Witness Statement from Tom Considine to the Joint Committee of Inquiry into the Banking Crisis.

This statement covers the themes and lines of inquiry I was directed to address in respect of my roles as Secretary General of the Department of Finance, March 2002 to June 2006.

Effectiveness of the regulatory, supervisory and governmental regime structure

The role of the Department of Finance was to bring forward to the Minister primary and secondary legislative proposals to maintain an appropriate legal framework for regulating the Financial Services Sector. The Department also represented Ireland in the development of EU legislation governing the regulation of financial services and, in turn, that EU legislation had a strong influence on domestic legislation. By 2002 the bulk of the regulation of the Irish financial sector was the responsibility of the Central Bank of Ireland within the legislative framework provided by the Minister, the Government and the Oireachtas.

The Minister did have an appeal function in relation to the approval of payments systems and he also made appointments to appeals panels and to the Central Bank Board, with the exception of the Governor who was appointed by the President on the advice of the Government. The Secretary General of the Department of Finance was ex-officio a member of the Central Bank Board.

On 20 October, 1998 the Government agreed in principle to establish a Single Regulatory Authority and established an Implementation Advisory Group chaired by Mr Michael McDowell, Senior Counsel. The Group reported on 19 May, 1999 and recommended that the Single Regulatory Authority (SRA) should be an entirely new independent organisation. As a member of the Implementation Group, I proposed an alternative model on behalf of the Department of Finance. This model located the SRA within a restructured Central Bank while providing for increased autonomy for the regulatory function but under the direct control of the Central Bank Board. This alternative model, supported by a minority of the Group, is at Appendix 2 of the report. In the event the Government legislated for a model with a separate Board for regulation but within an overall Central Bank and Financial Services Authority framework. The Regulatory Board was appointed by the Minister for Finance after consulting the Minister for Enterprise, Trade and Employment and did not include a representative of the Department of Finance. The new two board model came into operation on 1 May, 2003.

The Financial Services Regulatory Authority published a Strategic Plan for the years 2004 – 2006. This Plan stated the Authority believed that a mainly principles-based supervisory system would deliver a good balance between having a competitive industry and requiring high entry standards for doing business. That Plan stated that a key part of the approach would be "Putting a comprehensive on-site review process in place".

The Government's White Paper "Regulating Better" was published by the Department of the Taoiseach in January, 2004. It identified the principles of good regulation as: Necessity, Effectiveness, Proportionality, Transparency, Accountability and Consistency. The White paper advised that "The recommendations and actions in this White Paper are best seen in the context of the continuing drive for competiveness and people's expectations of high quality public services".

The 2006 Annual Report of the Irish Financial Regulator (page 26) refers to its approach to regulation as follows:

> "In order to ensure that our regulatory requirements do not become a barrier to competiveness and innovation, we apply the Better Regulation principles which the Government published in January 2004 (table reference) and are an active member of the Taoiseach's Better Regulation Group"

This approach in turn appeared to be aligned to the prevailing international belief, particularly in the US and Europe, in the economic benefits of rational self-correcting markets and the merits of financial intermediation. For example, in his evidence to this Committee on 18 February last Mr Buti, EU DG for Economic and Financial Affairs stated:

> "Yes, we understood that the Irish housing boom would not be sustainable. But in line with the "Great Moderation" paradigm we, as others, did not anticipate that the end of the housing boom could give rise to the dislocations that eventually emerged after 2007 and which later on lead Ireland to ask for financial assistance from the EU and the IMF. The Financial sector was thought to simply channel funds in an efficient manner to where the real economy needed them. Dangerous excesses were thought to originate only in monetary and fiscal policy making".

The Larosiere Report of 25 February, 2009 gave the following examples of regulatory tools which can help meet counter-cyclical objectives:

> Introducing dynamic provisioning or counter –cyclical reserves on banks in "good times" to limit credit expansion and so alleviate pro-cyclicality effects in the "bad times";
>
> Making rules on loans to value more restrictive; and
>
> Modifying tax rules that excessively stimulate the demand for assets.

However, the Report states that "These tools were not, or were hardly, used by monetary and regulatory authorities in the run-up to the present crisis." Despite the background environment, Ireland did move to increase the capital weighting on high loan to value mortgages and to phase out tax support for a number of property schemes. With the benefit of hindsight, it is reasonable to say that these measures should have been taken sooner.

The Department of Finance was staffed to deal with the functions and regulatory model outlined above and that was considered adequate during the 2002 to 2006 period. The Central Bank and the Regulatory Authority had the structures needed to decide the required staffing levels for the functions they were required by legislation to perform. Clearly, with the onset of the crisis it was necessary for all three organisations to review their staffing and skill levels and to move as quickly as possible to secure and allocate any additional resources required to manage the crisis. With the benefit of hindsight, more consideration could have been given to how the legal framework would cope with a major crisis.

Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

The strategic priorities of the Department of Finance in regard to **financial regulation** were listed in our statement of Strategy 2005 – 2007, as: the provision of a modern regulatory regime for financial services; supporting competitive and efficient markets; participating in the development of EU policy; ensuring the timely transposition of EU legislation and promoting best practice, consumer protection and financial stability. The legislation which established the Irish Financial Services Regulatory Authority became operational in 2003 and the Department noted in its 2005 annual report, published in March 2006, that the Financial Services Ombudsman Bureau began operating on 1 April 2005 and that a programme of work and consultation was underway to consolidate and modernise financial services regulation.

The Department of Finance discharged its responsibilities to process the legislation which was required to put in place the regulatory framework decided on by Government. The two Boards which made up the new regulatory structure worked together by agreement to give effect to that legislation, including the production of annual Financial Stability Reports. The last such report during my period on the Board was published on 1 November, 2005 based on data available up to end-September, 2005. It identified credit growth and indebtedness as the primary risk ahead of an unanticipated and sudden fall in residential property prices because of a moderation in house price growth since the previous report. However, the Report did note the emergence of tentative evidence that this moderation may not have persisted and goes on to state that if house prices were to accelerate this would increase the risk of a sharp correction to house prices in the future.

The Report went on to conclude that "The stability and health of the Irish banking system appears generally sound, according to the standard indicators of financial health such as asset quality, profitability, solvency, liquidity and credit ratings" The IMF Executive Board published an assessment of the Irish financial system in August 2006. That assessment stated "Directors welcomed the Financial System Stability Assessment Update, which finds that Ireland's financial sector soundness indicators are generally strong and that the major lenders have adequate buffers to cover a range of shocks" I have already referred to the use of macro-prudential tools above in the context of the Larosiere Report.

In regard to **fiscal policy**, during each of the four years ending 31 December 2006, the General Government was in surplus and these surpluses ranged between 0.4% of GDP in 2003 to 2.9% of GDP in 2006. During the same period the General Government Debt declined each year as a percentage of GDP, from 31.8% in 2002 to 24.6% in 2006.

During the four years to end-2006, gross Exchequer capital expenditure increased by 19 ½% on a cumulative basis, from €5.6 Billion in 2002 to €6.7 Billion. The percentage change for each of the four years was -4.0%, -2.9%, 13.0% and 13.2%.

During the same four years, gross voted current expenditure, or day-to-day spending increased by a cumulative 43.4%, from €30,225 million in 2002 to €43,355 million. During the first two years the annual rate of increase was declining, from 14.8% in 2002 to 9.2% in 2003 and 7.7% in 2004. During the second two years the rate of increase was higher at 10.3% in 2005 and 10.6% in 2006.

During the four year period ending December-2006, the current account of the balance of payments was in balance in 2003, had a deficit of 0.6% of GDP in 2004 and the deficit in each of the years 2005 and 2006 was close to 3.5% of GDP. However, in the run up to Budget 2006, Department of Finance economic projections put the 2005 deficit at 2.4% of GDP.

Regarding taxation, the reductions in personal taxation were modest during the years 2003 and 2004 but moved higher in the years 2005 and 2006, when there was strong political emphasis on keeping those on the minimum wage outside the income tax net and reducing the number of taxpayers on the higher rate of income tax.

Clarity and effectiveness of the nexus of institutional roles and relationships

There was a good working relationship at all levels between the Department of Finance, the Central Bank and Financial Services Authority of Ireland and the Financial Regulator. As already indicated, I was ex-officio a member of the Board of the Central Bank and Financial Services Authority. Six of the thirteen members of that Board were also members of the Board of the Regulatory Authority. The fact that the Department of Finance was not represented on the Board of the Regulatory Authority did distance the Department from day-to-day regulatory issues but did not impact on the working relationship between the Department and the Regulatory Authority. Finally, there was regular contact between the Governor and the minister, particularly in relation to the annual Budget and the annual Financial Stability Report.

The annual Financial Stability Report was a joint production on the part of the Central Bank and Financial Services Authority and the Financial Regulator and the two Boards came together to approve the document. During my period on the Board of the Central Bank and Financial Services Authority, no liquidity or solvency issues were identified by the Board. Given that the Regulatory Authority had a separate Board within the overall Central Bank and Financial Services Authority, the two sides worked to an agreed Memorandum of Understanding so that they could work together effectively. In his foreword to the 2005 Financial Stability Report, the Governor stated that: "The Central Bank and Financial Regulator co-operate fully on matters relating to financial stability. A joint committee, the Financial Stability Committee (FSC), chaired by the Director General of the Central Bank and with senior representatives from the Financial Regulator, oversees financial stability matters. The Financial Stability Report reflects the extensive input of the FSC". Despite this level of co-operation, I consider that the single board structure, recommended by a minority of the McDowell Group, was the best option and in the aftermath of the crisis the Government reverted to a single Board structure.

Appropriateness and effective utilisation of the expert advice

In his 2005 Budget Statement the Minister for Finance announced that the Department of Finance and the Office of the Revenue Commissioners would undertake in 2005 a detailed review of certain tax incentive schemes and tax exemptions in the areas of property and housing. The Minister also stated that the review would evaluate their impact and operation including their economic and social benefits for the different locations and sectors involved and to the wider community. In addition the review would examine the degree to which these schemes allow high-income individuals to reduce their tax liabilities.

The Minister for Finance considered the outcome of the review as part of his work on Budget 2006. The December, 2005 Budget Statement announced the ending of a number of property-based tax incentive schemes subject to certain conditions. The main condition was that the period during which qualifying construction expenditure can be incurred was extended to end-July, 2008. This extension was only made available for those projects that had already satisfied the terms of the particular scheme. The Minister also introduced with effect from 1 January, 2007 a new measure to limit the use of tax breaks by those with high incomes.

The 2006 Budget Statement also noted that the major review of tax reliefs that gave rise to the changes just outlined involved both internal reviews and the employment of two firms of external consultants. Both sets of consultants dealt with the transitional issue and both recommended an extension of relief for pipeline cases. One recommended a simple extension of 100% relief for seventeen months beyond 31 July 2006. The other recommended an extension of five years but at only 50% relief. The Minister decided on a middle course between the two. He noted that the review also included an extensive public consultation in which nearly ninety submissions were received from a wide range of persons. These submissions were reviewed by the Joint Oireachtas Committee on Finance and the Public Services and the Minister noted that he had the benefit of that Committee's discussions.

The Department of Finance monitored the economic views of other organisations. For example, the 2006 annual Budget material included at page E11 a Table comparing the economic forecast of the Department of Finance, which underpinned the Budget, with other current forecasts. The other forecasts included were from the Central Bank of Ireland, the ESRI, the European Commission, the IMF and the OECD. In addition, to the weekly Management Advisory Committee(MAC) meetings, the MAC met annually with each Assistant Secretary and Director together with their staff, at least to Administrative Officer/Higher Executive level, to exchange views on current issues of interest to each unit.

The 2006 Budget material made clear that the forecasts that underpinned the Budget were based on EU Commission technical assumptions regarding key external variables and developments in our major trading partners. It also made it clear that as a small open economy, Ireland was particularly vulnerable to changes in the world economic outlook. Among the significant international and domestic downside risks highlighted was the following:

> "Given the loss of competiveness in recent years, the economy is vulnerable to any further deterioration. In addition, the fact that the construction sector now accounts

for a historically high share of economic activity and employment, implies that the economy is vulnerable to any shock affecting this sector."

However, despite the acknowledged risks the consensus view was that the external environment appeared to be broadly positive, with international forecasting agencies projecting continued strong growth in the world economy over 2006 and 2007 and, in particular, a pick-up in the euro area.

In the run-up to the 2006 Budget it appeared that the economy and the public finances in particular were sufficiently strong to cope with any likely shock. For example, the December, 2005 ESRI Medium-Term Review, 2005-2012, included an economic assessment of a housing shock. **The ESRI stressed that the assessment was not a forecast and that it was not suggesting that such a serious shock was inevitable.** For illustrative purposes, it calibrated a housing price shock with a fall in house prices of approximately a third in 2007 and with house prices only beginning to recover after 2010. They analysed the potential impact of these major changes on the economy over the period 2007 to 2010. The study concluded that annual housing completions would not fall much below 40,000 and GNP growth would fall sharply in 2007 but remain above 1%. Unemployment is shown increasing sharply and peaking below 12% in 2009 before beginning to ease back, with the rate of wage increases falling sharply to just above zero.

The paper went on to say that cutting expenditure and raising taxation to fully offset the impact of the shock on the Government's finances would be very pro-cyclical and considered a scenario where the Government allowed the deficit to rise without responding. The paper concluded that the impact on the public finances would be quite large, with a peak Exchequer deficit of 4 ½ to 5% of GNP in 2009. The paper opined that such a neutral fiscal policy might be appropriate given the then low level of Government debt and would provide some insulation to the economy from the shock i.e. GNP might recover to the levels it might otherwise have been at by 2010 rather than 2011.

In late October, 2003 the ESRI completed a medium-term evaluation of the National Development Plan and Community Support Framework for Ireland, 2000-2006. The main conclusion was that the strategy was broadly correct. Suggested changes to improve the evaluation of projects were acted upon. Other expert advice related to project specific and technical matters such as the consolidation of legislation. As I was not on the Board of the Regulator I did not have sight of their contacts with auditors.

Clarity and effectiveness of the Government and Oireachtas oversight role.

Fiscal policy, incomes policy and regulation were the key policy instruments available to the Irish Authorities to manage the domestic economy within the Euro area. This was recognised from the outset of our EMU membership. The Department of Finance established an internal Working Group to examine the implications of EMU membership for public policy. The report entitled "The Implications of EMU Membership for Various Aspects of Public Policy" was approved by the Minister for Finance for publication in October, 1999 on the Department's website. The Report noted (page 10) that:

> "The "Celtic Tiger" economy is already having a major effect on expectations in terms of income, taxation and expenditure policy and it is clear that, far from moderating, these pressures are likely to continue to grow. In the circumstances, it will undoubtedly prove extremely difficult to persuade the social partners, interest groups and the public in general to accept a prudent fiscal stance"

By 2006, financial markets had become increasingly globalised, accustomed to readily available credit, significant product innovation, greater financial integration in the Euro area, large current balance of payment imbalances and low interest rates. Technology had transformed the efficiency, speed and complexity of financial instruments and transactions. Internationally, there was a widespread view among regulators that it was generally advantageous to champion the economic benefits of rational, self-correcting markets and the merits of financial innovation. This was supported by a strong belief that new modes of finance had reduced systemic risk. In the United States in 2004 Ben Bernanke, then a Board member of the US Federal Reserve, stated that:

> "One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility",

From the introduction of the Euro up until the start of the crisis, member States of the Euro area and countries with a good credit rating had no difficulty financing their borrowing requirements at competitive bond yields. During the same period, Irish banks were also able to access the wholesale money markets at competitive interest rates.

Against that background, Ireland experienced an extended period of strong economic expansion, interrupted only by lower growth rates in 2001 and 2002 arising from the ending of the dotcom bubble, the nine-eleven terrorist attack in the US and the impact of animal foot-and-mouth disease. Consequently, Irish expectations were high that living standards and asset prices would continue to advance. This in turn was reflected in strong demand for credit and housing.

Fiscal policy in particular was strongly influenced by the provisions of the Programme for Government published in June, 2002 and by the Social Partnership Agreement, 2003 – 2005 entitled "Sustaining Progress" Consequently, the Department's Statement of Strategy prepared after the formation of the new Government included the following reference in its Mission Statement:

> "The Department has a central role in implementing Government policy, in particular the Programme for Government (June, 2002)…"

Each year the Department of Finance engaged with the Minister on the preparation of the Budget Strategy Memorandum that was submitted by the Minister to Government at mid-year. The Government decision, based on that Memorandum, formed the basis for the preparation of the spending, taxation and deficit/surplus framework for the upcoming Budget. Government Departments were required to submit their spending proposals by early autumn, based on that Government decision. The Department of Finance would also prepare an estimate of the cost of funding the existing level of public services during the following year and this would be used as a reference point for the discussions with Departments/Ministers in the lead up to the Budget. Each year the Department published a Budget Statement with supporting documentation (including the Irish Stability Report submitted to the EU), a book of estimates, an Economic Review and Outlook and finally Tax Strategy Group papers.

The Budgets for 2003 and 2004 were difficult because in each case Departments were required to prepare their pre-Budget expenditure figures at a level significantly below what the Department of Finance estimated it would cost to fund existing service levels during the following year. For the 2003 Budget the required reduction was €900 million and in the case of the 2004 Budget the corresponding figure was €500million. In the case of the 2004 Budget, line Departments contended that the Department of Finance base was €2.1billion too low. These two Budgets were naturally unpopular and subject to criticism.

When it came to preparing the 2005 Budget the pressure to ease up on what were seen as expenditure cuts was very strong. In addition, the pressure was more difficult to resist because the economic recovery from the 2001/2002 downturn was more firmly established.

Against that background, Government decided, on the recommendation of the Minister for Finance, that Departments should prepare their estimates for 2005 on the basis of Department of Finance estimates of the cost of funding the existing level of services in 2005 and that in addition €900 million would be provided to cover the cost of the Budget day social welfare increases and tax changes. In the event the Budget Strategy Memorandum targets were exceeded by approximately €1 Billion in gross terms. The Budget day tax package accounted for almost €580 million and gross public expenditure accounted for the remainder of the €1.9 billion. The year-on-year increase for gross voted public expenditure was just over 9%.

In preparation for Budget 2006, the Department tabled a paper for the Ministerial Management Advisory Committee of 2 February, 2005 entitled "Draft Framework for developing the Budget Strategy Memorandum 2006 – 2008". That paper (attached to this statement) recommended that the target for capital expenditure be about 5% of GNP and that gross voted current public expenditure be increased by 6.6% over its 2005 level. In the event the 2006 Budget Strategy Memorandum was based on an increase of about 7 ½% in gross current expenditure and gross voted Exchequer capital of 4.6% of GNP. Post-Budget, the gross voted current expenditure increase was 10.9% and gross Exchequer capital was 4.7% of GNP. The particular focus on gross current expenditure reflects the difficulty in reversing welfare, pension and pay increases, once granted. The gross 2006 cost of the Budget day tax package was €763 million.

Prior to the financial crisis economic governance in the EU was primarily delivered through the Stability and Growth Pact (SGP) and the Broad Economic Policy guidelines (BEPGs). The SGP was designed to deliver sound public finances largely by facilitating, at the national level, balanced budgets and prudent debt levels. The BEPGs provided economic recommendations for Member States and the region as a whole. However, euro area governments had considerable discretion when it came to deciding changes to the total volume and composition of expenditure and taxation. There is a range of published material explaining how events evolved in each of these policy areas and the thinking behind them.

Being a Euro area member State, the Irish Government had no function in relation to official interest rates or the Euro exchange rate. During the period 2002 – 2006 Ireland had an AAA credit rating and Irish banks were able to borrow wholesale funds at competitive rates. The average Irish variable mortgage rate at end-1998 was around 6%, compared with an average for the euro area of around 5.3%. By end-1999 the Irish rate had fallen to 4.19% and below the euro area rate of 5.79%. A significant development in the Irish mortgage market relevant to these events was the emergence of mortgage brokers and the development of telephone banking. The Central Bank's 1999 winter bulletin noted that, an increase in competition led to a reduction of the order of 1.25% in Irish mortgage rates as Irish lenders responded to competition from late August by the Bank of Scotland.

The National legal and regulatory framework for financial services during the period leading up to mid-2006 was mainly based on relevant European legislation. However, individual member States had significant discretion when it came to the details of their structures and the implementation of that framework. For example, each country was free to decide whether to have a single financial regulator or a number of separate regulators. At a more detailed level each country was free to implement its regulations using either a "Principles" based approach, a "Rules" based approach or some combination of the two. The government's legal and regulatory framework also extends to areas other than financial regulation, including the legal framework that applies to corporate governance and the arrangements and structures in place for influencing the evolution of wage rates and for helping to resolve industrial disputes

By end-2006 there were significant buffers available in the system to deal with an economic shock. The General Government had a surplus equivalent to 2.9% of GDP and under the Stability and Growth Pact we could run a deficit of up to 3% of GDP in the event of a serious economic shock. Given that 2006 GDP was €177 billion, this provided a buffer of up to €10.5 billion. In addition, in 2006 the Exchequer financed €6.7 Billion of capital expenditure from current revenue, spending that could be reduced significantly in the event of a crisis. The General Government debt at end-2006 was 24.6% of GDP, some 35.4 percentage points below the 60% figure required by the Stability and Growth Pact, equivalent to €63 billion in 2006 prices. Therefore, in a crisis situation significantly higher levels of Government borrowing could take place to help cushion the impact of any economic shock. Finally, the Government was building up the National Pension Reserve Fund.

Downside risks that could cause economic shocks were clearly acknowledged. These were highlighted in the Minister's 2006 Budget statement, in his replies to PQs and in his public speeches. For example, in his address of 12 October, 2005 to the Institute of Directors he listed the key risks as relating to the world price of oil, the risk of renewed appreciation of the Euro, the high level of the US balance of payments deficit and "the considerable uncertainty surrounding the pace at which new housing output adjusts downwards to more sustainable levels – and the impact of any adjustment on the wider economy. In addition an ESRI study published on 7 October is concerned about the extent to which jobs growth here has been concentrated in the construction sector."

In addition, interest rates were rising, the 2006 Budget contained provisions to further cool the property market and the Department of Finance sought to keep the increase in public expenditure as low as possible. Given the general belief that the economy was strong and the then perceived healthy state of the public finances, the pressure on Government for additional spending and tax reliefs was intense. Clearly, lower increases in day-to-day spending would have increased the buffers available to tackle the crisis. Nevertheless, the 2006 Budget did include a range of measures restricting tax reliefs on property related projects. Those measures were designed to cool the property market without themselves causing the market to crash.

Relationship with and oversight by international stakeholders

The main contact with the EU between 2002 and 2006 was through the Euro Group of Finance Ministers and the ECOFIN Council. During that period Ireland had a good working relationship with those bodies.

The EU broad economic policy Guidelines, 2001 – 2005, had the following specific reference to Ireland: "Achieve a smooth transition from double digit economic growth to lower, sustainable growth by ensuring stable macro-economic conditions and strengthening the supply side of the economy" In 2006 the EU report "Public Finances in EMU 2006" concluded in relation to Ireland "Overall, the public finances are expected to remain strong in 2006 and 2007." While Ireland complied with EU public finance rules, the EU did point to medium term risks, as had the Minister for Finance both in the run up to Budget 2006 and in the Budget itself. In both cases these risks included possible developments in the Irish housing market and the international economy. The method agreed by the ECOFIN Council in 2002 to estimate the structural budget balance for the purposes of EU fiscal surveillance did not signal any specific problem for Ireland.

I confirm that to the best of my knowledge and belief the document attached to this statement is a true and correct copy of original documentation and it is not in the public domain.