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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Cathy Herbert

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[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

Introduction

I worked as special advisor to the late Brian Lenihan throughout his period in office as Minister for Finance. I had been his special advisor since January 2006 when he was first appointed to Cabinet as Minister with responsibility for Children and I continued in that role when he was appointed Minster for Justice after the general election in June 2007.

The role of special advisor, as defined by the Public Service management Act, 1997 is to assist the Minister by:

- providing advice;
- monitoring, facilitating and securing the achievement of the Government objectives that relate to the Department, as requested by the Minister;
- and performing such other functions as may be directed by the Minister that are not otherwise provided for in the legislation.

In the performance of these functions, the advisor is accountable to the Minister.

As his special advisor in the Department of Finance, my main duty was to advise Brian Lenihan on the communication of complex and difficult government decisions. Working closely with officials in the Department, I wrote speeches, provided briefing for Oireachtas debates, drafted articles for print media and advised on media strategy. I also worked with advisor colleagues in government on the formulation of policy responses as the crisis unfolded and on the implementation of government decisions.

The particular job assigned to me by the Minister was to work with officials and political colleagues in other government departments on the design of budgets that would stem the fiscal crisis while gaining the acceptance of the public. Between mid 2008 and April 2011, Brian Lenihan introduced six separate sets of budgetary correction in his constant battle to stabilise the public finances.

The banking crisis was a separate theatre of battle involving a discrete group of officials and three other government agencies: the Central Bank, the Financial Regulator and the NTMA. Initially, I had no involvement at all in this area of the Minister's work. Because of its highly confidential nature, particularly in the months before the Guarantee, discussion relating to the banks was, of necessity very tightly held to a small group of officials.

Apart from some notes for information in the month preceding the Guarantee which outlined the febrile state of the international financial markets and its impact on Ireland, I have no recollection of receiving any direct information or taking part in any meetings about what was happening in the banks.

After the Guarantee, my involvement on the banking side revolved around the communication of the very unpalatable actions and decisions that had to be taken by the Government. I contributed to the drafting of speeches and briefing material for Oireachtas debates and I worked closely with colleagues in the press office on preparing for media interviews and responding to the very significant number of media inquiries relating to the financial crisis in Ireland. The Minister did not ask me to play any role in the formulation of banking policy or to attend any meetings about decisions relating to the banks.

In my reply to the lines of inquiry which the Joint Committee requires me to address, I have drawn on all the knowledge and information I have been able to recall. However, seven years on from the onset of the crisis, I cannot definitively distinguish between my "real time" knowledge of events and what I subsequently learned about them. Inevitable therefore, my account is not truly contemporaneous.

Role of Advisors in analysing the crisis (to include crisis management options)

In the months leading up to the Guarantee, the Minister was advised by the Central Bank, the Financial Regulator, the NTMA, the Attorney General and Department officials. Just days before the Guarantee decision, Merrill Lynch was brought in as independent advisors. Arthur Cox provided independent legal advice to the Department.

Following the announcement of the Guarantee, PWC was commissioned by the Regulator to provide a detailed assessment of the capital position of the six guaranteed institutions. Their report contained an analysis of likely loan impairments in these institutions up to 2011. A further assessment was made informed by work undertaken by independent valuers, Jones Lang LaSalle who assessed a sample of the banks' property based loans and the value of the collateral underlying them. This assessment informed the Government's initial proposals to recapitalise the banks.

Because I was not directly involved in decisions relating to banking, I had little exposure to the outside agencies advising the Minister and the Government though, I did have contact with the Department officials. From the knowledge I subsequently acquired, it is clear that many of these advisers were hampered in their analysis of the crisis by their unswerving belief that our banks were fundamentally sound and their failure to consider the possibility that their might be a crash rather than a soft landing in the Irish property market.

Indeed this blind spot was not confined to those advising the Minister. When in May 2008, Brian Lenihan observed, as an aside in a speech that it had been his misfortune to be appointed Minster for Finance just as the building boom had ground to "a shuddering halt", a torrent of criticism rained down on him. He was castigated for talking down the economy and for being gaffe prone. Prior to the Guarantee, few were willing to countenance the idea that our property bubble was starting to burst.

Notes prepared by the Department for the Government on financial market conditions in September 2008 did warn about the banks' exposure to property lending and drew attention to the waning interest among international investors in our banks. The Government was also warned in the note of the importance of avoiding any "action that might be interpreted in financial markets as an indication of perceived weakness." This concern above all to shore up confidence in the banks and not to frighten the horses, so to speak acted as a constraint on advisors' capacity to analyse what was happening and come up with possible solutions.

The Merrill Lynch advice on the night of the Guarantee did outline a range of options pointing out their pros and cons but not giving any clear direction as to the best option. The document which, it should be remembered was prepared in a matter of days and under considerable pressure, was also unclear on a number of issues, including what the Guarantee should cover. In the context of the crisis that prevailed on the night of the 29th of September 2008, the Merrill Lynch advice can only have been of limited use to those who had to make a decision against the very stark backdrop that had been painted for them by the leadership of the two main banks.

In addition to the sources of advice outlined above, throughout his time in office, Brian Lenihan canvassed the views of a range of economists. Among those he met on a regular basis were Patrick Honohan (later appointed Governor of the Central Bank), Philip Lane, Alan Ahearne (who became his Economic Advisor March 2009), Jim O'Leary, Colm McCarthy, and economic commentator David MacWilliams. He also regularly sought the advice of the ESRI.

In the end, the problem for all who grappled to come to terms with the crisis was the speed at which events overtook the solutions being considered. Each course of action opened up its own Pandora's Box creating another set of problems that had to be managed. To quote the hastily prepared Merrill Lynch memo written the day before the Guarantee: "There is no right or wrong answer and the situation is very fluid".

Appropriateness of the Bank Guarantee decision.

The afternoon of 29th of September 2008 had been set aside in Brian Lenihan's diary for meetings with various bodies in advance of Budget 2009 which was then just two weeks away. At the beginning of September, it had been decided to bring forward the budget from its usual December date to the 14th of October. Between 2pm and 6pm, I accompanied the Minister and officials at five meetings, the final one being with ICTU. The budgetary position was front and centre of our minds following a steep deterioration in the public finances notwithstanding the €440m savings achieved in early July by a series of expenditure reductions. Barely two months on, the Department was warning of a revenue shortfall of at least €5bn by year end. It turned out to be over €8bn. The meetings that afternoon had been difficult.

I was not aware of the frenetic activity that we now know had been taking place in our banks that afternoon. After the round of pre-budget meetings had ended, the Minister asked me and his press officer to go with him that evening to a meeting in Government buildings about the banks. Though I don't have a clear memory of it, I believe he told us a media announcement might have to be made next morning arising out of the deliberations which were to take place and he wanted us to be briefed.

As I recall, it was a long night of hanging around as meetings were taking place: I knew there were representatives from various agencies as well as senior bankers from the two main banks in different rooms around the building but I don't recall knowing or understanding in any detail what was being discussed or what the outcome might be. I believe I only spoke to Brian Lenihan at the end of the evening as he was preparing to leave: he had a six am start next morning and it was late. The press officer and I had a conversation with him on the steps of Government Buildings; we briefly discussed the outcome of the meeting and the arrangements for next morning's briefing of key members of Ecofin before meeting the media. My recollection is that he was worried about whether or not the decision they had taken would be enough to stabilise the banks.

Was the decision appropriate?

Given what the Chairmen and Chief Executives of the main banks told the Government on the night of the 29th at a meeting which they had sought, it was clear that some decisive government intervention was required to ensure the survival of our banking system.

It had also been made clear by the ECB that Ireland, and any other Eurozone country with banking difficulties, should do whatever was required to save their own banks. The preponderance of the advice to government that night and for some time leading up to the Guarantee was that our banks were fundamentally sound and well placed to ride out what was expected to be a modest correction in the property market: their difficulties at the time were temporary in nature and related solely to liquidity issues.

The Merrill Lynch memo did point to the exposure of our banks to residential and commercial property where asset values were continuing to fall. But it also said: "It is important to stress that at present, liquidity concerns aside; all of the Irish banks are profitable and well capitalised." In these circumstances, the decision by the Government to put in place an immediate guarantee to safeguard all deposits and liabilities was, in my view, appropriate in that it was the least worst option available at the time. The fact that the assumptions that underpinned the Guarantee were proven to be entirely unfounded within a short period of time shows how woefully ill-equipped and ill-prepared the system was to meet the scale of the crisis.

An alternative frequently advanced is that Anglo should have been nationalised that night and the other banks guaranteed. There has been much reference to the fact that Brian Lenihan argued strongly in favour of this option. In that context, it is useful to return to what he had to say on the subject five months later when he was before the Joint Committee on Finance and the Public Service on the 26th of February 2009:

"I stated within a few days of the decision of 30 September — therefore, it is not, as has been suggested in some quarters, as if there is something new or conspiratorial about this — that the choice facing the Government was very clear. Either we nationalised Anglo Irish Bank which was already under examination and guaranteed the remaining institutions or we guaranteed all of them. That was the real decision that had to be taken and it was not an easy decision to take. …..It should be remembered that the liquidity problems at that stage, which were severe in the case of Anglo, were serious for the other institutions as well so there was no assurance that nationalisation would lead to the kind of inflow of funds we needed in our banking system at that stage. Having weighed up the arguments, the unanimous view of the Central Bank and the regulator and the advice I received from my officials, with my own conclusion, the conclusion reached by the Government was that we should guarantee the institutions. This is the history of how the decision was arrived at on that night in September. It is important always when considering that decision to remember the core issue at all stages has been sustaining the liquidity of the Irish banking system and the touchstone of decision-making is what one can do to sustain and secure that system at all stages."[1]

Full and open discussion about proposals before it was a feature of Cabinet meetings during Brian Cowen's tenure as Taoiseach. Once the Government decision had been made Brian Lenihan understood that his duty as a member of Cabinet was to stand by that decision. In the event, Anglo was nationalised within 3 and a half months

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[1] Joint Committee on Finance and the Public Service. 26/Feb/2009 Banking Sector http://oireachtasdebates.oireachtas.ie/Debates%20Authoring/DebatesWebPack.nsf/committeetakes/FIJ2009022600003?opendocument

Decision to Nationalise Anglo in 2009 and a review of the alternatives available and or considered

The decision to nationalise Anglo was taken for governance and ethical reasons. Issues came to light in the course of the due diligence carried out following the Guarantee. As a result, the Chairman and chief executive of the bank resigned on the 18th of December and Anglo was nationalised on the 15th of Jan 2009.

As stated above, serious consideration was given to nationalising Anglo on the night of the Guarantee. Based on information that emerged subsequently, the arguments against this course of action seem to have revolved around its likely knock on effect on the other banks rather than an outright rejection of this option per se.

After the Guarantee, the Department and the other agencies involved worked with the banks to stabilise their positions and a decision was made to recapitalise them to the tune of €5.5bn, €1.5bn of which was earmarked for Anglo. But the position of the bank was found to have been worse than had originally been thought; after an initial improvement post the Guarantee, market sentiment quickly turned negative towards Anglo. In contrast with the other banks, it had failed to attract any investor interest which meant that the State would have to step in to keep it in business.

The disclosure of the serious governance issues and the resignation of its Chairman and Chief Executive exacerbated its fragile position. Corporate deposits flowed out of the bank and it was decided that nationalisation was the best option. I was not involved in this decision and knew little at the time of the detailed information underpinning it. But my memory is that once the governance issues arose, it was clear that Anglo would have to be taken over by the State. There was no question of allowing a bank with a deposit base of €11.6bn from its Irish clients alone, to close its doors. In these circumstances, nationalisation was inevitable.

Decision to recapitalise Anglo, AIB, BoI, EBS, PTSB and the alternatives available and/or considered.

The recapitalisation of the banks was the running sore of the crisis. It seemed like every step of progress that was made in the battle to restore the public finances to a healthier position was swallowed up by another gaping hole in the banks.

The recapitalisation of the banks was essential for the maintenance of a functioning banking system that would allow citizens to access their money, businesses to access a secure payment system, and the economy to continue to function normally. The banks had been encouraged to raise capital from their own sources through disposals or rights issues involving shareholders where possible. But it was clear that they needed outside help and in the absence of the development of a pan European approach to the financial crisis, the only source of capital was the State. In Dec 2008, the Government announced it was prepared to invest in the banks along side private investors. Without the Guarantee and the follow on step of recapitalisation, our banks would have had to close their doors.

Initially, the Government undertook to invest €2bn in both AIB and Bank of Ireland. By February, that figure was raised to €3.5bn for each bank as property values fell and the global crisis worsened. Speaking at the Joint Committee within a fortnight of that second announcement, Brian Lenihan said:

"The market view of the Irish banking system at present is very negative and shares are traded at very low levels on the markets. Professor Honohan made a very good point in respect of recapitalisation in a considered comment he wrote on the subject. He made the point that while the capitalisation plan might not achieve all that we would wish it was an essential step in safeguarding the position of the banking system. It would not be possible for the two larger banks in Ireland, whose shares are trading at such a low level, to enjoy any international confidence without a demonstrated capital investment commitment by the Government in the absence of private capital. For that reason alone, capitalisation was essential."

The long, tortuous process of recapitalisation had only begun. From the outset, the Government made clear it didn't want to take over the banking system and I recall the Minister's anxiety that, for the sake of our reputation, at least one of our institutions would successfully raise private capital as quickly as possible. It soon became evident that Bank of Ireland was to be our only hope: in terms of its exposure to bad property lending, it was a blow to discover that AIB was not far behind Anglo.

The downward spiral of property values and the ever deepening recession throughout 2009-2010 meant that the amount needed to repair the banks kept growing. The fact that the banks' information about their loan book was so poor added to the difficulties. It was shocking to discover that they didn't know that their biggest clients had borrowed from other banks for the same projects: and so "cross-collateralisation" was another banking phrase we all came to understand.

After the initial investigation by PWC in late 2008, the new team in the Central Bank, Patrick Honohan and Matthew Elderfield sought to come to grips with the extent of the banks' exposure to property in two separate Prudential Capital Assets Requirements (PCAR) exercises undertaken in 2010. These were informed by the NAMA transaction by transaction analysis on the major development loans to be transferred to it. My role in this process was to advise on communication. I worked with officials and the external advisory team drafting the set piece speeches in the Oireachtas and preparing briefing for media engagements. It was an extraordinarily difficult political message to give to citizens who had endured the painful budgets the government had to visit upon them. The poor state of the banks' data systems and the long drawn out process of transferring the loans to Nama did nothing for the reputation of our financial system at home or abroad.

Was there an alternative?

One course of action canvassed at the outset of the crisis was the nationalisation of the entire banking sector. Again, Brian Lenihan addressed this option at the Joint Committee:

"I have always made it clear that nationalisation of financial institutions has to be the last option for us. My reason is that each of the treasury departments in the local banks is an international fund-raising agency for the country. If we decide to amalgamate them all into the State, the risk of funding the Irish banking system then rests exclusively on the State and we are a small state. There has been reference to the Swedish example in the early 1990s and it is certainly a period of banking history that repays study. However, the position in the early 1990s was that the Swedish Government had a currency of its own which was massively devalued during the banking crisis; a central bank of its own from which it could issue paper freely and a relatively closed economy compared to Ireland. There are material differences between what happened in Sweden in the early 1990s and what is happening in Ireland now."[2]

It is important to remember that the State has already recouped its investment in Bank of Ireland and that the investment in AIB may eventually be fully returned to the Exchequer. Decisions taken at the height of the crisis to resist some investment offers ensured the protection of that State investment.

Credit Institutions Stabilisation Act 2010- effectiveness of the actions to merge AIB and EBS, Anglo and INBS and deposit tansfers.

This legislation was fast tracked through the Oireachtas for early signature by the President in December 2010 to allow for the reorganisation of the guaranteed domestic credit institutions in fulfilment of the terms of targets set out in the Joint EU/IMF Programme. It provided a framework for dealing with bank failure without triggering default while also providing a way of reducing the payments to subordinated bondholders. The publication of the legislation was approved by Cabinet two days after the 2011 Budget was presented to the Oireachtas and the Second Stage was passed by the Dail a week after Budget Day. The focus of my attention at that time was preparations for budget day and specifically, the drafting of the budget speech. I have no recollection of any involvement in any discussion of this legislation and the reorganisation of the banking system for which the legislation allows was executed by the next government.

Appropriateness and effectiveness of the international Ireland specific policy responses: EU/IMF/ECB programme of assistance

There is no doubt that the Joint Programme of Assistance for Ireland has been very successful. That is largely because Ireland went into the Programme with a ready made plan, the National Recovery Plan that was adopted with just minor changes by the Troika. In effect, the Programme was a continuation of the Government's strategy for recovery which had governed all its actions since the crisis began in 2008. There was no volte face on the plan to restore the public finances and no reversal of any of the Government's banking policies.

The major benefit of the Programme for Ireland was that it provided a safe haven from the maelstrom that had buffeted our economy and our financial system from the middle of 2010.

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[2] ibid

The Greek crisis in the Spring culminating in their (unsuccessful) bailout; a downward revision of global growth prospects; and at home, the announcement in September that the cost of recapitalising our banks, had risen to €50bn. It was a lethal combination that resulted in a ballooning of our borrowing costs. Our funding position had become unsustainable as international investors lost faith in our capacity to solve our banking crisis. Brian Lenihan announced a temporary withdrawal from borrowing on the international markets.

In his budget speech in December 2010 he explained why he believed we had to go into the Programme:

The Joint Programme of Assistance, involving stand-by resources of up to €85 billion, provides us with the firepower we need to restore market confidence, strengthen the financial sector and press ahead with our plans to reduce the budget deficit and facilitate the economy's return to sustainable growth. Without this support, there would have been serious doubts about the ability of the State to raise funds at reasonable cost to pay for key public services and to provide a functioning banking system to support economic activity. That is the reality.[3]

Our success in successfully exiting the Programme on schedule having met all our fiscal targets and restructured our banking system is evidence of its effectiveness.

Was it appropriate?

In the circumstances in which we found ourselves in late 2010, outside assistance was our only option. Whether it needed to be a full scale Programme is open to question. After all, Ireland's strategy for dealing with its fiscal and financial crisis had the approval of the ECB, the IMF and the European Commission: indeed Commissioner Olli Rehn had visited Ireland on the 8th of November and endorsed the approach laid out in the National Recovery Plan.

It is difficult to avoid the conclusion that putting Ireland into a bailout programme was killing a number of birds with one stone. It solved the ECB's problem with the extent of our banks' dependence on the Eurosystem for emergency lending and it eased the concerns of the then US Treasury Secretary, Tim Geithner who made clear to his European colleagues at the G-7 meeting in Seoul earlier in November the need to prevent a banking collapse in Ireland in order to protect the global financial system.

Appropriateness and effectiveness of other EU-wide policy responses: Role and influence of the ECB

Because I was not involved in the detail of banking policy, I had no contact with the ECB or indeed with the Central Bank of Ireland. But I was keenly aware throughout the crisis of the influence of this body on our banking and fiscal policy. As our effective lender of last resort, the ECB played a key and very powerful role in our banking crisis. Although it was clearly understood by the Government and the Central Bank that the ECB wanted us to find our own way of addressing our banking difficulties, the guiding principle was that no bank should be allowed to fail. That strongly held position by the ECB was a key factor in the decision to guarantee our banks and it was communicated indirectly and, I understand, directly to the government at the time

[3] Budget 2011
http://budget.gov.ie/budgets/2011/FinancialStatement.aspx

ECB concern about the extent of its exposure to the Irish Banking system was also an influential factor at critical points in the crisis. In late 2010 when our banks were losing large scale corporate deposits on a daily basis, emergency loans from the Eurosystem grew to €130 bn. As mentioned above, the ECB's anxiety about that level of exposure was the main pressure point behind our entry into the Joint Programme of Assistance. In his interview with Dan O'Brien for the BBC shortly before he died, Brian Lenihan gave his account of the matter:

"Where Ireland's position became complicated was this enormous dependence on the European Central Bank funding and the ECB appeared to have arrived at the view at governing council level that Ireland needed to be totally nailed down in a programme. I thought it was a bit unfair because one of the points I made consistently was that we had met every fiscal target set for us, we had kept to the fiscal rules, but the bank clearly was unhappy at the idea that we were still not in a programme."[4]

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

As mentioned earlier, my only role in the banking side was to advise on the communication of most difficult and unpalatable policy decisions. In that context, I worked with Rothschild which advised the Department and the Minister during 2009-2010. I found those who worked in that team to be very thorough and professional and cognisant of the need to communicate to the public the complex, technical matters in which they had expertise.

The work done by the late Max Watson and Klaus Regling and separately, Patrick Honohan, in analysing the sources of our banking crisis in 2010 was highly effective. Brian Lenihan recognised the importance of communicating policy decisions to the public and he firmly believed the best way to achieve that was to explain what went wrong, to take responsibility for mistakes made, and to tell citizens how you propose to put them right

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For that reason, he commissioned these two independent Reports, the findings of which were subsequently accepted by Government. I believe this independent analysis had the effect at the time of enhancing the public's understanding of our predicament. This undoubtedly contributed to the stoicism with which citizens endured unprecedented and unparalleled budgetary adjustments.

My former colleague, Alan Ahearne who was appointed as Economic Advisor by Brian Lenihan in March 2009, was an invaluable resource to the Department and the Minister. He had considerable expertise and experience in banking crises and property crashes. He had been among a few experts who had foreseen the crash and he could advise with authority on the subject.

Appropriateness of the advice from the Department of Finance to Government and the use thereof by Government.

The successful turnaround of our economy and our financial system is testimony to the quality of the advice given to Government since the crisis began in 2008. That turnaround required some brave and innovative policy initiatives at a time when the country found itself in uncharted waters, at the epicentre of the global financial crisis and by and large, left to fend for itself by the EU. In terms of policy responses to the banking crisis, the Department, with the NTMA forged solutions that broke new ground and have been used elsewhere.

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[4] BBC Radio Four interview with Brian Lenihan Dan O'Brien April 2011

Apart from the long hours and work at weekends, the group of officials with whom I worked closely gave advice that was clear, well argued and achievable. Some attended Cabinet meetings to brief Ministers and most recognised the crucial role of communication during a crisis.

The Wright Report, commissioned in 2010 provides an assessment of the policy advice given by Department of Finance to Government over the pervious ten years. There have been some criticisms of omissions from the Report but it would be difficult to take issue with its findings.

As someone who worked in the Department at the time, the fact that this independent assessment was taking place and that it was embraced by officials was a positive signal that the organisation recognised it had made mistakes and was willing to learn from them.

Appropriateness of the relationship between Government, the Oireachtas, the banking sector and the property sector

Charges about an inappropriate relationship between builders and politicians and big business generally have long been a theme of Irish political discourse. Tribunals have established that in some cases, these relationships were indeed inappropriate.
Politicians of all parties quite properly engage with representatives of sectors that are key players in our economy. The crucial point is that interaction with these and any other interest group should always be in the common good. In that regard, Brian Lenihan was utterly scrupulous.

Conclusion

In this submission, I have endeavoured to be as helpful and as accurate as I can in my recollection of information, insights, and views which I hope will assist the Joint Committee in its Inquiry. I didn't take contemporaneous notes and the passage of time dulls the memory. As I said in my introduction to this statement, it is difficult at this remove to distinguish between my contemporaneous state of knowledge and the information I have acquired subsequently about some of the lines of Inquiry such as the Guarantee, for example. I would ask the Committee to bear the possible distorting impact of this in mind when assessing the information contained in this submission. Notwithstanding this, I hope the foregoing will be of assistance to the Committee in this inquiry.