Written Statement: William Beausang

1. Background (pre-August 2007)

1.1 I was appointed Assistant Secretary in the Department of Finance (DOF) in April 2005 with a broad range of responsibilities in the financial services area [TAB A]. I reported to Mr Noel O'Gorman Second Secretary-General who headed the Banking Finance and International Division. Mr O'Gorman reported to the Secretary-General, Mr Considine. Mr O'Gorman retired and was replaced by Mr Cardiff in September 2006 who reported to Mr Considine's successor Mr Doyle.

1.2 My primary responsibility was the domestic and EU legislative and policy framework for financial services. A major programme of EU financial services directives was being negotiated and transposed into national law to strengthen the EU single market in financial services.

1.3 Addressing gaps in the legal framework for protecting consumers was a further priority (e.g. the enactment of legislation to ensure IFSRA could regulate "sub-prime" mortgage lenders, other non-deposit taking lenders, equity release and home reversion products).

1.4 I was also the Assistant Secretary responsible for legislation and policy relating to financial regulatory structures.

1.5 I attended some Management Advisory Committee (MAC) and Ministerial-MAC meetings. This occurred on the basis of a rota for all Assistant Secretaries / Directors or where a specific agenda item related to my area (e.g. credit unions).

1.6 Three Principal Officers reported to me. They and their teams had extensive experience of the national and EU legislative and policy framework for financial services. They worked closely with officials from the Central Bank (CB) and IFSRA. The detailed technical knowledge required for the area was met by my team's own expertise and experience, the specialist technical expertise of CBFSAI officials and through access to industry experts.

2. Financial Regulatory Structures (R2c, R3c)

2.1 On my appointment, I was not advised by Mr O'Gorman or Mr Considine of any substantive concerns regarding the CBFSAI structure. The 'hybrid' model was a balance between a stand-alone "Single Regulatory Authority" and an "integrated" approach where a central bank is responsible for financial supervision of banks. I was satisfied it was appropriate given, for example the case made for the establishment of a SRA in the McDowell Report, the shift internationally towards a single financial regulator model and the ECB assessment of the CBFSAI model.

2.2 Analysis published by the FSA in May 1999 and 2002 [TAB Ba, TAB Bb] concluded that the case for regulation in response to systemic risk did not provide an argument in favour of the central bank undertaking regulation (although it would be essential to preserve a flow of information between the financial supervisor and the central bank).

2.3 The ECB reported that the CBFSAI structure was fit-for-purpose. In its legal opinions on the legislation the ECB welcomed the features of the legislation which it regarded as fundamental to allowing the continued close involvement of the CB in supervision. The ECB concluded that the safeguarding of the contribution of the CB allowed the Eurosystem to contribute adequately to monitoring the risks to financial stability in the euro area [TAB Ca, TAB Cb].

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3. BFID's relationship with CBFSAI (R1b, R2c, R3c)

3.1 The relationship between my area of the Department and the CBFSAI was clearly defined by the statutory framework detailed in the CBFSAI legislation, EU legislation and the EU Treaties.

3.2 The CBFSAI legislation provided IFSRA with strict operational independence in performing its prudential and supervisory responsibilities. Regulatory independence was a core principle of international best practice as set out in the Basel Core Principles for Effective Banking Supervision [TAB D]. It was also a fundamental principle of EU financial services legislation. Under the EU Treaties, the Central Bank was independent in performing its Eurosystem responsibilities.

3.3 In order to balance IFSRA's strict independence, a detailed framework of accountability was central to the legislation [TAB E]. The elements of that accountability framework which related to the Minister for Finance were exercised by my area. Under the accountability framework in the legislation, there was no basis for the DOF to oversee, review or scrutinise IFSRA's performance in supervising individual institutions or the Central Bank's in relation to financial stability.

3.4 My unit was highly attuned to the essential requirement not to encroach on IFSRA's operational independence. Freedom from any perception of inappropriate interference was integral to the reputation of Ireland's financial regulatory system.

3.5 A 2007 IMF working paper emphasised the case for ensuring that regulatory and supervisory agencies benefited from a high degree of operational independence corresponding to that enjoyed by central banks [TAB F]. Analysing regulatory structures in 32 countries, the paper concluded that IFSRA had the highest rating combined for independence and accountability. The result was highlighted by IFSRA in its Annual Reports etc. as a key external endorsement of Ireland's independent regulatory model.

3.6 IFSRA briefed the Minister / DOF on significant issues that IFSRA was making decisions on (e.g. not to introduce a general requirement for directors compliance statements). The main issues on which briefing took place are set out in the reports of / briefing notes prepared for the Minister for meetings with the Chair and CEO of IFSRA [TAB G]. Credit unions were the main prudential / stability risk highlighted at these meetings.

3.7 Where a prudential issue was raised with us by another Department, representative body or individual institution relating to IFSRA's responsibilities, we would respond having consulted with IFSRA given IFSRA's independent legal and regulatory responsibilities in relation to the matter (e.g. 100% LTV mortgages).

4. CBFSAI - powers to supervise banks and maintain financial stability (R1b, R2c, R3c)

4.1 IFSRA had extensive powers and tools to carry out its prudential and supervisory responsibilities. It was a priority for my area to ensure that there was no deficit in the legal powers available to IFSRA to effectively perform its mandate. Where any significant gap in the regulatory landscape came to light it was quickly addressed.

4.2 Specific powers were provided in CBFSAI legislation to ensure consistency between the CB's responsibility for financial stability and IFSRA's responsibility for the supervision of individual financial institutions (i.e. macro- and micro-prudential policy). No shortfalls in CBFSAI's powers to effectively discharge its responsibilities to maintain financial stability and to align their exercise to IFSRA's micro-prudential powers were advised to me by the CB.

5. Supervisory Model (R1b, R2c, R3c)

5.1 A core element of IFSRA's statutory independence was its ability to determine itself the most appropriate supervisory model.

5.2 The model of 'principles-led' 'risk-based' supervision was set out in IFSRA's Strategic Plan, Annual Reports [TAB Ha, TAB Hb] and public pronouncements. A central feature of IFSRA's supervisory regime was that responsibility for the proper management and control of each financial institution and the integrity of its systems were, in the first instance, the responsibility of its board of directors and senior management. The supervisory approach mirrored that adopted in other jurisdictions including, in particular, the UK [TAB I].

5.3 My unit had extensive direct knowledge of, and close involvement in, the development and introduction into domestic law of EU financial services regulation. This included those relating to capital adequacy for banks. This legislative framework provided detailed regulatory requirements for financial firms, as well as furnishing IFSRA with wide and robust supervisory and enforcement powers.

5.4 We knew that IFSRA's supervisory approach was, therefore, strongly underpinned by a comprehensive system of technical regulation encompassing specific rules, regulations, codes and the supervisory powers necessary for their implementation.

5.5 IFSRA described in its Strategic Plan [TAB J] how its prudential oversight and supervision focused on verifying that robust and effective structures of corporate governance, best practice compliance and risk management rigorous internal audit etc. were in existence and properly implemented by the banks. IFSRA also highlighted how its supervisory activities were determined on internal risk-rating system to ensure that supervisory resources were allocated to the areas of greatest risk. IFSRA reported how prudential supervision of financial service providers is carried out by means of administering the provisions set out in legislation and regular interaction with institutions supported by the collection and analysis of financial information and by on-site visits.

5.6 The approach was endorsed by the IMF in its 2006 Financial Sector Assessment Programme (FSAP). In particular, the IMF concluded that the general approach of the CB and IFSRA was appropriate and the regulatory framework showed a high degree of observance of the Basel Core Principles [TAB K].

5.7 Balanced against the information and assessments provided by IFSRA and the CB regarding the financial standing of the banking sector, the suite of precautionary measures taken over the period set out in the statement made to an Oireachtas Committee in January 2009 [TAB Kb] seemed to be proportionate to the risks identified.

5.8 The information disclosed in the Honohan and Nyberg reports regarding IFSRA's performance, for example, cataloguing the weaknesses in IFSRA's supervisory approach or in not developing a consolidated system-wide picture of concentration risks and large exposures was not available or advised to me. Under the national and EU legal framework such prudential information was subject to strict professional secrecy requirements.

5.9 Under the legislation or in terms of the accountability framework, my area had no role or mandate in assessing the efficacy of financial supervision or in overseeing systemic stability. We were, however, cognisant of a broad range of factors which appeared to provide substantial assurance over that period that the supervisory and prudential system was operating effectively. These included:-

5.9.1 The Central Bank's and IFSRA's legal mandate, responsibilities, expertise and resources in relation to financial stability and prudential supervision respectively, as well as the corporate governance structures in place in the CBFSAI (i.e. the Board of the Central Bank and Regulatory Authority in IFSRA with senior expert and experienced financial, business and regulatory / central bank personnel participating in both cases).

5.9.2 The detailed and comprehensive framework for determination of capital requirements and bank supervision under the EU Capital Requirements Directive (CRD) closely reflecting the international Basel II accord.

5.9.3 The performance of a financial stability surveillance role by the ECB / Eurosystem.

5.9.4 The conclusions of the detailed and comprehensive Financial Stability Reports published by the expert Central Bank's financial stability team in 2005, 2006 and 2007.

5.9.5 Positive international assessments of financial supervision and the resilience of the banking system to shocks reported by authoritative international organisations (i.e. 2006 IMF FSAP and the OECD).

5.9.6 The broad consensus among a wide range of economic forecasting bodies, including those of the ESRI, OECD, EC and DOF that a soft landing would be achieved for the Irish economy.

5.9.7 The favourable ratings for Irish banks from credit rating agencies.

5.9.8 The lack of evidence of any concerns in financial markets regarding the creditworthiness of Irish banks in terms of share price, the sale and trading of bank debt, inter-bank lending, CDS spreads etc.

5.9.9 The financial performance and financial results of the banks and external audit requirements under both company law and prudential policy.

5.9.10 The performance of IFSRA's reporting and accountability obligations to the Minister and to the Oireachtas.

5.9.11 IFSRA's reporting in its 2006 Annual Report on the dangers of individual and sectoral concentrations risks and the prudential restrictions on large exposures.

5.9.12 The C&AG's Special Report No. 57 (May 2007) that concluded that IFSRA had developed and implemented a formal risk rating model which had improved its ability to target its available supervision resources in proportion to assessed risk.

5.10 As highlighted in its Annual Reports, as a core supervisory function IFSRA had full access to any banking information it required through the prudential returns from each banking institution. This detailed information was not and could not be shared with us because of the professional secrecy obligations in place under section 33(AK) of the Central Bank Acts.

5.11 Where IFSRA "brought issues to the table" such as its concern regarding stability risks in the credit union sector, we responded swiftly and engaged intensively in seeking to assess and address the matter. IFSRA in fact identified the credit union movement as the most significant prudential risk to financial stability during the relevant period. It was one of the main items at the meetings that took place between the Chair and CEO of IFSRA with the Minister for Finance.

5.12 This generated a major programme of work for my unit during the relevant period. In practice it focused my area's attention on credit union risks to the exclusion of other sectors and broader financial stability planning. However, IFSRA's willingness to highlight credit union risks led me to expect that if IFSRA had similar concerns in relation to other sectors of the financial services industry, these would certainly be brought to our attention.

6. Regulatory Climate (R1b, R2c, R3c)

6.1 A strong feature of Government policy and also at EU level was meeting regulatory objectives but minimising the regulatory burden on enterprise and ensuring regulation was balanced and proportionate to its costs and benefits (i.e. "Better Regulation"). In the financial sector there was a particular focus on maintaining confidence in, and the credibility and reputation of, Ireland's financial regulatory and supervisory arrangements. What was characterised as a responsive and accessible regulator for the financial sector was regularly highlighted by industry representatives in the Department of the Taoiseach Clearing House Group as a prerequisite to Ireland's competitiveness in terms of the IFSC.

6.2 At EU level, the objective and benefit of creating a single financial market in financial services and what were often characterised as 'a deep and liquid' EU capital market was consistently highlighted. An EU Commission Discussion Paper prepared for ECOFIN level in September 2006, drawing on ECB research highlighted the role of enhanced efficiency in EU capital and financial markets and greater financial market integration in boosting productivity, innovation and economic performance in the EU [TAB L]. This broader policy climate clearly contributed to obscuring the serious risk for us that the process of financial integration could almost instantaneously go into reverse.

7. Department of Finance - relationship with banks (R3b)

7.1 There was relatively limited direct engagement by my unit with individual financial institutions and in particular domestic banking institutions during this period. Consultation usually took place with the relevant representative bodies on issues arising in the context of the transposition of key EU Directives or important legislative initiatives (i.e. Asset Covered Securities (Amendment) Act).

8. Weakness in Regulatory Framework for Banks (R1b, R2c, R3c)

8.1 The EU Capital Requirements Directive (CRD) adopted in June 2006 and closely based on the international Basel II Accord, laid down the detailed set of rules to determine minimum capital requirements for banks. The CRD also detailed the supervisory review process for regulators to validate a bank's own internal assessment of its risk profile and capital adequacy.

8.2 Basel II was widely regarded internationally as modernising and making capital requirements more comprehensive and risk-sensitive, fostering enhanced risk management amongst financial institutions as well as strengthening financial stability [TAB M]. The CRD provided wide discretion to banks to assess the riskiness of their asset portfolios, subject to the oversight by supervisors. It provided banks with the opportunity to adopt the approaches most appropriate to their situation and to the sophistication of their risk management. A December 2005 ECB Paper [TAB N] concluded that the Basel II framework was expected to foster stability in the EU financial system by strengthening incentives for banks to conduct sound risk modelling and managing and by involving supervisors more directly in the review of banks' risk profiles, risk management practices and risk-bearing capacity.

8.3 The report of the High-level (de Larosiere) Group on Financial Supervision in the EU published in February 2009 [TAB O] concluded that the international banking crisis heightened the need for a fundamental review of the Basel II / CRD framework. The de Larosiere Group concluded that Basel II

underestimated some important risks and over-estimated banks' ability to handle them and that its methodology seems to have been disproportionately based on recent past economic data and good liquidity conditions. It concludes that these mistakes led to too little high-quality capital being held by banks.

8.4 Serious weaknesses in the Basel II framework did not cause the banking crisis in Ireland. However, Basel II clearly created an undue confidence in the capital adequacy of banks in my area based on the fact that:-

- capital requirements of banks were calculated on the basis of sophisticated quantitative risk models;
- banks' internal capital adequacy assessments and standards were reviewed and evaluated by IFSRA;
- there was scope for IFSRA to require banks to hold additional capital.

This underpinned an unwarranted sense of security regarding the prudential strength of the banking sector, their capital buffers and the ability of the banking system to withstand significant shocks.

8.5 In the Second Stage Speech on the Bill providing for the introduction of the guarantee in early October 2008, the Minister referred to the fact that it was estimated that total assets of the six financial institutions concerned exceed their guaranteed liabilities by approximately €80bn. This was described as a very significant buffer, before there was any question of the guarantee being called upon [TAB P]. In reality as subsequently emerged banks – both in Ireland and internationally - did not hold sufficient high-quality loss-absorbing regulatory capital.

9. Response to Contrarian Perspectives (R4c, R3c)

9.1 A key extract from the Nyberg report draws attention to the large number of simultaneous, institutional and judgmental failures required for what are uncommon systemic financial crises to occur [TAB Q].

9.2 The conclusion of a systematic review of this issue[1] examining the commentary at the time which might have influenced the thinking of officials concluded that, with a small number of notable exceptions, the economics profession did not question the consensus and failed to foresee the possibility of a broader banking and financial crisis. This accords with the broad international experience, in respect of which the question was posed[2]:-

"*…while there were a few Wise Owls who saw trouble coming, why did most of the profession fail to spot the dangers?*"

9.3 In Ireland's case, as set out in Nyberg Report (para. 2.3.4) a great number of credible authorities and experts were stressing that various "unique Irish circumstances" (e.g. demographic, immigration, catch up in terms of living standards, shortage of housing) would at worst, guarantee a "soft landing" in the event of an economic downturn. The report also states (para. 2.12.5) that the vast majority of academics and independent economists were strongly supportive of expansion rather than fearful of a "hard landing".

[1] Donovan, Donal and A E Murphy, The Fall of the Celtic Tiger – Ireland the Euro Debt Crisis, Oxford (2013)

[2] "The Great Moderation, the Great Panic and the Great Contraction" Charles Bean Annual Congress of the European Economic Association.

9.4 In conclusion, the overwhelming weight of opinion among economists was against the forecasts of the very few contrarians.

9.5 In addition, from a 'pure' financial stability perspective the outcome of the stress testing reported in the FSR and the assumed robustness of the Basel II framework seemed to confirm that the domestic banks would weather a 'hard landing' notwithstanding the broader serious impact on the economy.

10. Financial Stability Planning (in advance of the establishment of the DSG) (R1b, R2c, R3c)

10.1 I was asked by the Secretary-General shortly after my appointment to undertake two significant projects in this area.

10.2 One related to planning for safeguarding financial stability taking stock of international experience, the Central Bank's planning document (i.e. the "Black Book" or subsequently "Red Book") and building on the limited work previously carried out.

10.3 The output of this project was presented to the Secretary-General (Mr Considine) and Second-Secretary General (Mr O'Gorman) in July 2005 [TAB Ra, TAB Rb]. The analysis highlighted a number of issues in relation to financial stability planning, including the important differentiation between the roles of the various public authorities and the benefit of agreed principles and options. The primary role of the DOF was identified as developing resolution options in circumstances that Government intervention using legislative / fiscal instruments was warranted.

10.4 The analysis also pointed to the need to establish a formal structure for communication and information exchange on financial stability matters between with the CBFSAI. In light of the outcome of the project and EU developments, the establishment of a DSG with the CB and IFSRA was identified as the next step in this area on which work should commence.

10.5 The resources available for contingency crisis planning in BFID were limited in light of the extensive work programme for the Division overall and those that were available were absorbed by the comprehensive programme of work carried out on the assessment of credit union stability issues highlighted by IFSRA.

10.6 In addition, the business case for a substantial increase in those resources for financial stability planning would have been difficult to sustain. The backdrop was the benign state of financial markets, the economic assessments of authoritative national / international commentators, as well as the conclusions of the 2005 FSR (reiterated in subsequent years) that there was not any significant or immediate threat to broader financial stability.

11. Domestic Standing Group (DSG) (C1b, R3c, R5b)

11.1 As set out in the Honohan report, good communication channels are essential between the various public authorities dealing with financial sector matters comprising:-

- IFSRA, the body with the best knowledge of the condition of each bank;
- the Central Bank, able to form a policy view on broader financial stability issues and the provision of liquidity;
- the role of the Government relating to covering underlying losses via taxpayer support if necessary.

11.2 This clear differentiation responsibilities was a clear feature of the DSG from the outset. The establishment of DSG in member states was one of the main requirements of the national financial stability frameworks agreed by the EU Economic and Financial Committee in September 2006 and endorsed by ECOFIN in October 2006.

11.3 I commenced working with the CB and IFSRA in January 2007 on the creation of a national DSG. Consistent with EU requirements the key purpose of the DSG was to ensure full and timely information exchange. Also it was intended to provide a forum to establish principles for co-operation between the three authorities [TAB Sa, TAB Sb].

11.4 The mandate of the DSG is set out in the Memorandum of Understanding (MoU) agreed in July 2007 by IFSRA, the CB and the DOF [TAB T]. In view of its non-binding, non-statutory nature, the MoU highlighted that it was without prejudice to the institutional and legal responsibilities of the parties. The DSG was not intended - nor would it have been legally permissible for it – to 'pool' distinct organisational responsibilities of its participants. It was a particular priority for the CB and IFSRA to safeguard their independence.

11.5 The DSG structure, therefore explicitly recognised the key delineation highlighted in the July 2005 financial stability planning document between:-

- the role and responsibilities of the CBFSAI in relation to maintenance of overall financial stability and the supervision of individual institutions; and

- that of the DOF in relation to the design and implementation of resolution options in a financial stability crisis.

11.6 The planned work programme for the DSG focused on the development of national contingency plans and the preparation of crisis simulation exercises.

11.7 In August 2007, shortly after its formal establishment, the chief role of the DSG became to ensure that the DOF, Minister and Government were fully advised on an ongoing basis of relevant developments impacting on the banking sector from information available to and provided by the Central Bank and IFSRA. This reflected the marked deterioration in funding conditions from August 2007 onwards.

12. Adequacy of the DSG process (C1c, R2c, R3c)

12.1 The main function of the DSG was to provide for improved communications and information flows between the authorities, in particular on account of the strict confidentiality restrictions in place in CBFSAI legislation, reflecting both national and EU law. The terms of reference of the DSG explicitly recognised that the establishment of the Group did not impinge on the statutory independence and distinct roles and responsibilities of either the CB or IFSRA. There were, therefore, clear parameters on the mandate of the DSG and it clearly did not subsume the specific and distinct roles and responsibilities of the participating organisations.

12.2 The DSG played a significant part in ensuring that the Minister for Finance and Government was provided on an ongoing basis with detailed briefing and assessments provided by the Central Bank and IFSRA.

12.3 The planning undertaken in advance of the establishment of the DSG formally recognised that in a crisis situation that the appropriate decision-making level would be at a highest level – the principals of the relevant public authorities - rather than at the subordinate DSG level. Hence,

following the emergence of a significant financial stability issue, it was not expected that this issue would be managed by the DSG.

12.4 This was borne out in practice in that as the financial crisis deepened, the DSG structure was primarily concerned with communicating information and assessments from the CB and IFSRA to the DOF for the purpose of briefing the Minister and Government.

12.5 While the DSG provided a forum for efforts to develop financial stability planning among the various authorities, this work did not lead to the development of a shared / common model for crisis management.

12.6 Ultimately in the course of 2008, the formal DSG structure fell into abeyance, replaced by frequent informal *ad-hoc* contacts between the key highest-level decision makers which became the main channel through which significant policy issues were discussed and agreed as the crisis worsened.

13. Availability of a Special Resolution Regime (SRR) (C1c)

13.1 A presentation made to the MAC in DOF dated 31 March 2008 on resolution issues, stated that a special insolvency regime for banks could not be achieved quickly [TAB U].

13.2 The process to prepare legislation to resolve a financial institution in distress commenced in November 2007. The approach taken was not a SRR model because of the significant technical and legal obstacles to put such a regime in place, including potential constitutional difficulties (on account of the adjustment of creditor rights inherent in the operation of a SRR). The UK Financial Markets Law Committee highlighted in July 2008 that uncertainty regarding the design or operation of a SRR could potentially make it more difficult for banks to obtain finance at all in some circumstances or significantly increase the cost of funding [TAB V].

13.3 SRRs were not in place in most industrial countries prior to the crisis. A comprehensive UK SRR was put in place in February 2009 notwithstanding the collapse of Northern Rock in September 2007. There was also a significant doubt whether SRR-type legislation could credibly and successfully be applied to a large systemically important credit institution.

13.4 An IMF Staff Discussion Note[3] published in March 2009 concluded that internationally, resolution tools for dealing with failing financial firms were inadequate as most countries did not have special administration regimes, to allow early intervention prior to insolvency. Resolution options were therefore limited to liquidation, bailout or nationalisation if private sector solutions failed

13.5 There was no template SRR model available internationally which could have been adapted for Ireland. Ireland was not exceptional in not having such a resolution framework available reflecting the technical, legal, constitutional and market difficulties in constructing a SRR.

13.6 The strong and consistent advice and assessment of the responsible authorities, IFSRA and the Central Bank was that the Irish banks were victims of an international liquidity squeeze and not under any threat of insolvency. Substantial legal risks would have arose in seeking to undertake a bank resolution when the board, senior management and shareholders of that institution would vigorously assert that the institution was fundamentally sound (and IFSRA also held this assessment) and constitutional rights were being overridden.

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[3] Claessens S. et al, Crisis Management and Resolution: Early Lessons from the Financial Crisis, IMF Staff Discussion Note, March 2009

13.7 The Nyberg report concludes that the existence of a SRR in itself would not necessarily have been a panacea to avoid high costs to the State in the absence of burden sharing with senior bondholders.

13.8 Our view was also that in circumstances that any institution was taken into public ownership, it was open to implement resolution options based on the individual circumstances consistent with much that would be permitted under a SRR.

14. Crisis simulation exercises (C1d, R3c)

EU exercise

14.1 In April 2006 I participated in a comprehensive pan-EU exercise involving national finance ministries / treasuries, supervisors and central banks to seek to examine how international co-operation would work in circumstances where a cross-border bank headquartered in one member state but with subsidiaries in others experienced financial distress. The purpose of the exercise was essentially to explore the extent to which 'burden-sharing' between different member states might be agreed in that situation. The exercise was, therefore, of limited relevance to the management of the subsequent banking crisis in Ireland. A detailed report was prepared by the EU Economic and Financial Committee on the exercise [TAB W].

CBFSAI exercise

14.2 In December 2007 as part of the work programme for the DSG, a national exercise designed and organised by the CBFASAI was conducted with the DOF (represented by the Second-Secretary General Mr Cardiff, Mr Manley Principal Officer and I). A report was prepared by the CBFSAI on the exercise based on feedback received from participants. The exercise drew attention to a number of issues that were relevant to the ongoing conduct of financial stability planning [TAB X]

15. Financial Stability Planning (August 2007 – August 2008) (R2c, R3c, R5b)

15.1 Our main focus was on ensuring the preparation of legislation to ensure that the Minister for Finance had appropriate legal powers to respond to a financial stability crisis. This was carried out in parallel to ensuring that top management in the DOF, the Minister and Government were fully informed of the CBFSAI's assessment of the financial market conditions and the financial position of the domestic banks. This focused in particular on their funding position and the steps being taken to ensure maximum access to ECB liquidity facilities. A briefing note I prepared at the end of November 2007 summarises the main elements to the contingency planning being carried out and planned at that time and the assessment of how the situation might unfold [TAB Y].

15.2 In November 2007 work commenced in my area prepare draft emergency legislation primarily to enable nationalisation of a distressed financial institution.

15.3 My area also took the lead in seeking to develop an integrated and effective crisis management model underpinned by a shared understanding and assessment of each organisation of key legal, policy and resolution issues. In September 2007 I initiated work on a detailed scoping paper on financial stability which was formally furnished to the CBFSAI in February 2008 exploring a number of different financial stability and resolution scenarios [TAB Z].

15.4 This assessment highlighted the different options that might arise for the Government if the liquidity crisis intensified to a point where Government intervention was unavoidable. It discussed the information that would be likely to be required from the CBFSAI. The presentation summarising this work and its implications presented to the DSG highlighted the need for the CBFSAI to have

appropriate prudential information which would support the assessment of sustainability of financial institutions [TAB AA].

15.5 The response from CBFSAI to the scoping paper [TAB AB] stressed the requirement for the provision of State guarantees, including the potential for a comprehensive guarantee given the likelihood that any public knowledge of Emergency Liquidity Assistance (ELA) would be negatively received by the public and by the markets.

15.6 The CB also highlighted that it would be likely to be very difficult to determine the solvency position of an institution and that the failure of even a small bank which is not systemically important in itself, may not be acceptable in certain circumstances because of fear of contagion at a time of market uncertainty. The CB comments stressed the potentially serious risk of refusing to lend to a bank because it was wrongly considered to be insolvent when in reality it was merely illiquid. The CB also emphasised the difficulty in providing detailed and comprehensive information at short notice in a crisis situation.

15.7 In June 2008 the CB circulated a draft of its analysis of crisis resolution options [TAB AC]. This analysis had a single institution (i.e. bank or building society) rather than a systemic focus. The CB argued that a public intervention on a weekday in order to achieve an assisted takeover or nationalisation was unlikely to be feasible. The paper raised a number of issues in particular the length of time that it would take to enact legislation which would effectively rule out nationalisation as an option that could be used swiftly in a crisis. According to the CB nationalisation was fraught with obstacles.

15.8 The work at DSG level to develop a shared analysis, agreed principles and a consensus model of crisis management and resolution did not develop further beyond this point. Against the backdrop of the further deterioration in financial market conditions the central spine of financial stability planning continued to be the preparation of emergency legislation by my unit. This was essential to ensure that there were sufficient legislative powers for the Government to stage an intervention if this proved unavoidable.

16. Bank liquidity versus solvency debate (C2c, R2c, R3c, R5b)

16.1 The CBFSAI never deviated in its advice that the domestic banking system was experiencing anything other than severe liquidity difficulties and that the domestic banks were solvent, liquid, with good asset quality and profitable.

16.2 The DOF did not have any legal mandate to undertake its own analysis of the banks' financial position and the prospects for their loan books or to scrutinise the assessment reported by the CB and IFSRA.

16.3 In view of its statutory responsibilities for prudential matters, any such exercise would have directly challenged the independence and expertise of IFSRA, its legal responsibilities under the CRD and international best practice standards for banking regulation set out in the Basel Core Principals. I have no doubt that it would have been resisted by the Central Bank and IFRSA at senior executive and Board / Authority level and to proceed would, therefore, have required legislative change. If legislative change had been proposed, in all likelihood it would have been characterised as highly undesirable 'politicisation' of financial regulation.

16.4 The DOF did not in any event possess the specialist expertise that would have been required in a number of specialist / technical areas to seek to conduct its own analysis of the banks' financial position and prospects for their loan books to invigilate IFSRA's assessments nor would we have had

any access to detailed information for the banking sector and individual banks required for the assessment.

16.5 The CB's assessment contained in its annual Financial Stability Report over the three year period 2005-2007 was considered expert and authoritative and was corroborated by the results of the IMF FSAP in 2006 which concluded that financial institution profitability and capitalisation was very strong. The FSAP noted that the results of recent stress tests suggest that, even in an extreme scenario involving a sharp rise in unemployment and a sharp decline in house prices, capital remains adequate in every bank. The OECD's assessment in 2007 was also sanguine concluding that the exceptional rise in property values in recent years was largely driven by higher incomes and demographics and that a soft landing was the most likely scenario.

16.6 In the pre-autumn 2007 period, financial market indicators, market commentaries and assessments, credit ratings etc. were almost exclusively supportive of this assessment. The subsequent onset of turmoil in financial markets gave rise to a situation in which it seemed entirely unclear whether share prices, bond prices or CDS spreads reflected 'signal' or 'noise' regarding the prospects of the domestic banks. Controversy regarding the role of (and the introduction of prohibitions on) short-selling and allegations both of speculation by hedge funds against Irish banks and market abuse exacerbated this uncertainty.

16.7 The outcome of a review of the credit positions of INBS and Anglo reported by PwC in the course of the afternoon of 28 September (and also reflected in the memorandum drafted by Merrill Lynch) was that under a stressed case the total provisions that would be expected to arise over a three year period while depleting their Tier 1 and Upper Tier 2 capital, did not call their solvency into question [TAB AD].

17. Financial Stability Planning - September 2008 (R3c, R4a, R5b, C2b)

17.1 My main responsibility during the period was continuing to lead a three person team working very closely with the Office of the Attorney General (and the State's legal advisers Arthur Cox appointed 24 September 2008) to resolve a broad and complex range of outstanding policy and legal issues in order to finalise the draft emergency legislation.

17.2 The legislation initially related to bank nationalisation was extended in early September 2008 to bringing a building society into public ownership. By mid-September 2008 the priority was to have legislation that could do both and also provide for other legislative interventions that might be agreed by Government. These included providing financial support to banks, including guarantees and lending facilities through the establishment of the proposed Secured Lending Scheme (SLS), and facilitating any market solutions that may be available through the modification of competition law.

17.3 As much as was possible given pressure of work on this project, I also contributed to the ongoing consideration of resolution options, contingency planning for dealing with any retail bank 'run', the increase in maximum level of protection under the Deposit Protection Scheme and preparation of briefing / speaking points for the Minister etc. in response to unfolding events.

17.4 There was constant and ongoing engagement between the principals (or their representatives) of all of the other public authorities during this period, including the NTMA which had participated in national crisis management planning since December 2007 following a request made by the Minister to the CEO.

17.5 While I was sometimes involved or was informed of the substance of discussions at principal-level, I was not involved in, or advised of, all of the communications and meetings that took place given, for example, my priority focus and that of my team on the emergency legislation.

17.6 As the month proceeded and the financial environment continued to deteriorate, one of the most significant issue that eventually emerged was the effort to gain some insight into asset quality in Anglo Irish Bank (as well as INBS) given the degree of negative market sentiment towards Anglo and the increasing likelihood of the need for a Government intervention to safeguard the banking system [TAB AE].

17.7 The DOF highlighted the importance of continuing to brief the ECB at senior / top level on serious funding difficulties arising for the Irish banks and the potential euro-wide systemic impact, as well as the need to seek to ascertain the extent to which other euro member states were experiencing these difficulties in order to explore scope for an euro area wide intervention by the Eurosystem [TAB AF].

17.8 In mid-September, arrangements to review the loan books of INBS and also of Anglo were initially made by IFSRA with Goldman Sachs who were currently engaged by INBS in the context of the proposed sale of INBS. A summary email report of a meeting in IFSRA on 19 September highlights the information that was being sought at that time and the challenges in obtaining it [TAB AG]. An email dated 20 September reported that IFSRA had communicated to the DOF on the basis of the review by Goldman Sachs that INBS's loan book was "better than expected." The same message was conveyed to the NTMA [TAB AHa]. Another email also dated 20 September indicated that a review of Anglo's loan book by Goldman Sachs had commenced 22 September [TAB AHb]. Merrill Lynch (ML) were appointed as the State's financial advisers by the NTMA on 26 September 2008.

17.9 A wide range of resolution options continued to be under consideration as the month progressed including the building up of a €15bn. (approx.) cash fund in the Exchequer Account, the establishment of the Secured Lending Scheme (SLS), encouraging AIB and BoI to maximise their access to ECB liquidity and distribute it through the domestic banking system, as well as the need to resolve Anglo and INBS on a joint basis (discounting the option presented by Anglo management a take-over of INBS), bank nationalisation as well as the implications of a blanket guarantee [TAB AIa, TAB AIb, TAB AIc[4], TAB Aid, TAB AIe]

17.10 I was not involved in the high-level meetings involving the public authorities on 25/26 September and advisers (i.e. Merrill Lynch and PwC), summary reports of which were released to and published by the Public Accounts Committee along with the presentation prepared by Merrill Lynch on strategic options. At that time the NTMA were requested by the Secretary-General to assess the impact on Ireland's sovereign rating, in the event that the State provided a broad guarantee to the banks [TAB AJ].

17.11 As far as the assessment of options at that time are concerned, I knew that ML was working closely with the NTMA to finalise the memorandum containing its assessment of strategic options which appears to have been finalised by ML on 28 September but further amended in the course of the day on 29 September with the inclusion of information from PwC on potential impairments [TAB AK].

17.12 Around lunchtime on 28 September, PwC advised the NTMA of its assessment of the liquidity position of Anglo, INBS and ILP [TAB AL]. This identified the risk of a significant negative cash balance

[4] Record was created on 19 September which is the correct date of the meeting.

in Anglo the next day (i.e. 29 September 2008) which could potentially be exacerbated during the following week and under certain assumptions could grow to €4.6bn. by 3 October (and between 7bn.-12bn. by end-October).

18. 29/30 September 2008 (R2c, R3c, R4a, R5b, C2b, C3b)

18.1 I spent Monday 29 September continuing to work with colleagues and the Office of the Attorney General on the emergency legislation.

18.2 In the early evening I met the Secretary-General who advised me that a meeting with the Taoiseach was being convened and asked me to attend.

18.3 I was present for the initial discussion following the convening of the meeting in the Department of the Taoiseach. The content of this discussion and the attendance is documented in one of the handwritten notes available from the meeting.

18.4 I left the meeting following that discussion to prepare the 'letter of comfort' the CB required to provide ELA the next day. I did not return to the meeting room (other than briefly at a later stage to have the letter signed by the Secretary General).

18.5 Later, during a break in the meetings, I was advised by Mr Cardiff that the discussion was tending towards the provision of a blanket guarantee for the domestic banks.

18.6 I also recall being involved during the course of the night with the Minister's Press Officer in the preparation of drafts of the guarantee announcement issued 30 September.

18.7 My email records show that at 21.11 I received a document intended to be a draft Government Press Release announcing the introduction of a guarantee for the domestic banks [TAB AM]. It appears to have been authored earlier in the evening in the Central Bank in advance of the commencement of the meeting in Government Buildings. My electronic files show that I was subsequently involved over the next twenty minutes or so in preparing a revised draft of the statement which set out its intended scope [TAB AN].

18.8 Later I awaited the conclusion of the meeting in an ante-room to the main meeting room with Mr McDonagh (NTMA) Mr O'Riordain (Arthur Cox). On account of the NTMA's close engagement with Merrill Lynch over the preceding days I assumed that the Merrill Lynch memorandum reflected the NTMA's assessment of the position and resolution options.

18.9 I had no contact with any representatives of the banks. I cannot recall any substantive engagement with any representatives of the Central Bank or IFSRA (other than a conversation with the Director-General of the Central Bank to confirm the wording necessary for the letter of comfort required for ELA).

18.10 Following the conclusion of the meeting, the Secretary-General asked me to prepare a Memorandum for the Government meeting later that day seeking approval for the guarantee legislation.

19. Dated Subordinated Debt (R4a, R5b, C2b, C3b)

19.1 When the guarantee was announced, I was not specifically aware of the rationale for its inclusion. Guaranteeing lower Tier 2 capital was discussed in the Merrill Lynch memorandum and it appears to have been included - at least implicitly - in an early draft of the press statement announcing the guarantee.

19.2 I prepared a short paper shortly afterwards for DG COMP in the European Commission setting out the case for its inclusion in the guarantee. The information I relied upon was I believe based on discussions I had with personnel from Merrill Lynch as well as based on information provided by the NTMA [TAB AOa, TAB AOb].

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