Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Dermot McCarthy

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

Statement by Dermot McCarthy, former Secretary General to the Government

1. Introduction

1.1 This statement is made on the basis of facts known to me as Secretary General to the Government, a position in which I served from January 2000 until 31 July 2011.

1.2 I have been directed to make a Statement regarding 15 lines of inquiry before the Joint Committee. I believe that the conclusions of the Nyberg Commission of Investigation provide a broadly convincing account of the circumstances which led to the crisis. My Statement deals with matters within my direct knowledge, having regard to the applicable legal obligations, notably in relation to Cabinet confidentiality.

Crisis Management System and Policy Response

2. Appropriateness of the bank guarantee decision. (C3b)

2.1 In the period leading up to 29 September 2008, the Government was briefed on liquidity difficulties in the Irish banking system by the Minister for Finance and increased the deposit guarantee to €100,000 on 20 September 2008.

2.2 The Government met on Sunday, 28 September to discuss expenditure reductions in preparation for Budget 2009 and was to have its regular meeting on Tuesday, 30 September. On Monday evening, 29 September a meeting in respect of banking matters was attended by the Taoiseach, the Minister for Finance and the Attorney General, together with representatives of the Central Bank, the Financial Regulator, the Department of Finance, the Taoiseach's advisers and myself. The meeting was advised of the very substantial outflows from Irish financial institutions, the critical position of Anglo in particular, and that unless measures were taken before the financial markets opened on Tuesday morning, irreversible damage could be done to the economy through a banking collapse.

2.3 The expectation that no government would allow a bank to fail, especially in the aftermath of the Lehman's example, was reinforced by the potential consequences outlined to the meeting. It was made clear that no European or European Central Bank (ECB) initiative was in prospect which would address the immediate crisis faced by Ireland. The depth of the international crisis was reinforced by news that the US Congress had rejected bank rescue proposals.

2.4 The advice was that the Government had one opportunity to make a decisive intervention to stabilise liquidity and secure the Irish banking system. It would have no certainty of success but the alternative was certain disaster. A Guarantee to support the liquidity position of the banks was considered as the option most likely to stabilise the situation. The form and extent of such a Guarantee was discussed.

2.5 A request to meet from the Chairs and Chief Executives of AIB and Bank of Ireland was agreed. The banks' representatives were met by the Taoiseach, the Minister and the Attorney General accompanied by Department of Finance officials, the Governor of the Central Bank and myself. The banks' representatives confirmed the gravity of the funding situation for the Irish banks, with difficulty in getting even short-term funding from the money markets. The negative sentiment towards Ireland was focused on particular institutions but all were now impacted. They argued that effective action was necessary to reassure the markets. As regards a Guarantee, they suggested that a Guarantee of two years would be required. The capacity of AIB and Bank of Ireland to provide liquidity support on an emergency basis to Anglo was discussed.

2.6 Following discussion with the banks' representatives, there was further consideration about the action to be taken. The Taoiseach and the Minister resolved that a Guarantee of two years duration with a broad scope would be recommended to the Government. The option of nationalisation of Anglo was considered but it was concluded that such action could have more negative than positive effects on market confidence. It was also understood that a decision to nationalise Anglo could be taken at a later date should it be appropriate. The Guarantee would be offered on commercial terms and would provide a framework for any measures required to build market confidence in the Irish banking system. The Scheme of the Guarantee when introduced made provision for a range of matters which would be subject to supervision and control within the covered institutions, including senior remuneration. It was decided that the approval of Government would be sought by an incorporeal meeting, which was conducted in the early hours of Tuesday, 30 September.

2.7 A particular concern was that the Guarantee might be challenged on European State Aid grounds and that such a risk could hamper its effectiveness. It was agreed that a formal notification to the European Commission would be made immediately. A full supporting case including all of the material considered in the discussion would be detailed in a submission, supported by expert analysis, at the earliest opportunity. It was also agreed that legislation to implement the Guarantee would be brought to the Government on Tuesday, 30 September.

2.8 The European Commission subsequently approved the decision as an appropriate means to remedy a serious disturbance in the Irish economy. On 6 October the French Presidency stated that all EU leaders had made clear that each of them would take whatever measures were necessary to maintain the stability of the financial system.

3. EU/IMF/ECB Programme of Assistance. (C5)

3.1 The deteriorating economic situation and the cost of recapitalisation of the Irish banks in March 2010 created international concerns by mid-2010 about the State's financial position. In response, the Government began the preparation of a Medium-Term Expenditure Framework, in tandem with a fiscal responsibility framework to reflect measures recommended by the Van Rompuy Task Force. The ECB's concern about the extent of liquidity support to Irish banks was reported to the Government by the Minister for Finance. It was considered that public confirmation through a Recovery Plan of the adoption of a comprehensive programme of fiscal reforms, and specific measures to achieve the necessary deficit reduction by 2014, would improve market sentiment towards Ireland.

3.2 In October 2010 the Government considered the budgetary adjustments required in 2011 and subsequent years. The European Commission and the ECB favoured a front loading of adjustment within an overall adjustment of at least €15bn by 2014. The continuing dependence of the Irish banks on ECB liquidity support was evident, as was a market view that further recapitalisation would be necessary.

3.3 On 12 November the Taoiseach received a phonecall from the President of the European Commission expressing the concern of the G20 at the risk to international financial stability posed by the fragility of the Irish situation. The ECB Council conveyed to the Minister for Finance that the Government should apply for Eurpean financial support. Department of Finance officials travelled to Brussels for exploratory discussions on the parameters of a possible Programme of Assistance if the Government were to decide to apply. The tentative nature of these discussions reflected concern that the conditionality of any such Programme could include unacceptable terms, such as changes to the Irish corporation tax regime.

3.4 The situation was reviewed by the Government and the text of a four-year Recovery Plan was approved. There was a concern that the full implications of any Programme of Assistance, including affordability, should be clear before the Government would apply for assistance.

3.5 Subsequently, the Minister for Finance, in consultation with the Governor and the CEO of the NTMA, sought the approval of the Government for a formal request for external assistance to the EU/ECB and IMF in implementing an adjustment plan of €15bn over the period to 2014, given that the Government could not borrow in the market at current rates, and the serious liquidity problems in the Irish banks. Some days later the National Recovery Plan was published by the Government.

3.6 The terms of the draft Programme of Assistance were considered by the Government together with the recommendations of the Secretary General of the Department of Finance, the Governor and the Chief Executive of the NTMA. The Programme was formally announced on 28 November 2010. The arrangements for the monitoring of the implementation of the Programme and for coordinated action across Government Departments were put in place and continued over the life of the Programme.

4. Role and influence of the ECB. (C6d)

4.1 The ECB played a major role in the evolution of the European response to the developing international financial crisis. The ECB exercised a major influence on the evolution of the Irish response to the crisis as a consequence of the extent of the reliance of the Irish banks on ECB liquidity support.

4.2 Its primary direct involvement in the Irish situation was through the provision of liquidity support to the Irish banks. It did this both through direct liquidity measures and approval for Emergency Liquidity Assistance (ELA).

4.3 ECB concerns at the level of its exposure to the Irish banks were conveyed directly to the Minister for Finance and through the Governor. The extent of that concern grew with the outflows from the Irish banks during 2010. By early November 2010 the ECB expressed its strong view that the Irish Government should apply for European financial assistance. On 19 November, the President of the ECB wrote to the Taoiseach and to the Minister for Finance stating that ELA could only be continued if Ireland applied to the Eurogroup for financial support and proceeded with a decisive restructuring and adequate recapitalisation of the Irish banks. The ECB stated that an affirmative response was being sought to ensure that ELA conditions were met.

4.4 Apart from liquidity support, the views of the ECB were sought on the terms of the legislation implementing the Guarantee. Its views were also sought, together with those of the European Commission, as the restructuring of the Irish banking system and its recapitalisation proceeded. At an earlier stage, the views of the ECB had been taken into account in the drafting of the legislation establishing the Financial Regulator.

4.5 Another strategic issue on which the views of the ECB were influential related to burden sharing, which is addressed in the following section.

5. **Options for burden sharing during the period 2008-2013. (C7a) and Role of the euro zone and international partners in this decision. (C7b) (together)**

5.1 The terms of the Guarantee precluded burden sharing with bondholders during its operation. For junior bondholders, that expired at the end of September 2010. Subsequently, significant losses were imposed on subordinated debt holders.

5.2 Imposing haircuts on unguaranteed senior bondholders became a significant focus in the context of the funding difficulties experienced towards the end of 2010 and was raised with the international institutions, including the ECB, during discussions on the Programme of Assistance. The concept was strongly resisted because of their concern about its potential impact on wider financial stability.

5.3 In March 2011 the agreement of the ECB was sought but declined for the announcement by the Government of a statement of intent to impose burden sharing on unguaranteed senior bondholders in Irish banking institutions in wind down.

6. Appropriateness of the regulatory regime. (R1a)

6.1 In October 1998 the Government decided in principle to establish a single regulatory authority for the financial services sector. Following consideration of the Report of an Implementation Group, the Government approved a joint proposal by the Tánaiste and the Minister for Finance to prepare legislation to establish a Financial Regulator within a restructured Central Bank. The proposed arrangements were altered following consultation with the ECB. In particular, a proposed Irish Monetary Authority within the Central Bank in parallel with the Regulator was dropped. The proposals were also altered to give the Governor a more direct role in relation to the budget and regulatory activities of the Financial Regulator. This was designed to reflect the Governor's responsibilities as a member of the Council of the ECB and to ensure that financial stability issues and ECB-related tasks were dealt with in a coordinated manner. The Government viewed the provision for a separate Board structure for the Financial Regulator within the Central Bank framework as an important focus for accountability and responsiveness to public and consumer concerns in the regulation of financial institutions.

6.2 Following publication of the proposed legislation in 2002, further comments were received from the ECB as a result of which the Governor's role in relation to the budget and staffing of the Regulator was strengthened. The ECB also welcomed the fact that the Financial Regulator would remain a constituent part of the Central Bank. The Central Bank and the Financial Regulator constituted a unified entity, with a large element of cross-representation on their respective boards. The legislation provided for sharing of information and analysis, and for enforcement measures and penalties to be applied by the Financial Regulator.

6.3 The annual reports of the Central Bank were submitted for information to the Government by the Minister for Finance. The annual reports of the Financial Regulator were also submitted to the Government. These recorded the significant number of inspections of financial institutions carried out and regulatory returns examined. The report in respect of 2006 highlighted that international independent reviews of the Financial Regulator's performance contained positive assessments of the regulatory system in Ireland. This supported the view that the regulatory structures and their legislative framework were appropriate.

6.4 While it is a matter of public record that from its Stability Report 2004 the Central Bank warned of the risks of excessive credit growth and the property boom, and the

Financial Regulator increased capital requirements for property development lending in 2007, these measures clearly were not sufficient to avert the serious instability which culminated in the crisis of 2008.

6.5 In the light of the financial crisis and in line with international trends, the Government decided in 2009 to create a new integrated regulatory system under the direction of the Governor. The Government was advised that pending the enactment of new legislation, the Boards of the Central Bank and the Financial Regulator had made changes to the operation of the existing legislative framework through improved linkages between the Banking Supervision Department in the Financial Regulator and the Financial Stability Department of the Central Bank.

7. Appropriateness of the macro-economic and prudential policy. (R1c)

7.1 The risks to macro-economic and financial stability represented by the rapid expansion in credit growth and the concentration on property-related lending were in the first instance a matter for the Central Bank. While it was a matter of public knowledge that these issues were adverted to in the Stability Report of the Central Bank from 2004 onwards, the degree of systemic vulnerability, in the light of subsequent events, was not highlighed.

7.2 The absence of a sense of impending crisis was reflected in an external assessment by the IMF in 2007. This report noted the vulnerabilities in the Irish banking system which had arisen from rapid credit growth, increased household indebtedness and bank reliance on wholesale funding. The IMF noted, however, noted that the banking system was well-capitalised and profitable, that stress tests by the Central Bank indicated that even in an extreme scenario the major lenders had adequate buffers to cover a range of shocks, and a substantial withdrawal of deposits would not exhaust any major lender's stock of liquid assets. The IMF also commented on the strengthening of the regulatory and supervisory system and supported as appropriate the risk-based framework operated by the Financial Regulator in prioritising supervisory resources.

7.3 The Government, having regard to the submissions it had received, did not believe that the macroeconomic and prudential policy of the Central Bank was inappropriate. The process of economic policy-making by the Government is addressed below.

8. Nature and effectiveness of the operational implementation of the macro-economic and prudential policy. (R2b)

8.1 The principal responsibility for Government arising from the operation of macro-economic and prudential policy related to the conduct of fiscal policy. The importance of an appropriate fiscal stance was communicated by the Governor in his formal and public statements and through his input to the formulation of budgetary advice by the Minister for Finance.

8.2 The Government received every year an Update on the Stability Programme, which was submitted to the European Authorities in the context of the Stability and Growth Pact. Its primary focus was on the trend in the cyclically-adjusted General Government Balance and the outlook for General Government Debt, which were the key parameters monitored under the Stability and Growth Pact.

8.3 From 2003 to 2006 the Stability Programme Reports presented to the Government identified a gradual and orderly reduction in housing output to a more sustainable level as a significant factor likely to impact on economic performance, partially offset by growth in other components of investment expenditure. In the report for 2006 the potential for economy-wide consequences of construction-specific developments, such as rising interest rates, was noted. The moderation in prices and activity in the property market in 2007 was highlighted.

8.4 While the advice and concerns expressed by the Central Bank were to some degree reflected in this analysis, economic policy was not formulated by Government in the belief that there was a serious risk to financial sector stability.

9. Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used. (R4a)

9.1 The engagement of experts in relation to banking and regulatory matters was not a matter in which I was involved. In general, the expert advice considered by the Government was that of the Governor and the Chief Executive of the NTMA.

9.2 Experts engaged by the Department of Finance or the Financial Regulator contributed to the assessment of options regarding the response to the financial crisis. Expert analysis was deployed in the application for European State Aid approval of the decision to issue the Guarantee. Expert advice was also commissioned in respect of restructuring proposals and options for dealing with significantly impaired loans on the balance sheets of the Irish banks. In many cases, these recommendations were cited in proposals put to Government for its approval.

9.3 External advice on the broad range of economic policy was received from the Economic and Social Research Institute and the National Economic and Social Council.

9.4 In general, the accuracy of the forecasts reflected in the advice received was subject to the rapidly unfolding situation, the interaction of domestic and international events, the evolution of market sentiment towards Ireland and its banks, and the economic outlook and asset values. Such advice informed, but did not remove the need for, judgements to be made by the Government in a rapidly evolving situation, both domestically and internationally.

10. Analysis and consideration of the response to contrarian views (internal and external). (R4c)

10.1 While groupthink may have operated to a considerable degree within the various elements of the financial and governance system, there was not a single view about the conduct of policy or the outlook for the economy.

10.2 The formulation of proposals which Ministers decide to bring to the Government for consideration involves discussion between officials and advisers, and engagement with external parties. The process of decision-making at Government facilitates debate and the flagging of concerns by Ministers.

10.3 Most decision-making requires judging the probabilities of events occurring, while striking a balance between competing objectives in the context of Government policy. Collective responsibility requires members of the Government to support decisions once taken. The legitimate exercise of its democratic authority by the Government must be respected by officials. For example, the Department of Finance in its budgetary submissions signalled a preference for a lower rate of expenditure increase than occurred in a number of years.

10.4 There was of course awareness of contrarian views occasionally expressed in the media regarding the risks of an economic collapse. It was widely considered that this was improbable while vulnerabilities were nonetheless acknowledged to exist.

11. Effectiveness of the Oireachtas in scrutinising public policy on the banking sector and the economy. (R5a)

11.1 The Oireachtas scrutiny of economic policy entailed Parliamentary Questions to the Minister for Finance or, in terms of broader strategy, the Taoiseach, Private Members' motions, debates on the Budget and the Finance Bill, and the consideration of Departmental Estimates by the relevant Oireachtas Committees. Changes in the budgetary process were introduced to facilitate more effective parliamentary engagement, including the earlier publication of the Stability Programme Report, the introduction of a single Budget format and Annual Output Statements to support discussion of Departmental Estimates.

11.2 As a general observation, it is understandably more likely that parliamentary time and political engagement will arise in respect of specific actions or measures rather than broader policies and options, since concrete measures provide a clear focus for the central role of the Oireachtas in holding the Government to account. In the years leading up to the crisis the direction of Government economic policy was not significantly altered in the light of parliamentary scrutiny.

12. Appropriateness of the advice from the Department of Finance to Government and the use thereof by Government. (R5b)

12.1 The Minister for Finance and the Department have a major role in the development of Government policy which is recognised in Cabinet procedure, such as the requirement that they be given advance notice of all Government submissions. The Department makes regular submissions to the Government during the course of the year regarding economic and financial policy.

12.2 The budgetary cycle up to 2011 involved the Minister setting out the broad economic framework within which budgetary decisions should be shaped. This provided a context for the engagement by the Department of Finance with individual Departments to settle their spending Estimates. In recent years, these discussions have taken place within a multi-annual framework which, during the period of the Programme of Assistance from 2011, reflected the commitments on fiscal adjustment.

12.3 In general, the Department of Finance's proposals were based on securing financial stability (within the terms of the Stability and Growth Pact) and the productive capacity of the economy, while avoiding inflationary pressures and addressing priority needs. The Department pointed out the potential for reverses, both domestic and international, associated with declining competitiveness, exchange rate movements, increases in commodity prices and the possibility of a downturn in construction activity. The Department recommended the maintenance of a cyclically-adjusted positive General Government Balance and containing the growth in current expenditure to the nominal rate of economic growth.

12.4 The framing of budgetary proposals and Government discussions had regard to the terms of the relevant Programme for Government. Within that broad framework, objectives adopted by the Government in respect of poverty, disability, Overseas Development Aid, Social Partnership Agreements and a variety of other issues were relevant.

12.5 The substantial reduction in the debt to GNP ratio, substantial Budget surpluses, significant annual transfers to the National Pension Reserve Fund, and an ambitious programme of investment in infrastructure to increase productive capacity with little or no recourse to borrowing, created a sense of confidence with regard to fiscal matters.

12.6 The outcome required a balancing by the Government of the commitment to fiscal stability with the desire to address significant and pressing deficits in both infrastructure and public services. In the event, the Government decided on increases in public spending that cumulatively were significantly greater than were recommended by the Department of Finance.

12.7 Following the crisis, the severe adjustment in the public finances, on both the expenditure and revenue sides, required intensive engagement across all areas of activity. The commitment to achieve a 3% current deficit by the end of 2014 while protecting priority needs was made all the more challenging by successive revisions in the scale of the adjustments required, not least as a result of bank recapitalisation costs.

12.8 These fiscal adjustments were accompanied by measures to stimulate economic activity and employment within the fiscal constraints, such as the sectoral measures set out in the Smart Economy Framework published at the end of 2008 and the National Recovery Plan of 2010.

13. Appropriateness of the relationships between Government, the Oireachtas, the banking sector and the property sector. (R5d)

13.1 In general, the Government's focus on the banking and property sectors reflected their overall economic significance more than specific lobbying or pressure.

Banking

13.2 The primary relationship between the banking sector and the Government was through the Minister for Finance and the Department. The banking industry was represented by the Irish Bankers Federation and Financial Services Ireland on matters relating to general policy, such as the development of the National Payments System. It was, in my experience, unusual for individual banks to have or seek direct engagement with Government. Presumably there would have been more bilateral contact with the Department of Finance, and naturally, the Financial Regulator.

13.3 From the establishment of the IFSC, the Department of the Taoiseach had chaired the Clearing House Group, whose members included representatives of the Departments of Finance and Enterprise and Employment, the Revenue Commissioners, the Financial Regulator, the IDA and, later, Enterprise Ireland.

13.4 The Clearing House Group and a range of associated working groups provided a forum for exchange of information and suggestions between different categories of participant in the sector, professional advisory practices which serviced the sector, as well as Government Departments and agencies. As its name implies, the Group was primarily a vehicle for commercial intelligence gathering in the context of the competition between jurisdictions for investment. The focus of the Group was the identification of opportunities for development and employment in a variety of specialist activities, such as asset and fund management, the development of technology and other support services. A particular focus was on the marketing of the benefits of location in Ireland and the tackling of barriers to growth, such as availability of skilled personnel. The operation of a credible regulatory system was seen as critically important in securing the reputation of the industry and attracting appropriate new entrants.

13.5 Discussion at the Clearing House Group covered a broad range of public policy. Concerns were voiced at times about proposals which were seen as disproportionate by reference to international practice. In general, the representatives of the relevant Government Departments and the Financial Regulator explained and defended such measures. Where the industry had continuing concerns, these were pursued bilaterally with the relevant agency in line with their consultative mechanisms. In strategies for the future of the industry, developed periodically, the industry representatives expressed support for a regulatory system which was effective, consistent and efficient.

Property

13.6 With regard to the property sector, a distinction might be made between the construction industry and those engaged in development. The construction industry, represented by the Construction Industry Federation (CIF), participated in social partnership and was party to the pay negotiations as well as the broader partnership process. In later years, a broader Construction Industry Council was established which sought to represent a variety of professions and interests in addition to the CIF.

13.7 The pursuit of tax incentives for particular types or locations of development had been common. Their introduction had reflected a widely-held view that such incentives were useful in stimulating investment, especially to meet specific infrastructural or regional needs. Following a review of their cost-effectiveness, the Government announced in Budget 2006 that a range of such property-linked tax incentives would be phased out.

13.8 Apart from tax issues, lobbying occurred regarding requirements to support the provision of social and affordable housing, the so-called Part V provisions, which were introduced and maintained. The construction industry attempted to resist the introduction of new standard forms of construction contract for use in the public service. The contracts were nonetheless introduced and operated.

13.9 Following the onset of the crisis, there was engagement with the construction industry regarding a variety of proposals that would support the sale of completed houses and encourage maximum output from the still significant public investment in physical infrastructure. Options to engage pension funds and other sources of private long-term investment in infrastructure projects, which had also been proposed by ICTU and others, were also discussed.

14. Assessment of what has been done. (R7a)
Assessment of whether further changes are required. (R7b) (together)

14.1 Significant relevant changes were implemented during my time as Secretary General, and further changes have been implemented in more recent times.

14.2 The restructuring and expansion of the financial regulatory institutions has addressed a priority arising from previous reports and investigations. Boards and management across the relevant banking institutions have been renewed. The development of regulatory and supervisory systems at a European level have strengthened the capacity to deal with cross-border issues, while the agreement of a banking resolution framework is a significant tool in supporting regulatory credibility.

14.3 With regard to the conduct of economic policy, the establishment of the Fiscal Advisory Council and the oversight by the European Institutions as part of the European Semester have brought a greater transparency to Irish fiscal policy. Tax and spending measures and the achievement of value for money are subject to analysis supported by greater economic expertise within the public service. The introduction of a National Risk Assessment Framework is a positive development. The legislation to provide for the registration of lobbyists and lobbying activity should also assist in the monitoring of efforts to influence public policy.

14.4 I am not in a position to assess how well the changes referred to above have been operating or whether any further changes are required. This reflects in large measure the fact that the relevant issues, including many other matters covered in this Statement, were not ones in respect of which I had expertise or responsibility.

14.5 It is clear, however, that irrespective of any structural and/or capacity developments that may be implemented, Governments will still be faced with the need to exercise judgement in setting fiscal policy and in assessing the risks to be taken into account in framing budgetary decisions.

(ENDS)