

Statement by Mary O’Dea to Banking Inquiry

The Joint Committee of Inquiry into the Banking Crisis has asked me to provide a statement and give evidence covering specific lines of inquiry over the period when I was Acting Chief Executive of the Financial Regulator, from 12 January 2009 to 4 January 2010. The specific lines of inquiry are R1a, R1d, R2a, R2c, R3a, R3b, R3c, R4c, R6a, R6b, R7A, R7b, C6a, C6b, C6c, C6d, B1a and B1b.

My role in context:

In January 2009, I agreed to take on the role of Acting Chief Executive of the Financial Regulator, a role that was estimated to be necessary for a period of about three months. During this period a Chief Executive Officer (CEO) was to be recruited so that my role was temporary and interim in nature. As it turned out, at the end of the three month appointment, I was asked to stay on as the competition for a new CEO had not been commenced. From June 2009, because I had held the position for six months, the approval of the Minister for Finance was required for me to continue as Acting Chief Executive. This was sought and received on a monthly basis until the appointment of a CEO was announced in October 2009. I remained in the position of Acting CEO until the newly appointed CEO took up the position in January 2010.

My period as Acting Chief Executive of the Financial Regulator started on 12 January 2009 and ended on 4 January 2010. In a crisis period it was a difficult and challenging year, requiring action and decisions on a number of fronts including bank funding and liquidity, bank governance, investigation of legacy issues and putting a system in place to manage the bank guarantee scheme, all in the context of a period when the organisation itself was in crisis. During my time as Acting Chief Executive, I also continued to hold the statutory office of Consumer Director, a post to which I was appointed in 2003 and in which I was responsible for consumer information and consumer protection codes, as assigned to the Consumer Director in the relevant legislation.

In accordance with the Committee’s request, I will focus in this statement on my role as Acting CEO for the relevant period and on commenting on the specific issues you have asked me to address.

Regulatory, Supervisory & Government Themes: Lines of Inquiry R1 – R7:

The Background: As the financial crisis continued throughout 2009, and the liquidity and capital positions of the guaranteed banks remained stressed, it was clear that a more permanent solution would be required. Anglo Irish Bank was nationalised in January and the government announced capital injections of €3.5 billion each for AIB and Bank of Ireland in return for preference shares. By April, the government had decided that an asset management company (NAMA) would be

established to remove the larger non-performing loans from the balance sheets of the banks, and this would therefore result in a separate process of valuing the banks' assets. In June 2009, €4 billion euro of capital was announced for Anglo. By the end of 2009, Anglo needed further capital, and the Minister committed to providing this (ultimately issued as the first promissory note in March 2010).

Confidence in the regulatory system was at an all-time low. Nevertheless, significant new responsibilities had been assigned to the Regulator associated with the guarantee introduced in 2008. In addition, new information on serious governance matters at certain banks was coming to light through our investigations. Finally, there was uncertainty around the restructuring of the Central Bank and the Regulator and its governance.

It was very clear that the system of supervision and regulation that had been in place internationally and in Ireland was inadequate, and needed to be overhauled to protect depositors' money, to protect the State's guarantee, and to give some level of confidence so as to avoid a large scale, unmanageable run on the Irish banking system.

As Acting Chief Executive I, along with my supervisory team, took the following actions with the full support of my board:

1. From the end of January, we significantly increased the volume and frequency of periodic reporting by each bank in the areas of profitability, impairment provisioning, regulatory capital, liquidity, lending and governance. The resulting information formed the basis of a comprehensive quarterly Report to the Minister, which was required under the Guarantee legislation.
2. We introduced a model of supervision that was significantly more intrusive and that required active and frequent engagement with the domestic banking sector. This involved officers of the Regulator attending meetings of the boards of these institutions and relevant committees (such as the credit committee) to ensure that we could see at first hand if governance practices were working, and to send a strong signal to the banks that the regulatory regime was different and that our expectations were different. Our purpose was to monitor the strengths and weaknesses of banks' governance systems, and to challenge banks where we felt their processes were weak. A report on governance issues was also included in the quarterly report to the Minister.
3. While it was clear that permanent solutions to the organization structure would have to be decided by a new CEO, on my appointment, I put in place an interim management structure to help address the fundamental issues we faced in banking supervision. In advising the Board of these arrangements in January 2009, I also stated that the arrangements, while appropriate on an interim basis, were not a lasting solution. In the context in which we were operating, a more permanent organization structure could only

be adopted when there was certainty as to the new regulatory structure, including its governance. It was clear that the level of intensification required for banking supervision could only be achieved by the addition of significant extra resources. In order to manage the crisis more effectively in the interim, we increased resources, recruiting an additional 20 staff including specialist staff in areas where there was a deficiency such as credit and liquidity analysts. By the end of 2009 there were over 75 staff in banking supervision, 35 of whom were dealing with domestic credit institutions.

4. Apart from the liquidity and solvency issues, there was also a lack of confidence in the Irish banking system related to some specific events which unfolded in 2008, and it was imperative to investigate these matters thoroughly. We therefore established a Special Investigations Unit with around 25 to 30 seconded staff (at different times) and initiated a number of investigations. Some parts of these investigations were reported to the Garda in accordance with the relevant law at an early stage while other strands continued throughout 2009 with a view to exercising the Regulator's own administrative sanctions regime in respect of any regulatory breaches that might be uncovered. At the end of 2009, I sent a detailed letter to the Garda Commissioner Oireachtas seeking a mechanism to ensure that the use of the Regulator's enforcement powers did not jeopardize any action on the part of the Garda. I understand that some of these matters are now subject to legal proceedings and I cannot therefore comment further.

To summarise, during my period as Acting Chief Executive, the new approach to regulating the banks, that were the beneficiaries of the guarantee (the covered institutions), can be summarized as follows:

- significantly increased reporting requirements and information flow
- a more regular on-site presence at each institution, with periodic attendance at board and committee meetings (such as the credit committee)
- greater review and scrutiny of management information
- more frequent meetings with key officers
- requirements for and reviews of business plans and the challenging and monitoring of key variables affecting these plans,
- a heightened focus on governance structures and processes,
- introduction of a Code of Conduct on Mortgage Arrears and a Statutory Code of Conduct for Business Lending to Small and Medium Enterprises.

With regard to the Effectiveness of the supervisory practice and the Effectiveness of the use of supervisory powers:

The Central Bank's supervisory powers were exercised extensively in 2009. Seconded inspectors were appointed to carry out special investigations into suspected breaches of the law and of

regulatory provisions. Some 73 separate engagements were held with banks at the level of Acting CEO. In 2009, ten administrative sanctions enforcement actions were concluded that resulted in fines ranging from €7,500 to €2.7million, and one disqualification direction.

With regard to the Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector:

By 2009, it was very clear that there was a high risk to both solvency and liquidity, some of which had already materialised. As described earlier, we significantly increased the volume and frequency of periodic reporting and engagement with each bank in the areas of profitability, impairment provisioning, regulatory capital, liquidity, lending and governance. We introduced new monthly returns, for example, one that monitored the overall level of impaired loans and the provisions that were being made for these loans in various categories. During this period, bank funding became increasingly short term in duration as the market sought to benefit from the guarantee.

In summary, I believe it's fair to say that supervisory teams were in constant dialogue with the banks during this time, trying to understand the extent of the problem and addressing the emerging issues appropriately.

With regard to the Clarity and effectiveness of the nexus of institutional roles and relationships, and, the Awareness and clarity of role and accountability amongst the regulatory and supervisory institutions of the state:

In early 2009, the relationship between the Department of Finance and the Financial Regulator changed significantly as the guarantee required regular reporting to the Department, and, appropriately, the Department was much more actively involved in banking issues. While there was potential for a lack of clarity, I do not recall any circumstance where this arose in practice. Under the Guarantee Scheme, the Regulator had a daily morning telephone call with the Department as well as providing weekly liquidity reports on the covered banks, a monthly summary financial return and quarterly reports on compliance with the terms of the scheme. In June 2009, the government announced the new regulatory structure and the Chairman of the Regulator and the Governor agreed to work together as much as possible in advance of the implementing legislation. In any event, almost all issues related to banking had some sort of financial stability angle at this stage of the crisis, so it was decided that the Bank and the Regulator would meet together and operate as a joint Board. Nevertheless, the Secretaries to both boards took care to ensure that decision making was within the requirements of the existing legislation.

With regard to the Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the Banking Institutions:

My recollection is that the relationship with some banks was somewhat strained at this time. Sending a full investigative team into Anglo elicited what I believed was a defensive response, and early in the investigation I required the full Anglo board to meet with me in relation to my concern about the level of co-operation. Similarly, the reporting of a suspicion to the Gardai on the so called back-to-back loan issue meant that relations were tense with the institutions involved. In general, the banks themselves were working in a crisis environment, trying to accumulate liquidity while absorbing new regulatory and reporting requirements. Contact at various levels was more frequent, dialogue was direct, so tensions were high at times.

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

In March of 2009, I circulated a written procedure to all staff relating to the escalation of significant issues. The purpose was to ensure that staff would feel more comfortable to highlight their concerns in areas where there might be disagreement. However, I would also comment that by 2009, so many things that were unimaginable had already happened so that no contrarian view was ruled out.

With regard to the Adequacy and impact of international organizations' oversight on banking regulation and supervision activity:

During 2009, there was one IMF Article IV mission to Dublin, which reported in June and referred briefly to regulatory and supervisory initiatives that were already in train. The main focus of the Report was on managing the fiscal situation and the establishment of NAMA and a special resolution mechanism. It also noted that Ireland would need to be guided by evolving European Union guidelines.

With regard to the Relationship with and oversight by international stakeholders and the Quality and effectiveness of European policies and regulations:

During my time as Acting CEO in 2009, the quality and effectiveness of policies and regulations both from a European and an international perspective had already been declared insufficient and reforms were well underway. For example, in February of 2009, the de Larosiere Group published its Report. The EU Commission had sought the Report in 2008 to advise on the future of European regulation and banking and this formed the basis for many of the subsequent changes to European regulation and supervision. Since the Report was analyzing the broader international financial crisis, it covered issues such as complex

derivative products, which had no bearing on the Irish banking crisis (although we should never become complacent on these matters). Certain specific findings of the Report are, however, worth recalling in an Irish context, such as "the misunderstanding by banks of the interaction between credit and liquidity" and the "overestimation of the ability of financial firms as a whole to manage their risks and a corresponding underestimation of the capital they should hold".

With regard to the Effectiveness of the policy and institutional responses post crisis: An assessment of what has been done, work- in-progress and what remains outstanding from the recommendations of previous reports:

The more intrusive regulatory regime put in place during my period as Acting CEO in 2009 was, by necessity, interim in nature and was not intended to be a permanent solution. I understand that regulation has now been set on a more intrusive and challenging model on a permanent basis with the associated significant additional staffing in place. Furthermore, the Single Supervisory Mechanism has now changed the nature of banking regulation much more fundamentally in Ireland and elsewhere, and while it certainly appears to be the appropriate response, it is, in my view, too early to tell how it is functioning in practice.

Apart from the changes to the domestic environment, Ireland, as part of Europe, will benefit from the changes in European structures. The Single Resolution Mechanism allows for banks participating in the banking union to be resolved if necessary in an efficient, centralized way. Most importantly, there is now a clearly defined mechanism for dealing with these issues, which will be recognized by the financial markets.

With regard to the Assessment of whether further changes are required:

It is clear that the banking crisis resulted in enormous costs for the country and its people. However, it is important that we do not lose sight of other areas in the financial sector which have the potential for harm. Ireland is home to a wide range of financial services firms ranging from large banks and insurance companies to collective investment schemes and smaller financial intermediaries. While the role of banks in the broader economy is unique and, as such, the repercussions of a banking failure are enormous, it is also true that other areas of the financial sector have the potential to cause detriment – this is why they are regulated by law. For this reason, it is entirely appropriate that we devote substantial resources to the regulation of these firms and that we continuously review our methodologies in this regard. In my experience, there has always been and will always be other matters or issues over and above the day to day supervision which require significant resources (e.g. DIRT enquiry, NIB Inspection, implementing Basle 11, Solvency 11, establishing a new regulatory regime). We need to explicitly acknowledge the extra workload involved in these and provide resources accordingly so that supervisory staff are never diverted from the day-to-day role of supervision.

Most importantly, we need to work in a system where the Regulator, now the Central Bank, is supported in making difficult decisions. If the regulatory system is to be effective, it will include taking preventative action at a time when this action is likely to be unpopular, and indeed, will be open to question.

But we must be realistic in our assessment of what the changes to the regulatory and supervisory systems can achieve. Ireland has moved from a principles based approach to an intrusive and challenging approach to regulation and this is appropriate. But in the US, where, despite their own wave of financial deregulation, a much more rules based approach had been adopted, there were also spectacular failures of banks and insurance companies. In the US, many changes have been adopted through new legislation and the conversation there is not so much about more intrusive regulation but stronger enforcement action, stronger consumer protection and changes to the culture of banks.

There is therefore no perfect formula for a regulatory system that will prevent financial crises and, indeed, no regulator can operate a zero failure regime. However, in working towards a better system, transparency and recognition of risk is, in my view, one of the most fundamental pillars of appropriate supervision. The relationship between risk and return rarely changes, so that a careful examination of the relative profit centres of any financial institution is likely to identify where the risk is. It could be derivatives trading, commercial lending, or credit card insurance, but if the relative profit seems high, the likelihood is that there's an unknown or unrecognized risk for which the bank is being rewarded. The bank's board, first and foremost, and then the regulator, should follow the money (especially the seemingly easy money) to probe these risks, both at an individual bank level and at a system level, paying particular attention to the most extreme scenarios.

Crisis Management System and Policy response: Appropriateness and effectiveness of other EU-wide policy responses - Lines of Inquiry C6a, C6b, C6c, C6d:

The responses, including Basel III (CRDIV) on capital and liquidity, Banking Union measures including the new Single Supervisory Mechanism, the Single Resolution Mechanism and the Deposit Guarantee Scheme, and, the Fiscal Compact Treaty and Sovereign Debt Restructuring Mechanism, seem appropriate. But, in my view, it may be too early to say this definitively. After all, Basle II was lauded at the time as a much better way of capturing the real risks of a financial institutions and freeing up capital for better use in the real economy. Clearly, that was wrong. It is also interesting to note that the structures which have been put in place in Europe to manage through a crisis and enable speedy resolution, did not exist before, most likely because no one expected a crisis of such monumental proportions to occur.

Today, we're unlikely to know the genesis of the next crisis so we need to have a system which can react quickly to changing circumstances including domestic, European and international circumstances. We also need to be confident to bring issues to the international arena where we see fractures in the system.

With regard to the Role and influence of the ECB:

During 2009, the Central Bank, rather than the regulator, dealt with the ECB in relation to providing liquidity support to the banks and amending their rules on collateral. I had no role in these discussions.

Banking: Effectiveness of banks' board governance, client relationships and business models: themes B1a and B1b: With regard to the Composition, skills and experience of the Board and Board Sub-Committees:

During 2009, our focus was on crisis assessment, trying to understand the scale of potential problems. Early in the year, our governance concerns were directed at the institutions in most difficulty. Our concerns in this area were set out in the quarterly reports to the Minister. For example, in June 2009, there were three banks seeking a new CEO, two seeking a new Chair, two seeking Heads of Finance and two without risk officers. For new appointments, the procedure was for a 'fit and proper test' to be carried out. This involved a framework which had been put in place in 2007 and included an individual questionnaire which elicited information concerning a proposed person's qualifications experience and personal history. As described earlier, we also commenced the practice of observing boards and committees in operation. Aside from the boards of banks, in 2009, it was clear that the expertise of staff in the lending areas was focused on sales and not on arrears management where there was a pressing need for expertise. Furthermore, preparations for the transfer of loans to NAMA tied up credit resources as this process was a lengthy and complex one.

We engaged with and challenged the banks regarding various revisions of their business models throughout 2009 as we considered how best to maintain a viable banking system. We were concerned with a number of areas within those plans - for example, a number of them had the same source of profitability - so we challenged the various assumptions underlying the plans. In addition, the sensitivities of their profits, capital and funding to various assumptions were challenged to ensure the plan was robust. In meetings with senior credit executives, we consistently challenged the banks to make more realistic assessments of the position of their portfolios.

With regard to the Integrity of financial reporting:

During 2009, the integrity of financial reporting gained heightened significance. In that year, IL&P was fined €600,000 for breaches of regulatory reporting.

I trust the above comments address the areas set out by the Committee and I am, of course, happy to elaborate should the Committee so wish.