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Oireachtais
Houses of the
Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Brendan McDonagh

Session 44

09 July 2015 (p.m.)

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Opening Statement by

**Mr. Brendan McDonagh, Former Finance Director
National Treasury Management Agency**

Joint Committee of Inquiry into the Banking Crisis

9th July 2015

Good afternoon Chairman and Inquiry members,

In this brief opening statement, you have asked me to address - from my perspective as Finance Director at the National Treasury Management Agency (NTMA) during 2007 and 2008 - the following lines of inquiry:

- Appropriateness of the relationships between Government, the Oireachtas, the banking sector and the property sector
- Adequacy of the assessment of both solvency and liquidity risks in the banking institutions and sector
- Appropriateness of the bank guarantee decision
- Appropriateness of the expert advice sought, quality of analysis and how effective this advice was used

Appropriateness of relationships between Government, the Oireachtas, the banking and the property sector/Adequacy of the assessment of solvency and liquidity risk

As advised to the Inquiry's investigation team in advance of this submission, in my position as the NTMA Director of Finance, I had no particular insights into the nature of relationships between the Government/wider political system and the banking and property sectors up to 2008 and therefore I do not believe that I am qualified to comment on, or add to, the first-hand testimony on this topic that has already been provided to the Inquiry by other witnesses. I am also not well positioned to opine on the adequacy of the assessment of solvency and liquidity risks in the banking

institutions because I had no role in assessing that back in 2007/2008 – that was ultimately a role for the Financial Regulator and the Central Bank. The NTMA had no special insight into the banks domestically or internationally; all we had were publicly-available documents such as credit rating agency reports, market updates, annual reports and broker/analyst reports. Not surprisingly, by reference to this published material from respected and financially literate commentators from 2005 to 2007, one could conclude that, while there were risks, there were no strong warning signals of the financial carnage that would ultimately emerge.

By late summer 2007, however, although we at the NTMA had no inside information about any bank domestically or internationally, we began to sense that there were early signs of market dislocation beginning to emerge in the capital and money markets: the first hedge funds failed in early August 2007, followed by regular market rumours about the fragility of various international banks and the unsettling sight of queues of depositors at Northern Rock branches in September 2007. This caused us at the NTMA to adopt a conservative view of managing the State's cash assets which were raised in the main to fund the National Debt – we had no idea at that stage of the global reach of the credit crisis or of how long it would last or of how serious it would become. As I previously advised the Inquiry we were always sceptical of the business models of at least two Irish financial institutions, Irish Nationwide and Anglo Irish Bank, particularly the heavy exposure to property lending and the limited distribution access of Anglo Irish Bank which had no branch network. We had no credit limit for INBS so we did not do business with them and we restricted our credit limit to €40m for Anglo Irish Bank even before the crisis started to emerge in 2007. However, from August 2007 we considered it prudent to reduce our counterparty credit limit exposure to the bank deposit market globally until a clearer picture would emerge. At the time, it was not an easy decision to justify as all we had was an uneasy sense that the whole global banking and capital market system was more fragile than appeared on the surface, but we had little by way of specific evidence. Unfortunately, things got a lot worse as the months passed and our August 2007 decision proved to be correct although it would be a year later before major bank difficulties became more generally visible.

Appropriateness of the bank guarantee decision

In relation to the other lines of inquiry, it is my understanding from discussion with your investigation team that you wish me to focus my remarks on the period from mid-2007 to September 2008. As I advised the Inquiry in April this year, there was no substantive discussion involving myself (and as far as I am aware with my senior NTMA colleagues) about a bank guarantee in the months, weeks or days leading up to 30th September 2008 and the NTMA had no involvement in the actual decision to introduce the blanket guarantee. Mr. Hurley in his evidence referred to a note prepared by the Department of Finance of an 18th September 2008 meeting at which Dr. Somers, Mr. Corrigan and I are recorded as being present and at which, Mr. Hurley states, a guarantee was discussed – my recollection, which is confirmed by the Department's meeting note, is that the discussion was purely about a *deposit* guarantee, not a *blanket* guarantee, and that the Central Bank and the Financial Regulator did not favour such an approach at that meeting. The meeting mainly centred on the merits of increasing the deposit guarantee from €20,000 to €100,000. For the record, I believe the meeting was actually held on Friday 19th September not Thursday 18th September but that is incidental.

Whilst my colleague, Mr Whelan, and I were in Government Buildings on the night of Monday 29th September, we were not, as I have previously advised, made aware as to the reason why we were required or consulted or otherwise asked for input prior to the Government taking the guarantee decision. Once the Government had decided to introduce a blanket guarantee, my focus and that of Mr. Whelan as public servants was, you will appreciate, on the implications of that decision and its effect on the NTMA as the State's debt manager and, most immediately, on how the NTMA would deal with the market and credit rating agency reaction to the decision at 7am that very morning.

As the banking crisis unfolded in the two weeks immediately before 30th September 2008, the NTMA's engagement with the Department of Finance had focused on three main strands:

- (i) the provision of secured lending by the NTMA to the banks, if so directed by the Minister;
- (ii) NTMA input into draft legislation dealing with the possible nationalisation of two financial institutions (a building society draft nationalisation bill and a bank draft nationalisation bill); and
- (iii) the NTMA's commissioning of Merrill Lynch on September 24th on behalf of the Minister for Finance to provide advice.

(i) *Discussions on secured lending by the NTMA to the banks*

The NTMA had in fact been engaged in discussions with the Department of Finance from April 2008 about the provision of emergency liquidity in circumstances where the Irish banks could not meet their funding requirements from the wholesale markets – this was separate to the engagement we had been having with the Department of Finance from the summer of 2007 in relation to the NTMA placement of bank deposits, which I will deal with later. By September 2008 these discussions had intensified and the NTMA had put in place arrangements to allow it, in the event that it was directed by the Minister, to engage in emergency collateralised lending to Irish banks – I estimate that we had about €5 billion in liquidity available at that time across various mandates that could be lent for up to one year. The NTMA had been maintaining a floor to its liquidity in order to allow it to supply a certain amount of emerging funding requirements but only if directed by the Minister. There had also been discussion about the NTMA accumulating a “war chest” of liquidity to deal with the emerging banking liquidity crisis. However, while the NTMA was issuing commercial paper debt of €20 billion which was as long-dated as possible (maximum 12-month maturity), it was clear that there was no appetite from longer-term bond market investors to invest on the scale needed to create a cash buffer to deal with even part of the potential fallout from the banks – this was particularly the case given the pressures the sovereign was already experiencing in terms of funding the National Debt which, during 2008, was €50 billion approximately.

(ii) NTMA's input into draft bank/building society nationalisation legislation

The NTMA's input into draft legislation being prepared during September 2008 by the Department of Finance to deal with the possible nationalisation of a building society and of a bank, related mainly to the role that the NTMA could play in providing restructuring assistance post-nationalisation and technical advices on obligations arising under the Companies Act which could potentially limit the Minister's power to manage a nationalised institution.

(iii) The NTMA's commissioning of Merrill Lynch to advise the Minister for Finance

The NTMA engaged Merrill Lynch on 24th September but we were not prepared to enter into a contract with them without the Minister's approval. On Friday 26th September 2008, the Secretary General of the Department of Finance, Mr. Cardiff, confirmed in an email to me that the Minister was instructing the NTMA to engage Merrill Lynch to provide corporate finance advice to him. I understand that Merrill Lynch met the Minister for Finance and senior officials within his Department, including Mr. Doyle and Mr. Cardiff, to discuss strategic options on that evening. I will discuss the quality of the expert advice later in my opening comments.

NTMA knowledge of a Blanket Bank Guarantee

The first and only reference to a blanket bank guarantee throughout all that engagement in September 2008 was an email that I received from Mr. Beausang, Assistant Secretary of the Department of Finance, at 1.26 p.m. on Friday 26th September. The email, issued on the instruction of the Secretary General, sought the NTMA's view on, *inter alia*, the potential sovereign implications of a blanket bank guarantee. I responded that afternoon at 2.22 p.m. after receiving a phone call from Mr. Beausang in which he sought an urgent response for the Department's Secretary General. Without having much time to consider the matter, I discussed it with my colleague, Mr. Whelan, and in my reply to Mr. Beausang, I pointed out that the real exposure to the Exchequer from the banking system had not yet been independently quantified and that would

make any assessment of a bank guarantee extremely difficult. The Department of Finance's email to me referred to a possible total funding requirement of approximately €100 billion for the two institutions expected to be nationalised as estimated by Merrill Lynch and also a wider guarantee for the other institutions. I pointed out that, in the event that such a major decision was made, the credit ratings agencies would be "*taken aback*" at the scale of State involvement that a blanket guarantee would necessitate and that there would be an immediate credit ratings downgrade of Ireland from AAA and a concomitant rise in the cost of funding the National Debt. I also made the observation that, given the potential size of any guarantee relative to the size of the economy, Ireland could expect to pay "*a lot more than Greece*" in the international money markets – Greece was, as you know, an outlier at that time in terms of bund yield spreads at about 75 bps in the 10-year maturity – Ireland was about 45 bps, as I recall. There was no follow-up from the Department to my email.

NTMA Deposit Placement

Prior to September 2008, engagement between the NTMA and the Department of Finance related primarily to the NTMA's placement of bank deposits. This reflected the view in many quarters that the problem in the banking system domestically was one of liquidity, not solvency. By August 2007, the NTMA had made the decision firstly to reduce existing counterparty credit lines with a range of global financial institutions and ultimately, to stop placing deposits with any bank. The NTMA policy was to move maturing bank deposits back to the Central Bank of Ireland – we referred to it internally as '*safe harbouring*' deposits. The Department of Finance was fully aware of the NTMA's position in this regard. The Secretary General of the Department, Mr. Doyle, was a member of the NTMA Advisory Committee which received updates from me as Finance Director on the NTMA's counterparty credit policy and counterparty credit list at its September and December 2007 meetings (and this continued throughout 2008). I recall at these meetings that Mr. Doyle as a member of the NTMA Advisory Committee did not agree with the NTMA's position on deposit placements and safe harbouring at the Central Bank but the Advisory Committee overall agreed with the NTMA senior management's position and consistently advised the NTMA to take a conservative and prudent approach to counterparty risk.

In mid-December 2007, the NTMA was invited to the latter stages of a Domestic Standing Group (DSG)¹ meeting with the Department of Finance and Central Bank to discuss the placing of deposits within existing credit limits with Bank of Ireland (€200m), AIB (€200m), Irish Life & Permanent (€50m) and EBS (€50m). An existing deposit of €40m with Anglo Irish Bank, with a maturity of one year, had been in place before the NTMA made its decision to cease placing deposits with the banks and to place them instead with the Central Bank. The NTMA's position at the meeting, which took place on 12th December 2007, was that, in the absence of a written direction from the Minister, we did not intend reversing its policy of not placing bank deposits in financial institutions. We made the point at the meeting that, if anything, the risks attaching to the banking system, internationally as well as domestically, had become even more pronounced since the original August 2007 decision to 'safe harbour' maturing deposits with the Central Bank.

Following that meeting, the Minister for Finance, Mr. Cowen, wrote to the Chief Executive of the NTMA, Dr. Somers, on 19th December 2007, *directing* the NTMA to place deposits with the four banks, namely, Bank of Ireland, AIB, Irish Life & Permanent, and EBS. The Minister also sought proposals for "*additional NTMA activity within financial markets*" and "*the expansion of NTMA credit limits vis a vis banks*" - I have already referred to our subsequent engagement in 2008, particularly in September 2008, with the Minister and the Department on these two points. My colleague Mr. Whelan wrote to the Second Secretary General of the Department of Finance, Mr. Cardiff, also on 19th December 2007, seeking clarification that the Minister's correspondence constituted a direction under Section 4(4) of the NTMA Act 1990. Mr. Cardiff confirmed on behalf of the Minister, in correspondence on 21st December 2007, that this was the case. As regard maturities, Mr. Cardiff added: "*The intention is to leave appropriate discretion to yourselves [NTMA], but the aim should be considerably in excess of one month and preferably towards three months*".

The NTMA wrote again to the Department of Finance, by email to Mr. Cardiff, on 18th February and 18th April 2008 respectively seeking clarification as to whether the

¹ NTMA was not a member of DSG.

Minister's direction of 19th December 2007 applied to the rollover of maturing deposits with Bank of Ireland, AIB, Irish Life & Permanent, and EBS. Mr. Cardiff responded on both occasions to confirm that the Minister's direction did so apply and that all deposits should be renewed on maturity.

On 17th June 2008, the Minister for Finance, Mr. Lenihan, in correspondence to Dr. Somers, directed the rollover of Bank of Ireland and AIB deposits on an unsecured basis and an increase in deposit sizes with Irish Life & Permanent, from €50m to €250m, and EBS, from €40m to €100m, on a secured collateralised basis. In correspondence to the Minister on 27th June 2008, Dr. Somers confirmed the placing of Exchequer funds in the Irish market as follows:

- Bank of Ireland €200m unsecured deposit for 2 months
- AIB €200m unsecured deposit for 2 months
- Irish Life & Permanent €250m collateralised deposit for 12 months
- EBS €100m collateralised deposit for 12 months

The NTMA Chief Executive also advised that the NTMA did not intend to renew a one-year unsecured deposit of €40m with Anglo Irish Bank which fell due on 8th August 2008 as the deposit was not covered by the Minister's December 2007 direction.

On 17th July 2008, I wrote by email to Mr. Cardiff to again advise that an unsecured deposit of €40m with Anglo Irish Bank would mature on 8th August 2008 and asked whether the Minister intended to *direct* the NTMA to renew the deposit. As advised in the NTMA Chief Executive's earlier correspondence to the Minister, it was the NTMA's view that the Anglo Irish Bank deposit was not covered by the Minister's December 2007 direction and the NTMA's position that it did not intend to renew the deposit. Mr. Cardiff wrote to me on behalf of the Minister directing the NTMA to place a €40m one-year collateralised deposit with Anglo Irish Bank and to roll over the NTMA's €200m deposits with Bank of Ireland and AIB on a six-month collateralised basis.

On 25th July 2008 I wrote to Mr. Cardiff to advise him that Anglo Irish Bank was not interested in "*doing a deal on a collateralised basis especially for €40m*" and had

requested instead that the NTMA renew the existing €40m deposit on an unsecured one-year basis. Mr. Cardiff advised on 28th July 2008 that the Minister wished the NTMA to renew the existing €40m unsecured deposit with Anglo Irish Bank on a three-month maturity.

There could have been no ambiguity at any time during this period on the part of senior Department of Finance officials or of the Minister for Finance as to the NTMA's position on global bank risk from August 2007 and our reluctance, given the increasing dislocation of financial markets, to put at risk any State money under our management by placing it on deposit with domestic or international financial institutions unless we were directed to do so by the Minister for Finance.

Appropriateness of the expert advice sought, quality of analysis and how effective this advice was used

From mid-September 2008, when my colleagues, Mr. Corrigan, Mr. Whelan and I were requested to attend meetings which the Department of Finance had scheduled with the Central Bank and the Financial Regulator, it was obvious to me and also, I believe, to my colleagues, that there was a dearth of information or analysis available in terms of real insight as to the financial state of the domestic banks and building societies. It surprised us that there appeared to be only one or at the most two Financial Regulator staff engaged in close monitoring of each financial institution, even those institutions with balance sheets of up to €200 billion. At one particular meeting at the outset of the evolving crisis, Mr. Neary enquired as to the *locus standi* of NTMA officials at these meetings given banking confidentiality issues. Mr. Cardiff dealt with this and advised that the NTMA had been requested to attend and provide advice to the Department of Finance by the Minister for Finance. Each of the financial institutions in late September 2008 was retaining investment banks as advisors. A decision was taken by the Minister for Finance that the State needed an investment bank to advise it also and the NTMA was requested to engage that advice and that was arranged by my colleague, Mr. Corrigan.

During the last two weeks of September 2008, the whole focus was on having legislation ready to nationalise a building society and a bank, if required. The NTMA provided technical input into that draft legislation. A separate piece of legislation was also being prepared by the Department of Finance and the Attorney General's office which would have enabled the NTMA and the Central Bank to provide secured lending to the institutions.

Considerable pressure was being applied at the September 2008 Department of Finance/Central Bank/ Financial Regulator meetings on the NTMA to increase the amount of deposits placed with the Irish banking system as Irish institutions rapidly began to lose liquidity. The NTMA refused and advised that it was the view of our Chief Executive, Dr. Somers, that it was the role of the Central Bank to be the lender of last resort. It was not the role of the NTMA as a debt management agency. This caused considerable tension but the NTMA maintained its position.

Merrill Lynch was in place for about four days before the Guarantee decision was made. In my view, it was only after that guarantee decision was made and through the work of PWC (on behalf of the Financial Regulator) and the work of Merrill Lynch after the Guarantee decision that the real picture began to emerge of what was really going on in the Irish banking system and the scale of property and other lending. That emerging picture of asset and liability mismatch based on the PWC\Merrill Lynch work from mid-October 2008 onwards was very alarming: excessive lending by financial institutions funded by short-term wholesale deposits which were disappearing rapidly with the result that liquidity from the Central Bank and the ECB was required and capital injections were inevitable. The ECB then, unlike today, was not very accommodative in terms of the type of collateral it would accept from the banks. By then, the damage had been done.

Conclusion

During the Autumn of 2008 and the early part of 2009, I continued to perform my full-time role as NTMA Finance Director while also attempting, on an almost full-time basis, to assist the Department of Finance with my senior NTMA colleagues in its efforts to

deal with the possible collapse of the Irish banking system and the direct effect on Ireland as the sovereign.

Subsequent to the period that we have just discussed, my professional responsibilities within the NTMA shifted to the establishment of NAMA in May 2009 and as you know, I have already provided the Inquiry with evidence as regards NAMA's experience. I hope that in these brief opening comments I have given you a sense of my engagement and that of the NTMA with the Department of Finance and Minister for Finance during 2007 and 2008.