least one of the IMF officials. The IMF, or at least those IMF staff we were dealing with, believed that imposing losses even on the senior bondholders was appropriate – they were very encouraging of the idea, even suggesting that if enough of these losses were taken by the bank bondholders of approaching €30 billion of bank bonds, the market might decide that the Irish Government would save enough money on the bank rescues to allow them to once more regard the government fiscal position as sustainable, and therefore to start lending again to the Irish government. If that minor miracle happened quickly enough, any need to borrow from the EU/IMF might turn out to be minimal.

It is not as easy as it sounds to 'burn' bondholders. They have property rights protected by the constitution. They are presumed to have made their investments in good faith. Their contracts may not in all cases be governed by Irish law. It is, in fact, quite a tricky thing to arrange while staying squarely on the right side of the law, but in the Department of Finance and NTMA we were looking at these issues, discussing them with our lawyers, who were developing what might be a workable approach. But even the IMF staff felt that there was a dilemma to be addressed: the advantages in terms of direct savings to the Irish purse would have to be set against the disadvantage of creating "havoc" in the Euro area. Of course, being in the Euro area, this was also a concern for Ireland.

Around this time a world-leading lawyer with extensive experience in this type of operation, arrived in Dublin for discussions with the Attorney General and the Minister for Finance. The discussions were known only to a limited group of people – we needed to take the space we needed for exploring the practicalities for burden-sharing before opening ourselves to a discussion with the Troika, and we certainly did not want premature leaks to the market. I attended some of these discussions and was reassured that the approach being suggested by this expert was in principle the same as that being developed by our own advisors.

Even if there were legal obstacles to be grappled with, and even if the IMF staff's presentation seemed optimistic, the prospect of saving significant amounts of taxpayer money by sharing losses with senior bank bondholders was an attractive proposition. However, there remained the big question of how to persuade all the Troika parties to go forward with this approach.

A plan was in the making - once the Irish authorities indicated an interest in going forward with burning the senior bondholders, the IMF team in Dublin would put Dominque Strauss Kahn on alert – he had already indicated through them that in that circumstance, he would personally initiate a teleconference with all of the major parties (the appropriate ministers from the bigger countries, the ECB, the Commission etc.) and expected to be able to persuade them of the merits of large scale burden-sharing. There were even indications (on 25 November) that preliminary discussions between Geithner, the US Treasury Secretary, and Strauss-Kahn had gone well, from our perspective – "in general so far there has been a positive response", we heard from one source. Strauss-Kahn had apparently met Geithner for a 'one on one' meeting the previous day, 24 November, so perhaps the matter was discussed then.

The telephone call between Strauss Kahn and various world financial leaders did take place, and like other such international discussions, we in Ireland got no full report on the outcome – but it seems clear that in the end Tim Geithner in the US and Jean-Claude Trichet in the ECB[gg], and no doubt others too, were very opposed to any burden-sharing on senior bonds (despite those initial indications about Geithner)[42]. The pro-burden-sharing views of the IMF officials on the ground in Ireland were overruled, and the IMF stance on such burden-sharing became officially negative. The Commission reported to us that the EU position was now that if there was to be burden-sharing for senior bondholders, there would be no programme. The ECB was similarly determined in its views. It was made clear that Ireland was going to have to accept that there would be no senior bond burden-sharing or face an impossible funding situation, and Minister Lenihan told me he would not therefore be recommending to the Government that we attempt it. What seemed possible if we had even some real international support, would not be possible with such blanket opposition.

[gg] In an interview for a German documentary entitled "The Secret Bank Bailout" available on YouTube, Joerg Asmussen, by the time of the interview speaking as an ECB executive board member said that the ECB "saw the dangers of contagion" and that it was "a priority objective to prevent the contagion"

MEMORANDUM OF UNDERSTANDING

The announcement on 21 November that Ireland would formally enter discussions with the EU/IMF parties to put together a deal did not suddenly alleviate all our problems. In fact, the parties became more rather than less alarmed about the Irish situation over that week, and the market situation seemed to be deteriorating rather than improving. There were €7 billion of outflows from the Irish banks in that week alone, and Standard and Poors reduced the credit rating on Irish government debt. Bond yields rose in Ireland, but also in Italy, Spain and Portugal. The prospect of a 'rescue' for Ireland was not dealing with market fears, and these fears were now being exacerbated in relation to other countries too. But discussions were continuing and we started to bring them to a conclusion.

The final 'deal' was captured in various letters and memoranda of understandings comprising a package of agreements, action plans, time-bound targets, and technical understandings, as well as information and reporting requirements allowing the Troika parties great access to Irish data – some of it even on a weekly basis.

As we came close to concluding the agreed package of documents, and so as to ensure there would be no ambiguity about what was or was not agreed, the documents were uploaded into a computer in the Department of Finance's main conference room in Merrion Street. From there, the documents could be presented on a large projector screen in the room, so that the senior negotiators on each side could see them. And there, with the documents on screen, we went through every document paragraph by paragraph – sometimes word by word – identifying remaining areas of disagreement and, usually, resolving each one on the spot. Occasionally, for a tricky point, a few people might leave the room to see what resolution could be found, or a matter might have to be referred for, for example, the Minister's guidance, but most of the work could be done there and then, reflecting all the prior preparation that had gone on. As a change was suggested, it would be inputted immediately and the draft revisions would show up in red print on the screen, and if everyone then agreed the new text, we would move on to the next paragraph.

Despite our efforts to reduce the number of people involved, the fact that there were three parties on the Troika side, and a number of Irish institutions were also engaged, meant that the numbers of people in these sessions rarely dropped below 30.

In addition to the memoranda that were to be agreed, there were various contracts to be negotiated and signed with the EFSM and EFSF, the two European facilities from which money would come, and with the bilateral lenders who had offered to be involved: principally the UK, whose loan was to amount to over €3 billion, but also Denmark and Sweden.

Generally speaking, the contract negotiations went without any difficulty, and where there were difficulties they were constructively addressed on all sides. At one point, for example, I received a phone call from my counterpart in the UK, Nick MacPherson, who was concerned that negotiations seemed to have stalled on the UK loan contracts. I told him that indeed seemed to be the case – there were contract terms being suggested by the UK negotiators that were unusual for a loan contract, or so I thought. MacPherson promised to fix the problems on his side immediately and asked that I would tell my team to be equally reasonable – the problems dissolved away in a matter of hours, with a bit of genuine good will.

We had been concerned that, relative to the experience with the EU facilities, that we were receiving very little documentation from the IMF. The Attorney General in particular was concerned that there might be some important documentation yet to be dealt with but not yet built into our work plans. He and I and a lawyer from his office, on secondment to the Department of Finance, spoke by telephone to the chief counsel of the IMF around 1 a.m. one morning to see what was going on. No, said the IMF man, we don't believe in a lot of extra documentation, if a country does not stick to the rules, they don't get their loans, so we don't need to overspecify everything. That seemed fair enough to us.

The final package was submitted to Government for approval on the evening of 27 November 2010. The Memorandum for Government this time reflected, as would be expected, many of the issues that had been outlined on a provisional basis in the earlier memorandum – the one that had been discussed the previous Sunday and which sought permission to enter this phase of the talks. The Memorandum for Government also contained, as appendices, letters from the Governor of the Central Bank and from the CEO of the NTMA recommending that the Government would agree to the proposed EU/IMF programme.

The Memorandum for Government that day outlined the negotiations which had gone on in the previous week and outlined the main elements of the proposed package[43]:

- a total funding package of €85 billion
- €17.5 billion of that to come from Irish sources, including by drawing down cash from the National Pension Reserve Fund
- The balance of €67.5 billion to be made available over three years by the various external agencies involved, but principally from the IMF, the EFSF and the EFSM. About €5 billion was expected to be contributed to the mix by way of bilateral loans from the UK, Sweden and Denmark (but of course this was in addition to their contribution via the facilities of the EU and IMF).
- There was to be a notional split of the facility, so that €50 billion would be available to fund the state, and the remaining €35 billion to fund bank supports – it was stressed that it was not expected to use this amount.
- Now working out at around 6% when converted to fixed rate funding, the interest rate was regarded as high – "the Minister for Finance will continue working to secure a lower interest rate"

- It was noted that there were to be a wide range of conditions to be met, and a good deal of oversight: "The programme contains a significant degree of conditionality and a level of monitoring that will be both intrusive and onerous"
- There was to be no requirement in the programme to change the corporation tax regime
- The EU would allow one additional year to reach the general 3% deficit threshold. This would not reduce the level of austerity envisaged already, but depending on economic developments, it might mean less pressure for further austerity measures.
- The economic and fiscal approach in the programme would closely mirror Ireland's own four year plan published only a few days before – "The National Recovery Plan is effectively embedded in the Programme", though some differences were of course to be expected and were noted.

Discussions about burden-sharing for senior bank bondholders were still going on while the Memorandum for Government was being prepared – it noted the arguments for requiring such burden-sharing, but also noted that any such effort might destabilise markets and have contagion effects in Ireland and elsewhere.

The memorandum also outlined the proposed plan for dealing with the banks:

- Additional capital to be required of the banks – it was noted that the Troika had not identified particular flaws in the stress testing approach adopted earlier in 2010, but that the capital ratios for banks would now be increased – immediate recapitalisations of about €10 billion would go ahead, and in addition there would be further stress testing to be carried out on a rigorous basis by external consultants, to determine a final capital target for each bank. Most or all of the banks would come into state ownership
- Banks would be required to deleverage – assets would have to be sold where possible and appropriate
- Additional transfers of land and development loans to NAMA would assist in the deleveraging process, but adding to the upfront recapitalisation bill (this was included in the €10 billion figure noted earlier). Various restructurings of the banking system would also take place
- Ironically, at the same time as the Troika partners were anxious that there be no burden-sharing, they were anxious that Ireland would introduce a bank resolution regime, for banks in trouble, to mirror developing plans for such structures in the EU – these structures normally *require* burden-sharing.

- There was also to be a confidential side letter about a proposed transfer of deposits from Anglo and INBS to other banks. This would take some time to arrange for, and it was important not to frighten depositors, who would be fully protected.

One noticeable element of the programme documents presented to the Government is that while the ECB was a party to each discussion – and not just in relation to the banking system – it was not a party to the agreement. The parties were generally referred to as the IMF and the European Commission *in liaison with* the ECB. In discussions they spoke and acted as if a creditor in their own right (and they had indeed big exposures to Ireland, but indirectly through the banks), but they would not, or could not, be party to any of the agreements. For that reason, there was no provision in the deal about support for bank liquidity, a huge gap in the framework.

So, while ECB officials might note in discussions that "the ECB had played its part in Greece and could be expected to do so in Ireland", and while the Central Bank Governor might be hopeful that the ECB would provide some longer term liquidity to deal with the ongoing problems of Anglo and Irish Nationwide[44], there would be no formal agreement from the ECB. John Corrigan of NTMA echoed many Irish views when he noted that the statement of the ECB in relation to Ireland's confirmation (the previous week) that it was entering the programme discussions had been disappointingly sanguine, and that a much stronger statement of support from the ECB would now be very important.

ANNOUNCING THE NEWS

I can't remember now what time the Government meeting finished on that Saturday night, 27 November 2010. Even as the Government was meeting, officials of the Department of Finance and other parts of the Irish system, as well as Troika officials continued to put the finishing touches to programme documentation. A further iteration of all the documents was circulated again shortly before 2 a.m.

The following morning's newspapers were filled with stories and opinion pieces about the bailout discussions. Some of these were very well informed indeed, and journalists had clearly been able to get access to a good deal of information about the ongoing discussions.[45] Some of them were well informed on the likely interest rate, on bank restructuring and on the failure to reach agreement on burden-sharing with senior bank bondholders, although the 'blame' was laid at the feet of the ECB, rather than any other party who might have been involved in the discussion. Cliff Taylor's analysis that morning, that for the Troika parties "Ireland was both a crisis that could spread and the precedent for what happens wherever else it spreads to", was a pithy way to explain much of the dynamic of the negotiations of the previous weeks. Our European and international partners were riding to our rescue, but Ireland was not the only case on their minds.

I met the Taoiseach that morning or early afternoon to go over the issues for the day. There was to be a formal press conference, at which the Taoiseach would announce the deal, in the late afternoon, to take place in the press centre in the basement of the Department of the Taoiseach. This was to be followed by a press conference by the Troika partners, for convenience to be held in the same room as the Taoiseach had just used.[hh]

But the choreography of that day was to be considerably more complex than that. Echoing Cliff Taylor's understanding of the importance of this event internationally, the decision on the Irish programme would be an international affair.

- In Dublin, there were to be the two press conferences, as well as the publication of a mini-mountain of supporting documentation, and various media interviews.
- In Brussels, there was to be a meeting of the ECOFIN ministers to endorse the deal and to form a conclusion on how to deal with the ongoing fallout from the Deauville declaration of October, in the context of a new support programme.
- In Brussels and Frankfurt there would be press releases to be issued on behalf of the various European institutions concerned.
- In addition to a joint statement with the Europeans, the IMF's President, Strauss-Kahn, would issue his own statement in Washington.

hh

- In other capitals around Europe finance ministries or prime ministers' offices would make their own comments, all of them hopefully guided by the agreed lines emanating from Brussels and Dublin.

Back in my office some time later, studying the documentation for the programme and probably pondering also the steps that had led us to this point, I got a call from one of the Taoiseach's advisers. He said the Taoiseach had asked would I accompany him on the podium for the press conference later. I said of course, I would not want anyone to have to stand on his own to deliver this particular message to the people of Ireland. He thanked me and was about to finish the conversation, when a thought occurred to me – were there going to be no Ministers to accompany the Taoiseach? Would it not look strange if there were not? The Taoiseach's adviser said that he would check the situation on that.

When I went over later to the Press conference and entered the little side room where Ministers and others would wait before entering a press conference, it turned out that there were, in fact a number of ministers: Eamonn Ryan, Mary Hanafin, Pat Carey[ii], as well as myself and my Department of Finance colleague, Ann Nolan. We lined up in the order in which we were to be seated, but the Taoiseach asked me to sit beside him, so as to be able to take any technical questions he might refer to me, or indeed to find relevant papers and pass them to him easily if necessary. This is quite a normal role for a civil servant in a press conference, but it meant that I was inadvertently seated above a nameplate for Minister

[ii] Minister Lenihan was in Brussels for the meetings there

Hanafin and she above mine. There is always someone looking for a conspiracy theory, and I was asked after the press conference if this perfectly innocent change of seating arrangement meant that the Minister had been trying at the last minute to distance herself from the Taoiseach or the decision taken, which of course she was not.

I was much deflated that day. We had seen the increasing danger to Ireland's fiscal sovereignty some time before. I had spoken privately to senior colleagues within the Department of Finance months before about the possibility that we would not be able to persuade markets about our future credit-worthiness, against a background of increasingly risk-averse investors, and the need to prepare. I had spoken to the Minister during the summer about the necessity to make greater upfront fiscal adjustments for 2011, and to announce them early. I had initiated the work on the four year plan, so as to have a more complete 'story' to give the markets and the Irish people about how we would emerge from the morass. I had engaged with my civil service colleagues on the need to move their adjustment efforts onto a more aggressive footing, given all the risks that surrounded us. In September, or early October I had outlined the issues to a gathering of senior civil servants and demanded their active participation in the adjustment processes that would be required.[46] But despite all the effort it was increasingly difficult to swim against the tide and bit by bit it had become ever clearer that we were going to need outside help.

This new effort might also fail – the complex interaction of expected growth in the economy, planned spending cuts and tax increases, likely bank costs, demographics, economic flexibility and dynamism, political instability, all set against a dangerously volatile international background, made it impossible to predict the outcome of our programme. On the face of it, it ought to succeed. But it would require public consent, enormous effort, and good fortune. The challenges were so great and the timescales so tight that there was, almost literally, not a minute to lose. There was to be no pause for contemplation, the work that was needed to establish the programme and get it running smoothly would have to start immediately, and I was determined that insofar it was within my scope to make the programme workable, I would put all my efforts into that.

Meanwhile, in Brussels, the Eurogroup ministers agreed and welcomed the Irish programme and also agreed on a compromise in relation to the approach to be taken in relation to burden-sharing with bondholders holding the debt of Governments affected by crisis. European and Irish policies in relation to burden-sharing were now so mixed up it is no wonder creditors were uncertain about the risks they held. As of end-November 2010, it was Eurogroup policy that there would be burden-sharing in the future where a country was insolvent, so that the private sector creditors of the country concerned would have to swallow a loss, to help the country back on its feet. However, this was explicitly not to arise until after 2013 – for any current cases, the policy was that there would be no such burden-sharing. Irish policy was that no such burden-sharing would take place in relation to our sovereign debt – in other words the Government would not default on any of its obligations. On the other hand, the Irish Government did want to arrange for burden-sharing where a bank was insolvent or close to it, while Europe, through the Commission and the ECB, said no, that must not happen. But they also said that Ireland not just should, but must, provide for burden-sharing in the future in the same sorts of cases. It was against this confusion of policies that the Irish government and the Troika had to 'sell' the Irish programme to the market.

THE PROGRAMME OF WORK

The next four months were very busy in the Department of Finance, Central Bank and NTMA[jj] – the big work economic and fiscal programmes envisaged in the National Recovery Plan and the EU/IMF programme, the preparation of the Budget and Finance Bill, the finalisation and introduction of new banking legislation, all had to be accomplished against the background of a political system that was temporarily distracted over this period by both the election of a new leader in Fianna Fail, by the decisions made by the Green Party in relation to staying in Government until after the Finance Bill and by the calling and fighting of an election and the formation of a new Government.

The programme of work agreed with the Troika parties in relation just to the banking system was enormous.[47] It was agreed that we (the Irish authorities) would do all of the following in just four months from the end of November 2010 to the end of March 2011:

[jj] During this time Brian Lenihan continued to work hard and honourably despite his illness, but at moments seemed to be losing some energy, hardly surprising given how much was going on, and the heavy responsibilities he had.

Capital

- Implement the bank recapitalisation measures which had already been announced on 30 September 2010
- Extend the NAMA programme to include approximately €16bn of land and development loans in AIB and Bank of Ireland, which had previously been excluded as they were below a value threshold of €20m. This would help to further deleverage the banks concerned by reducing their risk asset base. The NAMA legislation would be amended to provide the necessary means to do this efficiently.
- Increase minimum capital requirements for named Irish banks (AIB, BOI, EBS and ILP) to 10.5% core tier 1;
- Ensure that AIB, BOI and EBS are – notwithstanding the 10.5% requirement -initially recapitalised to a level of 12% core tier 1 capital, which will take account of haircuts on the additional loans to be transferred to NAMA and will fund early deleveraging by making available EUR 10 billion in the system; the recapitalisation will take the form of equity shares (or equivalent instruments for EBS);
- Design a new 2011 Prudential Capital Assessment (PCAR) exercise and complete it on a basis agreed between the Central Bank, the European Commission, IMF and ECB staff. Extensive external consultancy would

be used and the methodology used would be published in detail, to enhance market confidence and transparency.

Deleveraging

- The Central Bank was also to complete a Prudential Liquidity Assessment Plan (PLAR) for 2011 – just as the PCAR would assess the capital position of the banks with a view to developing a plan for addressing deficiencies, it was intended that the PLAR would outline measures to be implemented with a view to steadily deleveraging the banking system and reducing the banks' reliance on short term funding by the end of the programme period. Ambitious target loan to deposit ratios, to be achieved by end 2013, would be established for each bank by the Irish authorities in consultation with the ECB, ECB and the IMF by end Dec 2010.
- The PLAR would not only establish target funding ratios for 2013 for each of the banks, but also identify non core assets and set an adjustment path to these targets based on specified non public annual benchmarks. Banks would be instructed to comply with specific actions related to their funding targets and adjustment paths.

Reorganisation of banking sector

- A revised strategy for the future structure, functioning and viability of Irish credit institutions, providing for a comprehensive reorganisation and downsizing of the banking sector would be developed in detail and agreed with the European Commission, the ECB and the IMF.

- A specific plan for the resolution of Anglo Irish Bank and Irish Nationwide Building Society would be established which would seek to minimise capital losses arising from the working out of these non-viable credit institutions, but in the meanwhile the Government would be committed to ensuring they met the requisite capital adequacy ratios.
- Legislation on improved procedures for early intervention in distressed banks and special bank resolution regime (SRR) would be introduced, to be consistent with similar initiatives ongoing at EU level.

Burden-sharing by holders of subordinated debt

- Consistent with EU State aid rules, burden-sharing would be achieved with holders of subordinated debt in relevant credit institutions over the period of the programme. Legislation allowing for this to take place on a forced basis would be submitted to the Oireachtas by end-2010, but it was also possible that similar arrangements would instead be managed on a quasi-voluntary basis, similar to the exercises that were already going on at the time in relation to holders of

> subordinated debt in Anglo Irish Bank. These exercises would be commenced by end-Q1 2011[kk].

A side-letter[48] between the Minister and the programme partners committed Ireland to engaging immediately with bank asset disposals, and to introducing legislation very quickly which would allow the transfer of deposits from Anglo and Irish Nationwide into other institutions, leaving these two institutions as a 'rump' of loans to be worked out. It was agreed that any capital requirement generated within these two institutions arising from the working out of these loans would be met.

[kk] Programme documents are available at http://www.finance.gov.ie/what-we-do/eu-international/irelands-programme-eu-imf-programme, and the specific documents agreed in discussions at the end of November 2010, and finalised and ratified as appropriate in early December 2010 are available at http://www.finance.gov.ie/sites/default/files/euimfrevised.pdf

IMPLEMENTATION

There is a great deal that could be written about the process of implementing the programme in the months immediately after the bailout was agreed. It was quite simply a major feat of administration of a type that critics of the Irish public service would probably not believe could be done. Relatively small teams of staff in various public bodies – and also in the Troika institutions and in the banks – shifted huge mountains of work, ticking off one by one the various targets and benchmark actions that were agreed to be done. And this was all done with a high level of co-ordination, a great consistency of effort and with a mutually respectful relationship between the programme staff in the Troika institutions and the Irish parties concerned.

The work to be done by the Troika staff should also not be underestimated. Some of them had responsibilities in relation to the EU/IMF programmes in Ireland and Greece, but also in relation to economic surveillance, competition rules or Balance of Payments facility programmes. And this was a new line of business for both the Commission and the ECB, so they had to build on their existing resources to create new teams of people for all of this work – but that took time and was probably far from complete when the Irish programme commenced. In other words, they too were short-handed from the outset.

It was not just the visiting teams of economists and financial specialists that were concerned: in the Commission and in the EFSF new borrowing programmes had to be built to gather in the funds which would then be passed, in turn, to Ireland – and a significant programme of market information and reassurance was required to ensure that these new bodies could find the funds that we needed. It has to be remembered that the EFSF was itself only a few months old[ll], and untested, and even though they had been designed to attract a AAA credit rating, there was no guarantee that markets would rush to provide funds each time these institutions issued a new bond. I recall sending notes of congratulations, and thanks, to Klaus Regling in the EFSF and Gerassimos Thomas, who was responsible in the European Commission for the EFSM, on their early bond issues for the Irish programme, and feeling reassured that they had gone without a hitch. (In later months, even with their highly credit-worthy status and their AAA rating, the EFSF and EFSM had to continue to work hard to ensure they remained acceptable in the market place as the market became even more risk averse).

Coordination units were set up in each of the principal Irish public bodies concerned to ensure a smooth flow of information to and from the Troika, but also between the Irish parties concerned, and to track progress on the benchmark actions to be taken. Senior Irish officials met regularly and there was a weekly conference call between them and the senior Troika staff, while working and technical calls were happening all the time. As far as banking matters were concerned, it was mostly the Department of Finance, Central Bank and NTMA who were engaged, but the overall EU/IMF programme also engaged all the other Departments of Government, and their

[ll] It had been formed a few months earlier, over the course of a very short number of weeks, as a Luxembourg company. In other words, it was not even a part of the European Union framework, but rather was a vehicle established by the Eurozone member states for the specific purpose of borrowing and lending on to crisis countries. It was, so, an infant in age terms, and an orphan in institutional terms.

responsiveness was good. Meetings happened when they were needed, targets and actions were addressed almost always in good time. The system of Government responded well. In fact, when the IMF published a retrospective evaluation of the Programme in 2015, their evaluation showed an amazingly smooth implementation of all the agreed actions. Just about every single agreed action of the Programme was met at the time it was supposed to be met.[49] An important exception will be discussed below.

TENSIONS

Over the course of those months, and indeed afterwards, there were certain major issues dominating all discussions to do with the banking system. And one of the most important of those was the theme of the capitalisation of the banks. As the big date drew closer there were still a number of issues to be resolved, and real dangers in getting the resolutions wrong. The first of these issues was to estimate, precisely, how much extra capital each of the banks would require. The second big issue was how these capital requirements would be met. And both issues had direct implications for the size and sustainability of our national debt.

Assuming the capital requirements of the banks were to be met, mostly, by the Government, and that the potential for capital raising from other sources was limited, at the margin each euro of capital required by any of the banks concerned would translate into an additional euro of cost to the Government. And since the Government had considerably less revenue than it had outgoings, and no private sector lenders, that additional euro had to be borrowed from the EU/IMF partners, and therefore added directly to that national debt. This had two implications. The first was that taxpayers would be asked to repay that euro at some stage, with interest to be paid in the meanwhile. The second was that the sustainability of the debt – the extent to which the Government could expect to manage to live with the mountain of debt that was accumulating – worsened with each additional euro added to the top of the mountain. If the debt got too high, no-one would believe the Government could manage to pay the interest on it, let alone pay back all the money. At that point, lenders would refuse to lend to Ireland, or would lend only at interest rates that were too high to afford.

We had already seen, the previous autumn, private sector lenders demanding interest rates that were so high that we could no longer afford to borrow from them. Even the EU/IMF would not lend indefinitely if the debt seemed unsustainable in the long run. And since the interest on the mountain of debt had to be paid by the Irish taxpayer, each additional euro of capital was going to cost them five or six cents per year in interest[mm]. So if the additional capital requirement to be met by the State was, say, €30 billion, then the taxpayer would have to fork out more than €1.5 billion extra per year in interest, which would translate very quickly into additional tax hikes or additional cuts in benefits and services for our citizens.

We were already on the edge of a cliff in terms of debt sustainability, therefore, and the big question was whether this additional capital demand would push us over the edge. But for the person on the edge of a cliff, being able to move just a few inches away from the edge makes a big difference in terms of safety. So saving even a few billion euros from the cost of additional bank capital would make a very big difference to our national fiscal position.

Some experts would, with some justification, dispute elements of this argument. They might say that, in fact, if you put too much capital into

[mm] This is based on the expected interest rate on EU/IMF funds at the start of the programme; I have not tried to calculate an effective marginal rate at the point where capital was actually injected.

your banks and it turns out later that this was not necessary, well at that stage you can take the capital back out. So in this view there really is no great danger in overcapitalising, and having put so much capital in that no-one could possibly doubt the security of our banks, they will then be able to go back to their normal business of lending into the economy, which would in turn rebound. In fact, precisely this argument was made, in particular by the ECB, but by other parties too, at various points in our discussions with the Troika. But while there is some truth in this perspective, it is overly simplistic. In Ireland's circumstance at the time – on the very limits of our borrowing capacity, and without certainty that additional capital can be clawed back in the same amounts as it was put in, we did not have the luxury of going too far.

Moreover, even in a nationalised bank, providing too much capital provides all the wrong incentives to the bankers concerned. It says to them, look, here is free money to use to sort out your problems. If you save some of this money, the Government will take it back, if you spend it to buy your way out of problem loans, for example, well you will have a nice healthy bank at the end of it, and you can expect an easy return to the private sector, where you can tell everyone what a good job you did in cleaning up the old bank. Of course, this is not how all the bankers concerned would think, but that is the direction in which the incentives lie. And people who talked to us about the history of other banking crises did indeed report that some bankers treated state money with less proprietorial zeal than private money.

The big question to be determined, therefore, was what exactly the right, necessary, amount of capital might be, without going too far. In theory, one might expect this to have been scientifically determined by the various consulting groups who had been contracted at huge cost for the purpose, in conjunction with the Central Bank – and their input was indeed key to determining the capital levels. But the science in these areas is not precise and the intuitive preferences of the various parties did of course intervene. It seemed to us that there was a constant pressure from the Troika parties – especially but not only the ECB – towards increasing the amount of capital to be injected, while rushing the pace of sale of assets, to deleverage the banking system.

From the point of view of the Department of Finance, our constant interest was not to go too far too fast in disposing of potentially valuable assets. At the bottom of a recession, in the eye of a financial storm, this was hardly the best time to be judging long-term property values or expecting to get a reasonable market price for asset sales. Our constant refrain was 'no fire-sales': assets were not to be pushed for sale into an already poor market at a rate which in itself would drive the prices of such assets further down.

The Central Bank was in a strange position here. From a purely institutional point of view, it had the potential to take a position that was contrary to the general interests of Irish taxpayers: after all, additional capital and swifter resolution of banking problems, even at additional cost to the State, ought to have made their job easier. If they were taking only their institutional interest into account, they might well have ploughed the same furrow as the ECB. In fact, the Central Bank senior staff tried very hard to do the right thing, which was to help find the optimum level of capital injection rather than an extreme level. And they tried hard to be imaginative in finding solutions to the problems that came up.

There was, so, a constant pull in the relationship between the Irish parties and the Troika parties, the strength of which varied from time to time, around the pace and scale of capitalisation and deleveraging in the financial system. 'Tension' is probably the best word for it, so long as that word is not taken to imply a negative emotional dispute. Based on the different interests of the people involved in the discussion, and of their bosses back at their respective bases, there were real differences of emphasis.

An example of this constant tension came in a discussion between Jürgen Stark of the ECB and Brian Lenihan and myself. I forget who accompanied Stark – perhaps Klaus Masuch. Stark came to Dublin to see the Minister (I think that this was not long after the programme was agreed, but am open to correction) and his main point was, along the lines of 'look, the programme notionally allocates something like €35 billion towards bank rescues, and we think you should be ready to spend that amount'. From our point of view, that was horrific – it would bring the total banking costs up towards €80 billion. But looked at from the ECB point of view, the extra capital involved, would have, at the same time reduced the size of central bank exposures to the Irish banks, since the cash handed over would have immediately reduced the banks' requirement for central bank funds, and would have made the remainder of the central bank exposure less risky, since the extra capital would provide a greater buffer against losses – for them, two birds with one (very expensive) stone.

Of course, the Irish response was clear – we had agreed in the programme to inject the required capital, but that was to be determined by a process of examination of the bank loan books by outside consultants, following on agreed stress tests – we certainly should not be expected to commit to paying more than was determined to be necessary. In fairness, Stark (who tended to stick to his deals, once done) accepted this. But it was clear that just as the ECB would be watching us eagle-eyed for any backsliding on our part on our capital commitment, we would have to watch them for any attempt to ratchet up the capital levels emerging from the technical process, or to force the pace of asset sales beyond what was likely to produce reasonable value.

The bottom line for the ECB in this compromise was that they could expect a real and determined effort by Ireland to reduce its banking system's exposure to the ECB over time, but they could not expect us to cripple ourselves even more than was necessary to achieve that. So they had to – and generally speaking did – accept that there would be no immediate exit for the ECB from its Irish exposures. But even though they would commit to this approach in discussions, there was never a formal commitment from the ECB, and therefore we had always to be on our guard for attempted changes in their position. Perhaps from their point of view, they felt they had always to be on their guard against any attempt to load the cost of Irish banks in a permanent way onto the ECB.

This natural tension was stretched a little further by one of the last big decisions of Brian Lenihan as Minister for Finance. Even though it had been agreed that initial capital injections into the banks, reflecting in part decisions made the previous September, would proceed early in 2011, the Minister decided – towards the very beginning of February 2011 - that it would be inappropriate to go ahead with these capital injections, against the certainty of a new Government coming into office shortly afterwards. He told me he did not think he had the democratic mandate to continue to inject capital when the next Government might take a different view. From recollection, he spoke directly to Olli Rehn – I know he planned to speak to Trichet at the ECB, also, but I cannot now remember if he did so.

There was some push-back to this approach, and an Ireland/Troika conference call was hastily arranged to discuss the Minister's position. The Troika parties were naturally concerned by the change of plan. The programme was off to a good start, in terms of implementation, and this would appear to be an early 'blot' on the copybook. Moreover, there did not seem to be much controversy about the plan to input more capital – was it really necessary to delay?

In addition to the danger that a significant delay in implementation of an important element of the programme might undermine the credibility of the overall programme, there might also have been a concern that the delay would defer an opportunity to start to address the huge Irish banking exposure to the ECB. The planned injection of capital would have had the side-effect of reducing the ECB exposure of the Irish banking system by an equivalent amount, helping to put that very large exposure on a downward trajectory. In the end, there was a compromise which everyone lived with. The capital injection would have to await the new Government, but most of the monies that would have been applied – about €7 billion – would still be drawn down and deposited with the banks, so as to ensure that early downward push on the ECB exposures could happen.

MEETINGS IN FRANKFURT

A set of meetings in Frankfurt on 17 and 18 February 2011 provided an opportunity to review the whole programme with the ECB and other partners, and in particular the banking elements. Myself, John Corrigan and Patrick Honohan engaged over a series of meetings with Vitor Constancio, Jürgen Stark and Klaus Masuch from the ECB, Ajai Chopra from the IMF and Istvan Szekely, Sean Berrigan and Alberto Bacchiega from the European Commission – there were probably others present too. There was quite a bit of concern that the programme did not seem to be working at this point. Deleveraging was not happening as quickly as the Troika parties would like, the recapitalisation had been deferred, political parties likely to be in the new Government were renewing discussion about burning of senior bank bondholders. The ECB accepted that there was a need to avoid firesales – which was almost a tacit acceptance that the ECB exposure to Ireland could not be unwound at breakneck speed. But they wanted to see real progress. What was being said was that the programme was not delivering, but perhaps there was a sense that Ireland was not delivering.

On the Irish side there was some frustration, too. Although the ECB was making available liquidity in huge amounts to support the banking system, much of it had to be renewed in two weekly increments, and there was always an element of threat that this would not be allowed at some point. Indeed, rather than moving towards any agreement on providing medium term funds, the threat to the two-weekly renewal of short term funds for Anglo was itself renewed at these meetings, as the ECB colleagues pointed to new menaces – a legal review of the ECB's conformity with the Treaty was due to take place shortly – perhaps this would find that lending to Anglo was monetary financing, contrary to the Treaty, which would have to be stopped. I repeated, as I often did, that there was nothing at all in the Treaty to support this interpretation. We could not make progress if under constant threat that the ECB would precipitate a disaster.

But the ECB's problem was real enough – they had found themselves by default as long-term financiers of Anglo. They had perhaps hoped that the EU/IMF programme would provide enough funds to repay their lending to Anglo, but the other Troika partners had not wanted this, as it would mean a much bigger programme, and Ireland did not want it because cheap money for Anglo from the ECB was much better than expensive money from the EFSF.

On top of all this was the danger that Eurostat – the European Statistical agency – might at any stage decide that debts of the banking system would be classified as debts of the Government – suddenly on all the main international tables, the Irish Government's debt position would look much worse than it actually was, in net terms, and our credit rating might suffer even further[nn].

[nn] As I understand, Eurostat rules have since been changed in a way which had it been applied to Irish statistics at the time, would have been very unhelpful. A useful paper on statistical treatment of bank rescues is available in the ECB Statistical Papers Series – No. 7/April 2015

On the question of burning senior bank bondholders, the ECB had obtained their own advice on the legal position, in Irish law. They were reassured by this advice that, constitutionally, it was not allowable for the Irish Government to arrange for burden-sharing with the senior creditors. I could have explained that we had our own understanding of the constitutional difficulties, and that there might be ways to address them, but I did not want to weaken the hand of a future Irish Government, so I settled on a simpler response – that I was fairly sure that the necessary referendum could be passed very quickly if it were needed.

It was not just the ECB who were nervous – the IMF and Commission were also a bit jumpy. And the truth was that so were we – it was a period of considerable uncertainty and beneath it all was some uncertainty about what decisions a future Irish Government would take. Those decisions would have to wait a short while, and in the meanwhile everyone was bound to be nervous.

We were probably all too impatient – the programme was not three months old, the big actions planned as part of the programme for the end of March could not, of course, have had any effect so far. It was too soon to assess progress in any real way. However, Irish 10 year yields were still hovering around 9%, and Portuguese yields were holding at a relatively high 7.3%, also showing no signs of easing. Bank flows had continued. There was no reason to be cheerful. But there was a lot of work in train but yet to bear fruit.

CHANGE OF GOVERNMENT

In fact, the transition to the new Government went smoothly enough, as far as the programme was concerned. The Dáil had been dissolved at the beginning of February, in line with the previous announcements that the outgoing Government would fold its tents as soon as the Finance Bill was passed without great difficulty. The election took place on 25 February 2011, and the Dáil met to elect a Taoiseach on 9 March 2011, but it was clear a few days earlier that the Government would be a coalition between Labour and Fine-Gael. Both these parties had had discussion with the Troika back in November 2010, when the programme was being designed, and it seemed clear that the Troika would have room for negotiation on a number of key areas. In relation to fiscal policy, in particular, it seemed clear that so long as the main headline numbers were not to change, the Troika would be quite flexible about how to get to those numbers.

The programme for Government agreed between the parties[50] noted that the EU/IMF programme had so far not managed to restore confidence in the Irish economy, reflecting uncertainty over the affordability of the rescue package (debt sustainability again) and the unknown potential cost of resolving the banking crisis. It pledged to renegotiate the overall package in a number of areas, including the interest rate payable and, while many of the measures proposed were in line with existing plans, there was a pledge to halt further transfers to NAMA, and to look at making legislative provision for burden-sharing with senior bank bondholders. The Programme for

Government also indicated that no new decisions on capital would be made until the ongoing PCAR assessments were completed.[oo]

Even before the new Government was put in place, the political parties who were to form it renewed their contacts with the Troika. Two of their key economic advisers, one each from Fine Gael and Labour held a significant teleconference with the Troika. They were not quite yet in a position to formally represent the Irish Government, but they were ensuring that the transition from one Government to the next, in terms of the relationship with the Troika, would be managed in a smooth and professional way. The two advisers were able to point out that the new Government had a large majority and therefore a mandate to engage with and take difficult decisions. They noted concerns about debt sustainability, which would have to be considered with the Irish agencies concerned. They had always been clear that the sustainability of the debt was finely balanced, and they might need to address this, and there was also a need to find a 'sustainable direction' on banking policy.

The Commission was anxious to know more about their views on these issues – noting that coming to conclusions was difficult in advance of the completion of the then ongoing PCAR exercise, but there was a general reassurance that the new Government seemed likely to stick to the broad outlines of the previously agreed fiscal policy – any changes they planned to make with revenue or expenditure implications would be offset by other

[oo] This would not cause a huge delay, as the assessment was due to be completed by the end of the Month

measures. Naturally, the ECB stressed its perspective on the capital needs of the banks and this was noted.

The Troika parties at this stage seemed open to some experimentation – the IMF noted that they had been encouraging the EU to consider giving more tools to the EFSF to reduce the negative interaction between the problems of the banks and their Governments, though they acknowledged that even if the Commission was sympathetic, the political climate might not be conducive. Overall, the Troika parties seemed reassured – the new Government would be wanting change, but not in every aspect of the programme, and all sides were talking about the importance of early engagement at ministerial level and urgent work on the next steps to be taken, including more formal contact at Ministerial level. A formal review of the programme was due in April (having been deferred to allow for the election period), but some big decisions were due to be taken even before then.

The new Government created a cabinet sub-committee, called the Economic Management Council (EMC) to manage the flow of information and discussion on the economic and financial issues and to prepare for discussions and decisions of the Government, and there was a great deal of preparation and effort in that forum in preparing for a new campaign of negotiation in relation to Europe and the EU/IMF programme, and even though it was going to be an uphill struggle, there seemed to be signs, at least, of a sympathetic hearing from European quarters, if not any actual movement at first.

The EMC was to compose of the Minister for Finance, now Michael Noonan, and the Minister for Public Expenditure and Reform, Brendan Howlin, taking over the portfolio that had been Brian Lenihan's as Minister for Finance, plus some functions from the Department of the Taoiseach. The Taoiseach, now Enda Kenny, and Tánaiste Eamonn Gilmore were to lead discussions. Various senior officials and advisors were also to be present, and there would be a secretariat in the Department of the Taoiseach. For the moment I was to be present as Secretary General for both the Department of Finance and the nascent Department of Public Expenditure and Reform, until the latter was put on a statutory footing and had its own new Secretary General. Despite one or two rocky moments, this new forum very quickly became an effective way to clear business and to ensure both parties in the coalition were at one on policy decisions. It was especially important in the first couple of months of the new Government, when decisions had to be taken very quickly and unity was essential.

The first high level meetings between the new Minister for Finance and key European leaders seemed to go reasonably well. There were meetings in Brussels around Monday 14 March, for example. Minister Noonan spoke to Trichet en marge of a Eurogroup meeting. It seemed to Minister Noonan that Trichet was open to more definitive public statements of support for the Irish banking system, making clear to markets that the ECB was not going to pull out of its Irish commitments, provided they in turn would see a steady reduction in the ECB exposure to Ireland. Trichet also told Noonan that he understood that fire-sale type deleveraging for Ireland was not appropriate and so the ECB were not going to press for very fast deleveraging.

There were more extensive meetings also on 14 March with Commissioner Rehn and with Eurogroup Chairman, and Luxembourg Prime Minister, Jean-Claude Juncker (now President of the European Commission)[51]. Again, much of what was said from the European side was very positive, and Noonan got an open hearing for the new Government's policies. Even before the change of Government there had been some progress in convincing Europe of the need for lower interest rates on our borrowings. Rehn indicated he was supportive in this regard. He also agreed that bank deleveraging should be at an appropriate pace – no firesales, in other words. And he was supportive on the Eurostat problems. But Rehn had some limitations in relation to Eurostat – it was a peculiarity of the system's architecture that Eurostat was within Rehn's administrative domain, but not within his policy control. In other words, their decisions were made independently of the Commissioner. But a plan was hatching that if the ECB continued to classify Anglo as a bank, even if in run-off mode and no longer open for new business, Eurostat might in turn decide to use the ECB's classification for its purposes, so that Anglo would stay off the national balance sheet and its debts would not add to the national debt for accounting purposes.[pp]

Noonan also argued that some more of the burden of supporting the banking system should be transferred to the EU in some form, but both Rehn and his Director General, Marco Buti, felt there was little chance of progress on that at present.

[pp] In the end, and with the helpful and very active cooperation of the ECB, this is what happened

But there was a new fly in the ointment – or rather an old one had re-appeared. The previous Friday, new Taoiseach Enda Kenny had been presented with a joint demand from his French and German counterparts for changes in Irish Corporation Tax policy, which he had to reject, just as the previous Government had done in negotiating the EU/IMF programme in the first place. But since the French and Germans had made this initiative[qq], all negotiations were going to be complicated by this demand, and potential interest rate adjustments might have to wait for a calmer moment. Ireland could discuss tax issues, could consider the interests and demands of its European partners, but could not allow the programme to be used to undermine our economy in ways which would work against the objectives of the programme in the first place. This tax problem featured again in the discussions with Juncker who, as Chairman of the Eurogroup, was trying to find an approach that might allow progress to continue. That the Irish 12.5% corporation tax rate remains in place even now, despite these pressures, perhaps illustrates that there were no easy compromises available to Ireland at that most difficult of times.

[qq] At least this Franco-German approach was done in a transparent way. There were various – thankfully only relatively few – attempts to use our weakened financial position to make extortionate demands during the crisis. In one case a member state's authorities expressed a preference that a particular asset of one of the Irish banks would be sold to a state-owned institution in that member state. Otherwise, it was not very subtly made clear, the regulatory authorities of that member state would make life very difficult, in turn making it difficult for the Irish bank concerned to get a proper price, and indirectly worsening the position of the Irish taxpayer. In that case, we had to call their bluff, enlisting also the European Commission's support to ensure the asset sale could proceed. The asset was in the end sold to the highest bidder, but we did not of course know if other potential bidders might have been scared off in the meanwhile.

31 MARCH 2011 – A DEFINITIVE MOMENT FOR IRISH BANKING

The banking announcements made by Minister Noonan in less than a month after coming into Government represented weeks of work by him and the new administration, and very long months of preparation by the Irish administrative system. These announcements mark a key turning point in the rescue of the Irish banking system. The moment at which, with the help of external resources, Ireland finally came to grips with the problem. It was far from being the first radical attempt to deal with the problems, of the system, but it was probably the first package of measures that was not later overtaken by events: that did not have to be unpicked or redone in wholesale fashion, in the face of the overwhelming tide of events. Now the tide was on the turn, at least as far as the banking system was concerned. But it was not possible to be sure of that at the time. Then, everything seemed still to be very much in flux.

The package of measures announced that day[52] included a number of key policy decisions and some very important specific points. At the policy level, it was decided to

- Reduce the size of the banking system
- Produce two new "pillar banks", based on the existing Bank of Ireland and AIB platforms and create a restructures Irish Life and Permanent. EBS would be subsumed into AIB
- Ensure that these are highly capitalized, based on the Central Bank's new norms, and ready for the then upcoming new "Basel III" rules

- Ensure that the banks are more focused on core operations, and better funded relative to their size, so that each of the 'new' operations would create a split between core and non-core functions
- Non-core elements of the banks would be sold off over time, but at a pace that would avoid firesales. This would provide a much better balance over time between the deposits of the banks concerned and their lending – reducing the reliance on central bank and interbank and wholesale funding
- Ensure additional capitalization of the banks to meet the terms of the new PCAR exercise being completed by the Central Bank

- Anglo Irish Bank and Irish Nationwide would continue to be 'worked out' over time in an orderly manner, so as to minimize any further capital injections in those institutions – a further assessment would be carried out the following May (which, as it happens, did not give rise to further capital requirements)

For Bank of Ireland, the implication was that there would have to be asset sales of about €30 billion over time, but as there were some signs of potential for private sector interest in investing in Bank of Ireland, they would be given time to explore this possibility. This would help to maintain the commercial focus of the bank and reduce the burden on the State of recapitalization.

The combined operations of AIB and EBS would have to sell about €23 billion of assets over time. As with Bank of Ireland, AIB would be domestically focused, though retaining its important UK operations

Irish Life and Permanent (ILP) would immediately commence a process to sell its life insurance subsidiary Irish Life Assurance, as well as other non-banking assets – there would again be a core/non-core split and €10 billion of non-core assets would be available for sale. The State would provide the necessary capital for ILP, subject to its making its own contribution through the funds raised from the sale of its non-bank business.

For Anglo and Irish Nationwide, there was to be no capital injection – they were not a part of the PCAR exercise. The Government's policy was to continue to allow them to be 'worked out' – gradually run down in other words – over time, and a further capital assessment would be carried out in May 2011. As it happens, that further assessment did not give rise to a further capital demand, but had it done so, there would have been a significant point of tension with the Troika. The end March statement was careful not to promise to put additional capital into these failed institutions. Instead it said that the position would be considered, if required: "the Government will then consult with the external partners on the timeframe and means of recapitalising those institutions at minimum cost to the taxpayer, having regard to the financial stability impacts in Ireland and abroad". More about the background to this approach below.

Following on the work that had been going on in regard to the PCAR exercise, the Minister was able to note that the bank stress tests which had taken place were "certainly among the most thorough and demanding such tests ever performed in Ireland and or indeed anywhere". This was certainly the case – the work had been thorough and quite comprehensive and not just the results, but enormous amounts of detailed data which allowed market participants to interrogate the subcomponents of the work done, were being published. It was clear that the capital assessment was meant to be very conservative.

But the result was a very significant additional demand for capital for the banks. Noonan noted that the State injection in the banks to date had been around €46 billion, while bank investors had also lost about €70 billion, but now a further €24 billion was to be required. It should be noted that this cannot equated to finding additional losses in the banks which had not yet been taken into account.

The State's investment in the banks would, it was planned, lead to very high level of capital in the banks that we own. For instance if their PCAR requirements were not only looking at bank loan data from a conservative point of view, but also were aiming at higher targets. Much of the additional capital therefore would be required not simply to cover losses, but also to have higher target capital ratios in the future. In theory, therefore, there would now be additional value in the banks which the State could recoup at some later stage.

<u>SOME BACKGROUND TO THE 31 MARCH 2011 STATEMENT.</u>

But in explaining where the package came from, it may be useful to describe some of the events of the previous days, and that day. How was the €24 billion figure arrived at, and how was it that burden-sharing with senior bondholders was not mentioned?

As regards the question of capital, the basics are simple enough. Starting from an end-2010 base, the Central Bank took account of existing capital, and provisions for losses already made, then added in the expected (pre-losses) profit of the banks in that period. That added up more or less to the amount of capital the banks could expect to have without intervention. Then the Central Bank set against that the likely losses over the period, on the basis of the work done by the Blackrock consultants, and the required level of capital to be held at the end of the period, to give a capital shortfall amount, which added to €24 billion. In fact, this calculation was done twice: once on the basis of an expected 'base case' capital requirement and base case expectations for profit and losses etc., then it was done a second time making much more conservative "stress case" assumptions, and calculated against a lower target capital level in the stress case. This ensured that the banks would have enough capital to weather an even worse storm than was already blowing.

But within the science, there was a certain amount of judgement and debate about what assumptions were to be made, which also affected the final figures.

It was in these areas of judgement and debate that there was some controversy between Troika parties and the Irish authorities. It should be made clear that all the parties were fully committed to fully credible and evidence based capital provision. This was a common starting point. But wherever there was room for judgement, the Troika seemed to want to opt for more bank capital – and therefore more cost – while the Irish authorities, being concerned about the affordability of our debt, were anxious not to put into banks a lot more than was necessary to meet the market credibility test. These issues were the subject of discussions at a senior level between the Troika and the Irish authorities on Friday 25 March and – in great detail – on Sunday 27th March.

Before the discussion that was to take place on 25 March, I had a call from Istvan Szekely on these issues. He was anxious for my view on how the Government would react to the likely outcome of the capital calculations, which he felt were likely to 'start with a 2' – in other words, more than €20 billion. He was concerned that it seemed as if whenever a technical issue arose which seemed to push the eventual number higher, the Irish technical staff seemed to find offsetting technical reasons for reducing the number again. I asked him whether, in fact, the proposed increases in capital calculations were being driven by a desire for a higher outcome, or by the underlying 'scientific' approach. He thought it was the latter, but my own view at the time – informed by my own contacts – was that we were in fact entering a period of horse-trading: the science could only get us so far, and then there would have to be a high level discussion to tie things down. That was what the calls on Friday 25 March and Sunday 27th would in truth be about – to finalise the technical issues, but also to finalise the horse-trading.[rr]

As this conversation was, technically, about what advice the Central Bank should give the Government, much of the discussion was led by Patrick Honohan, Matthew Elderfield and Jonathan MacMahon of the Central Bank, but in the end the figure of €24 billion represented an increase on what the Irish Central Bank would have been comfortable with, left to their own devices, and there was reassuring news that, for the moment, the Central Bank was not expecting any extra capital demand for Anglo or Irish Nationwide. The discussion went back and forth for several hours, with a number of stops for side-discussions and consultations. It became clear that in addition to the technical arguments each party had a view of the 'bottom line'. In particular, a decision to add an extra buffer for potential bank losses in 2014 was outside the original scope of the exercise which was to cover 2011 to 2013. But the €24 billion figure did at least have the advantage of being acceptable to all the parties, albeit begrudgingly in some cases, and large enough to allow the Irish authorities to present the banking mess as being properly addressed.

[rr] As with all the previous banking announcements, this one might risked being dogged by difficult external circumstances – John Corrigan, for example, reported on the Friday that Standard and Poors might make a further downgrading of Ireland even before the announcement the following Thursday

BACK TO BURDEN-SHARING

In a letter to Minister Noonan on 29 March 2011, conscious of the fact that he would be announcing the proposed recapitalisation numbers just two days later, Patrick Honohan laid out the Central Bank's summary views[53]:

- A radical reorganisation of the banks around two pillar banks is highly desirable, now.
- The newly configured banks will need the extra capital that has been calculated if they are to regain market confidence
- A comprehensive statement on Government policy in regard to burden-sharing with bondholders of the continuing banks should be made soon
- But even taking all that effort into account, cost and availability of funding for Irish banks was also dependent on getting the Government finances fully under control.

A second key issue related to the question of burden-sharing for senior bank bondholders. In particular, whether the ongoing reluctance of the ECB to continue funding the banking system as required, could be turned into a positive statement of intent from the ECB in that regard, if at the same time the Government announced its intention to force burden-sharing on senior bank bondholders in Anglo.

This ought to have been the easiest case of senior bank bondholder burden-sharing for the ECB to agree to. The market prices of Anglo bonds already seemed to imply an expectation of burden-sharing, so there ought to have been no great shock to the market if bondholders in this defunct entity were to take a loss.

Moreover, there seemed to be some relenting on the ECB's position – the indications we were getting were of decreasing opposition in the ECB to such a move. Although a message received from Jürgen Stark on Wednesday 30 March[54] suggested that the ECB was still dead set against and burden-sharing for the seniors, but even he seemed to allow for the possibility of a purely voluntary burden-sharing[ss]. At the same time there were some indications that Trichet's view might have shifted, and for the first time we felt that there might be others within the ECB willing to press the Irish case for burden-sharing.

I will now recount my understanding of some conversations, of which I have no note and which I was not a party to, so I stand to be corrected. But as I recall what I was told at the time, the Taoiseach spoke to Trichet on the morning of the banking announcement, and the latter seemed to have moved somewhat in his position – especially if any burden-sharing in relation to Anglo could be presented as 'voluntary' – market prices seemed to suggest that even a voluntary approach could generate real savings. He would be prepared to put the proposition to his Governing Council, which was due to meet that afternoon in Frankfurt.

[ss] In the Financial Times earlier this year he wrote that "the losses of banks should not be borne by the whole of society"

Then we got news that Axel Weber, the head of the Bundesbank, Germany's central bank, and as such one of the members of the ECB Council, had stated in Berlin that morning that "Better that Ireland isolates bank deposits, lowers burden on its taxpayers and make creditors participate in losses". It seemed likely that even if Weber was not in Frankfurt for the Governing Council meeting, his view would be influential.

Finally, however, we got the message (I heard it by telephone from an ECB official, but Ministers may have heard directly also, I understand, and the same message was passed also by email[55]) that in fact the ECB Governing Council had decided to make it clear to us that in the event that we pursued even the merest modicum of burden-sharing – even purely voluntary – we could not expect any supporting statement from them, thus undermining all the power of the banking announcements. I felt that was wrong - there had been some logic when the ECB and others blocked burden-sharing a few months earlier, perhaps, but the market situation had moved on, and we were talking about a voluntary exercise and only in the defunct institutions. To the ECB, the benefit of doing the exercise probably did not seem to be sufficient to justify the small risks, but Irish people were going to have to bear the cost of this – and worse, they were leaving the new Government without even a modicum of protection from public opinion, which was expecting, demanding, some level of burden-sharing on these bonds. How were people to sign up to all the negative features of a programme if they did not trust the European institutions to help protect them? I thought then, and I still think, that it was short-sighted and unnecessary imposition of costs on Ireland. But we will never know who was right, and of course it might have made life more difficult, for example in Italy and Spain, if Ireland had taken the planned steps: certainly, even on the day of the announcement there were analysts in London predicting dire consequences in the European periphery if any burden-sharing took place in Ireland.

Later that evening the ECB issued a statement making clear that it would continue to accept Irish Government paper as collateral for ECB operations, making life easier for the banking system in Ireland and also welcomed the Minister's banking announcements in a press statement made jointly with the Commission and the IMF[56]. But more importantly, they issued further statement welcoming the package of banking measures on their own behalf[57] saying straightforwardly that the ECB will continue to fund the Irish banking system. A simple statement, months in negotiation.

So that was another €24 billion to for the Irish taxpayer to stump up? Well, not quite. The banks had to get €24 billion of capital, but it did not all have to come from the taxpayer. At the time of the Minister's announcement there had already previously been a €10 billion contribution from the holders of subordinated bank bonds to offset some of the Irish banks' losses, and the plan now was to force more such losses onto the holders of other subordinated bonds. Moreover, there seemed to be some prospect of getting some private capital for Bank of Ireland, from investors who thought the bottom had been reached and wanted to buy bank shares at low prices – taking more risk, but for greater potential reward. Moreover, some of the capital required – some €3 billion of it - would not be injected up front, but would be provided as so-called 'contingent capital' – the CoCos we discussed earlier. In that form the funds were available for a period of years, if required, but the CoCos held by the Government could be sold by the State to other investors if there was a market for them or, assuming they had not been converted into capital, would eventually and automatically be redeemed. The money would then come back to the State.

So the actual injection of capital by the State arising from the PCAR was likely to be closer to €17 billion than the total amount of €24 billion, even before taking into account any private capital in Bank of Ireland and the Irish Life asset sales.

In the 9 months between the end of March 2011 and the end of January 2012 some things got worse before they got better, but the March 2011 banking statement marked the turning point in terms of the banking crisis.

In the months after that announcement Bank of Ireland managed to raise significant amounts of equity capital from the private sector, principally through direct investments led by Wilbur Ross and Fairfax. This allowed Bank of Ireland to remain a majority privately owned institution – these investors provided funds at a time when others would not, and when they first started to sell their Bank of Ireland shares, it was at about twice the price they had paid.

At the same time a number of successful LMEs – liability management exercises – yet another euphemism for the process of burden-sharing or burning of bondholders, provided an opportunity for subordinated bondholders to contribute to the capital requirements of the banks. These exercises eventually contributed €5.2 billion to bank core capital[58], in addition to the €9.9 billion contribution in the period prior to March 2011.

Not all the bondholders went quietly. A group called Aurelius Capital Management tried hard to wriggle out of the same treatment as was applied at the time to other holders of AIB subordinated debt. When the Irish Government declined to engage with them, they commissioned powerful lobbyists in Washington to try to get the US Treasury Department, State

Department and members of Congress to pressure Ireland to come to the table. It was amazing how reactive the US system was to the lobbyists – almost immediately we started to receive messages from the US demanding that we should engage with these bondholders. I was so concerned by this that I sent an unusually strong email to a senior official in the Treasury Department, with whom I had a lot of previous dealings, followed by a detailed phone call. I pointed out that Aurelius were holding up a very important capital raising, and failure to complete that would have broad financial stability implications beyond Ireland. I also pointed out that the Irish public already held the US at least partly responsible for not being able to let senior bond holders take losses, at considerable cost, and would hardly be pleased to hear that the US was also now interfering with the imposition of losses on the subordinated bondholders.[59] I got a helpful response from the Treasury official and whether because of him or otherwise, we had little subsequent pressure from the US Government despite the lobbying. Aurelius were claiming they were going to be badly hit by 'discrimination' by the Irish Government[tt], but they never, to my recollection at this stage, showed any real damage and our suspicion was that they bought their bonds very cheaply, and with the intention of trying to force a legal settlement. In the end, Aurelius had to settle for the same terms as the other bondholders, and payment of their costs, as I recall.[uu] It was a great credit to my colleagues in the Department of Finance and the Attorney General's office and our other lawyers that they stuck to their guns in fighting this outfit, sometimes despite advice suggesting that they be bought off. The favourable outcome may well have saved Ireland € hundreds of

[tt] Irish diplomats in Washington were able to hear what was being said to members of Congress, through their own contacts

[uu] This same outfit have recently been fighting hard – and it seems winning - in the US courts in an effort to force the Argentinian government to pay more to them than to other bondholders

millions, because a failure in relation to AIB might also have interfered with the Bank of Ireland process.