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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Michael Somers

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JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Statement by Michael Somers, former CEO of the NTMA

I have been asked to provide a statement to the Inquiry covering 24 lines of inquiry relating to my role as Chief Executive Officer of the National Treasury Management Agency.

I was appointed to that position on 3rd December 1990 for a period of 5 years by the Minister for Finance and was re-appointed several times, finally retiring on 3rd December, 2009. I had previously been Secretary (General), National Debt Management in the Department of Finance from April 1987 and before that, Secretary (General), Department of Defence from February, 1985. I served at various levels in the Department of Finance, initially in the Pensions Section and later in the Finance Division. I also spent a period of just under two years in the Central Bank up to 1970.

As I was largely responsible for the establishment of the NTMA and its growing range of functions over 19 years, I would like to outline the rationale for its rather unique structure and how it operated.

The reason for the establishment of the NTMA was the very heavy burden of the National Debt at the end of the 1980s and the absence of suitably qualified personnel in the Department of Finance to deal with the complex issue of raising funds on the international capital markets at optimum rates of interest. The then Minister for Finance, speaking on the NTMA Bill before the Dail in 1990, said the debt was one of the highest in the OECD at over 120% of GNP at end 1989, while interest payments were put in 1990 at 9% of GNP, which he said was almost equivalent to the total yield from income tax in the PAYE sector. He continued that it was about 60% greater than total Exchequer expenditure on the health services.

The powers of the NTMA were very strictly circumscribed by legislation and related to the delegation of powers of the Minister for Finance to borrow money to fund the Exchequer. The NTMA had no power to provide any assistance to the banking sector and would have been acting outside its remit, and probably in breach of the EU law, to have done so by its own decision. The following paragraphs set out the carefully designed legal basis on which it was established and operated.

When funds were being raised abroad and legal documents had to be signed, it was generally done by officials of the Department of Finance acting on the basis of a signed and sealed power of attorney given by the Minister for Finance. It would have been completely impracticable for the Minister to personally negotiate and execute all the documentation relating to loans raised throughout the world. Nevertheless questions had been raised, generally by Irish lawyers, about the legitimacy of this procedure, on the basis that the Minister could not delegate his power to a civil servant. There could have been some validity in this argument. It was felt unwise to see it legally tested as, if found to be wrong, it would have created an impossible situation in the absence of some complex legislative change.

However, when the creation of the NTMA was being considered, it was essential that this issue be resolved as there was no room for questioning the legal capacity of the NTMA to enter into contracts binding the State for very large financial commitments. Also it was not intended that the NTMA would be required to obtain a separate power of attorney from the Minister for Finance for every transaction undertaken – a situation that, as mentioned earlier, could be legally challenged anyway.

In summary, therefore, the creation of the NTMA raised constitutional issues as the functions which it would be called on to perform were part of the executive power of the State. That power can only be exercised by or on the authority of the Government. It was felt that if the borrowing of money for the Exchequer and the management of the National debt were taken away from the Minister for Finance, it could be questioned as to whether he was still Minister for Finance. It was, however, recognised that the Government could delegate the functions of a Minister to a Minister of State, while still retaining the power to exercise those functions himself or herself.

The legislation passed by the Oireachtas provided that the NTMA would be established as a body to perform, on the authority of the Government, the functions delegated to it by the Government under the Act (at that time principally borrowing and debt management). In effect it was established as a type of corporate Minister of State. The Government would delegate to it certain functions of the Minister for Finance. These would be performed subject to the control and general superintendence of the Minister and subject to such guidelines and directions as he would give it. The chief executive would be appointed by the Minister and be directly responsible (i.e. not through a Department) to the Minister for the performance of the functions of the Agency. The chief executive, who could not be a civil servant, would be answerable to the Dail Public Accounts Committee. Because of the importance of the NTMA's functions as part of the executive power of the State, it was further determined that there could not be a board of directors, as with a State body, because this would diffuse responsibility to an unacceptable degree. Instead there would be an Advisory Committee to assist and advise the Agency on whatever it might request and be consulted by the Minister on the terms and conditions of appointment of the chief executive.

The above arrangements applied throughout my period as chief executive of the NTMA. They were, however, fundamentally changed by the National Treasury Management Agency (Amendment) Act 2014, but these changes are not relevant to my statement.

I would like to draw the Committee's attention to the evidence that my colleagues and I gave to the Public Accounts Committee on 14 May, 2009, over a period of about 4 hours. This covered quite comprehensively what the NTMA knew about the banking crisis at the time and the actions it had taken. I should add that, re-reading the evidence I gave then, I would not see any reason to significantly change any of it. I resigned/retired from the NTMA about six months later and just over one year before my contract expired.

As a general comment before turning to the specific lines of Inquiry that the Committee has addressed to me, I should make the point that the NTMA was quite a small organisation at that time, with a total staff of 169 when I left at end 2009. It had four main businesses, namely the borrowing and debt management functions of the State (its original purpose), the management of the National Pensions Reserve Fund, the State Claims Agency and the National Development Finance Agency, as well as a significant number of other functions including a small NAMA unit. These had all been assigned to the NTMA in accordance with a large number of pieces of primary legislation (a NAMA unit was set up in advance of legislation). I should emphasise that the NTMA had no regulatory, policing or oversight role and, except to the extent it might be asked for specific views, no policy input role. It was recognised by the Nyberg Report that the NTMA was not a public authority. Nevertheless, it did provide any and all assistance it was asked for during the banking crisis, but would not have been party to, or present at, many of the discussions between Government Ministers, the Attorney General, the Department of Finance and the Central Bank.

I propose to respond to each of the 24 lines of inquiry in the order that you set out. I should state that in several instances I am unable to provide any assistance as I have no information on the subjects. In the case of others, where I have no specific knowledge I have given such information or views as I have or may have expressed elsewhere.

C1(d) Effectiveness of ECOFIN and DSG

Adequacy of the DSG process including consideration of the bank resolution legislation.

I had no involvement with ECOFIN from the time the NTMA was established. The NTMA had been invited to attend DSG meetings from late 2007 onwards in relation to the placing of deposits with the domestic commercial banks. As stated in the

Nyberg Report, the NTMA reacted to the onset of the credit crisis like most market participants by withdrawing much of their deposits from private institutions and placing them with Central Banks.

The NTMA provided advice and assistance from 2007 in the following areas:

- Assistance in accessing specialist expertise
- Preparation of contract documentation
- Gathering market intelligence
- Assistance with communications with rating agencies and providing information concerning cost implications of changes in sovereign debt rating
- The provision of liquidity to Irish banks on the basis of a Ministerial direction. It also put in place arrangements to allow it engage in collateralised lending to Irish banks.
- The NTMA provided comments on draft legislation as requested from time to time.

C2(a) Effectiveness of the CBI liquidity group under the Joint Financial Stability Committee.

The NTMA was asked to attend a group to discuss liquidity. This was composed of a member or members of the Government, the Central Bank, the Department of Finance, Department of the Taoiseach, the Financial Regulator and the Attorney General (not all present on every occasion). There was generally a discussion on the liquidity situation of the banks, the extent of their borrowing from the Central Bank and the problems associated with emergency lending. Frequently all the attendees other than the NTMA, Central Bank staff and the Regulators staff would adjourn to another room to discuss the situation. The role of the NTMA was generally to specify what funds we had. There was from time to time discussion on the NTMA placing funds with the Irish banks. We would do so but (on legal advice) only on the basis of a written direction from the Minister for Finance.

I attended many of these meetings myself and invariably did so when the Minister for Finance wished me to be present. Generally however someone from the NTMA was present in Government Buildings when meetings were in progress, but in many instances would not have been in attendance at some or most of those meetings. This was also my experience.

C2(b) Role of Advisors in analysing the crisis

At the request of the Minister for Finance we hired Merrill Lynch to provide advice to him. The apparent reason for the involvement of the NTMA in this was that the Department of Finance wanted us to charge the cost to the NTMA operating budget as they did not have adequate funds in their own budget to meet the cost (ultimately about €6 million). We also hired Dr. Peter Bacon, at the Minister's request, to produce a report for him which ultimately became the basis for NAMA. In addition PWC and Arthur Cox were engaged to provide financial and legal due diligence services respectively in regard to the Minister's directed investments by the National Pensions Reserve Fund Commission into AIB and BOI in 2009.

C2(c) The liquidity versus solvency debate

There is some validity in the argument that lack of liquidity can lead to insolvency. Many businesses that are solvent on an ongoing basis will rapidly become insolvent if they run out of cash and have to realise assets suddenly in what might be called a fire sale. However, in the case of the banks, the enormous amounts that they lent to individual developers to enable them to pay extraordinarily high prices for property, and the rolling up of interest (much of which may have been taken into the profit and loss account) meant that insolvency was almost inevitable.

C3(a) Department of Finance Actions - Appraisal of the conditions prior to increasing the Deposit Guarantee Scheme.

See response to C3(b) below

C3(b) Appropriateness of the bank guarantee decision

I was in the United States on the night that the decision was taken and only became aware of it through a text message from a colleague the following morning. If there was a risk of a run on the banks, then a guarantee on deposits was probably the best course of action. I understand that the senior bonds were issued on the basis that they ranked pari-passu with deposits. The rationale for guaranteeing other bonds is not clear.

C3(c) Effectiveness of reviews of banks' loans books and capital adequacy

I saw the PWC review of the banks' loan books. At that stage the damage had been done and the only question was the scale of the disaster. The early review underestimated the size of the ultimate losses; much larger State support was later required.

C4(a) Decision to nationalise Anglo in 2009 and alternatives

At that stage it was probably inevitable. By then there was nothing to indicate that it had a future as a privately-owned institution.

C4(b) Establishment, operation and effectiveness of NAMA.

The decision to establish NAMA was taken very quickly by the Minister for Finance and I supported the Minister when he announced it. I also at his request went to see Mr. Trichet at the ECB to tell him that we would need about €60 billion from the ECB to fund it. I was hesitant about the amount of money that was going to be paid into the banks and the rapidity with which it was to be done. The Minister felt it would free up the banks to start lending again. I felt that we should take just some loans from the banks and see if that would encourage them to lend. I also felt that the banks should be pressed to recover the loans themselves as they knew "where the bodies were buried". Transferring them to NAMA would be a bonanza for lawyers and other professionals as well as requiring a large staff in NAMA. In the event, a very large number of loans were transferred to NAMA at a substantial discount. Regardless of what happened the likelihood is that the outcome would have been the same.

C4 (c) Decision to recapitalise Anglo, AIB etc. and alternatives.

Some type of banking system had to be preserved for the State and the Minister went for the two pillar bank model. EBS was taken over by AIB. The problem was that NAMA imposed very substantial discounts on the loans they took over (I am not in a position to give a view on the correctness of their discounts) and this had the effect of wiping out the capital of the banks. They had therefore to be recapitalised to stay in business.

C4(e) Cost of the Crisis and sharing of the impact

I have no particular insights into this area.

C6(d) Role and influence of the ECB

The ECB and the Irish Central Bank (as part of the ECB) had a role as lender of last resort. They did provide very considerable resources to the Irish banking system with a reported 25% of their total lending being extended to the Irish banking system. My only involvement with the ECB was as mentioned earlier, to ask Mr. Trichet for funding for NAMA.

C7(a) Options for burden sharing during 2008-2013

In terms of sharing the burden with other euro zone countries, this just did not find acceptance. In terms of what happened within the State, this was a matter for Government decision.

On the more general question, repayments abroad by the State in respect of its own debts were made as were repayments in respect of senior bank bonds which, as I understand it, legally ranked pari – passu with bank deposits. Other repayments on junior bonds were also made. However, many of the other payments were between Irish residents themselves, and as such were a transfer of wealth within the Irish State. In terms of the impact that they had on the balance sheets of banks, and on their incurred losses, these had the same impact as if the cash involved was transferred out of the country. There is, in my view, a valid argument that, to the extent that losses were incurred by Irish banks arising out of transfers between Irish citizens (and which gave rise in part to the need to recapitalise the Irish banks), the case for transfers from other countries (by way of free money or grants) to recapitalise the Irish banks was questionable.

Also to the extent to which cheap funds (i.e. at interest rates below what otherwise would have been the case) were made available to Ireland, there was a transfer of wealth from other Euro-zone countries to Ireland. This applied particularly to funds provided by the ECB. This could be classified as burden sharing.

C7(b) Role of the Eurozone and international partners in the decision

I was not involved in this area.

Banking

Effectiveness of bank's board governance, client relationships and business models

B1(a) Composition, skills and experience of the board and board subcommittees

(d) Adequacy of board oversight over internal controls to ensure risk is properly identified, managed and monitored

As CEO of the NTMA, I had no involvement with the above. However, I would have read their annual reports and was very impressed at what they said they were doing in the area of corporate governance and risk management. Boards can, however be quite reliant on management to bring to their attention such items as are of importance. There can be a tendency to "swamp" directors with vast amounts of paper and without prioritising issues with which a board should concern itself. This may be seen as a form of self-protection by management, which can argue at a later date that all matters were brought to directors' attention. I do not know to what extent this was happening in Irish banks prior to the crash or the rationale they had for the very rapid expansion of credit. Another important factor is the consensus culture on boards, where a discordant note may not be welcome, particularly on the part of a dominant chairman.

B3(a) Appropriateness of funding sources – the mix, maturity profile and cost

As CEO of the NTMA, this would not have been an area where I would have had an involvement. I would have presumed that the highest standards would have applied. However, I was somewhat perplexed at the very rapid growth in credit and on one occasion spent some time going through the Central Bank statistics to try to understand it. The closest I could get to finding out the backing for this credit expansion was that, in respect of their Irish business, the Irish banks had borrowed somewhere between €100 billion and €200 billion. As I was surprised at this, I asked a colleague to check my figures to see if this was correct. He confirmed my findings but was unable to arrive at a more accurate figure.

On the same general question of some banks' approach to funding costs, I should add that on a reasonably regular basis, I came across non-Irish banks that lent money to us and, as far as I could see, either made no money, lost money or took risks on their funding that I would have regarded as at best rather questionable on their part.

To some extent at least, banks internationally were buying market share or keeping themselves high in international rating lists, even where deals made little or no financial sense. I would not have thought this applied to Irish banks.

Regulatory, Supervisory and Government – Themes…..

Effectiveness of the Regulatory, supervisory and Governmental regime structure

R1 (c) Appropriateness of the macro-economic and prudential policy

As CEO of the NTMA, I had no functional role in these areas and would have very little knowledge of prudential policy. However, I was surprised that public expenditure was not cut back after the 2007 election, as it had been after the 2002 election, if for no other reason than to increase it again before the next election. I also felt that the level of house and apartment building was unsustainable by any measure, and, if applied proportionately to other countries, would have given figures that were multiples of what they were actually doing. I think the same view was held by some persons at Government level and the hope was that at least some of the building workers could be employed in other non-housing construction areas. I was also aware that costs and prices in Ireland were rising more rapidly than elsewhere in euro-land. These issues are difficult to correct, particularly in the absence of a crisis, and where so many people are benefiting.

The fundamental problem arose because Ireland moved from a regime which had relatively high annual growth in wages and prices but which also had its own currency and control over its value. While movements in that currency were constrained by Ireland's membership of the European Monetary System, it was possible to have currency devaluations with the agreement of other member states. What this meant was that when a country got into currency-related difficulties, it could in effect press the "reset" button by devaluing its currency and starting again.

This flexibility went when Ireland joined the euro but, in return, it was relieved of the risk of speculative pressures on its exchange rate and enjoyed a much lower interest rate regime. It also gained access to what appeared to be virtually limitless sources of credit. However, because the pattern of relatively high wage and price increases continued, competitiveness was gradually lost. Also the Irish banks, instead of covering their lending from a large population of small to medium deposits (i.e. not large corporate deposits) relied to a great degree on borrowings from the international interbank market. By their nature these funds are short-term and need to be constantly rolled-over. When this becomes difficult, and other sources of funding are not available, a crisis arises, which is what happened.

R2 (b) Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance

- **Nature and effectiveness of the operational implementation of the macroeconomic and prudential policy.**

The NTMA had no involvement in the supervisory practice.

R4(a) Appropriateness of the expert advice sought etc.

As mentioned earlier, on the instructions of the Minister for Finance, the NTMA got advice for him from Merrill Lynch and from Dr. Peter Bacon. It may be that the Minister was receiving advice from other sources also. His decision to create NAMA would have been based on the advice he obtained from Dr. Bacon. Advice was also got from PWC and Arthur Cox.

R4 (c) Analysis of Contrarian views etc.

By the time the crisis occurred, I do not recall any strongly voiced contrarian views which would have had a significant bearing on its outcome. There were always calls from the Central Bank and some other international organisations for more prudence on the part of Governments. This constant crying of “wolf” would have blunted its effectiveness.

R5 (b) Appropriateness of the advice from the Department of Finance to Government.

Apart from seeing a draft of a memorandum for the Government recommending the establishment of NAMA, I would not have been aware of what advice they were giving to the Government.

R5 (d) Appropriateness of the relationships between Government, the Oireachtas, the banking sector and the property sector

The NTMA would not have had any particular insights into what these relationships were and I would not be in a position to offer any view on them.

R6 (a) Adequacy and impact of international organisations' oversight on banking regulation and supervision activity

The NTMA would have had no knowledge of what was going on in this area.

There may be a perception in some circles that the NTMA was some sort of shadow Department of Finance or Central Bank. While this was most certainly not the case, the NTMA did provide all such assistance and advice as we could during the financial crisis, based on the experience and knowledge we had, and we assisted in procuring such other advice as was requested of us. The Central Bank/Financial Regulator had a very large staff to deal with the banking sector. The NTMA's role was very clear – it's primary function was to raise funds for the exchequer, not to provide liquidity for the banks. This was the role of the Central Bank as lender of last resort.

To put the role of the NTMA in context during the financial crisis and to show what we were actually doing in line with our legal obligations, it may be worthwhile to set out some of the challenges faced and the activities undertaken in 2009 and the situation at the end of that year. We had a very full workload.

1. The National Debt had gone up by €25 billion during the year, to stand at €75 billion. Even with that, however, the General Government Debt/GDP ratio was 65.6 per cent,

well below the euro area average of 78.7 per cent. On a net basis (after deducting off cash balances and the assets of the National Pensions Reserve Fund), Ireland's debt/GDP ratio was 37.9 per cent at end 2009.

2. The NTMA raised €35.4 billion in long term funding in 2009, of which €24.6 billion was used to fund the Exchequer deficit, €5 billion to refinance a maturing €5 billion bond leaving €5 billion in long-term funding for the 2010 deficit. Foreign investors held 84% of Ireland's bonds at end 2009.

3. The four major credit rating agencies still rated Ireland at AA at end 2009. The yield premium over Germany had narrowed to 1.45%, down from 3 % earlier in the year. The debt service costs were €686 million below budget, approximately half of which was due to interest rates achieved by the NTMA on 2009 borrowing which were lower than those prevailing at the time the Supplementary Budget was agreed in April 2009.

4. The State Claims Agency (the name used by the NTMA when dealing with claims) had received 1,219 new claims during 2009, had settled 1,631 claims and was managing about 4,000 claims at year end. Of these, there were 1,783 clinical claims under management with an estimated cost of €693 million. Obstetric-related claims, although only 18% of the total, represented 57 per cent of the total estimated liability.

5. The State Claims Agency had a statutory brief to provide advice and assistance to all health enterprises and worked to support patient safety and help minimise clinical claims. A comprehensive programme of training and services was undertaken in 2009, particularly targeted at hospital consultants and other speciality groups.

6. The State Claims Agency also dealt with Employer Liabilities, Public Liability and Third Party Property Damage claims, with 2,271 such claims (having an estimated cost of €90 million) under management at end 2009. In this area the SCA encouraged State authorities to implement internationally benchmarked health and safety management

systems and worked with the Defence Forces, the Irish Prison Service, an Garda Siochana as well as other Government departments.

7. The NTMA, as manager of the National Pensions Reserve Fund (NPRF) invested €7 billion in preference shares in AIB and Bank of Ireland, on the direction of the Minister for Finance (known as "Directed Investments"). Arrangements were also made to transfer the assets of sixteen universities and non-commercial State bodies' pension funds to the NPRF. The Fund disinvested from seven companies and excluded four others because of their involvement in the manufacture of cluster munitions or anti-personnel devices or because they had not sufficiently distanced themselves from their manufacture.

8. The NPRF was invested in Quoted Equities (including Global Large Cap, Global Small Cap and Global Emerging Markets), Fixed Income (including Eurozone Government Bonds and Corporate Bonds and Alternative Assets (including Private Equity, Property, Commodities and Forestry, absolute Return Investments and Infrastructure), as well as the "Directed Investments" in the two main banks. The Discretionary portfolio (i.e. excluding the investment in the banks) recorded a return of + 20.6% in 2009. The fund at end 2009 was valued at €22.3 billion).

9. The National Development Finance Agency (established in 2003 to provide a financial advisory service to State authorities in respect of capital projects) had its remit significantly expanded in 2007 to include the actual procurement of all PPP public capital projects except transport projects. By end 2009 the NDFA had completed its advice on 48 projects with a combined capital value of over €6.5 billion, was working on over 50 active projects and had brought the first bundle of schools to financial close. Among the projects on which the NDFA had provided advice and which were commissioned in 2009 or shortly thereafter were the Criminal Courts of Justice building, the Dublin Convention Centre, the Aviva Stadium, and the National Integrated Medical Imagining System. Much work was also put into the Metro North project as well as the Third Level Education PPP programme, the National Concert Hall, the DART underground project and the National Plan for Radiation Oncology.

10. In addition to the above functions, the NTMA was responsible in 2009 for:

(a) The Housing Finance Agency Commercial Paper Programme
(b) The provision of central treasury services to non-commercial State bodies, local government authorities, the HSE and vocational educational committees (providing them with a competitive alternative to the banking sector for their treasury business)
(c) European Central Bank Liquidity Management (regulating the level of Government cash balances at the Central Bank of Ireland)
(d) Agricultural Commodity Intervention Bills (issued on behalf of the Minister for Agriculture to fund the gap between agricultural intervention payments by the Minister and recoupment from the EU – turnover €465 billion in 2009).
(e) Dormant Accounts Fund (certain unclaimed balances on bank accounts and insurance policies are received and managed by the NTMA - €135 million at end 2009 – pending disbursement by the Government or repayment to the owners)
(f) Social Insurance Fund (the NTMA had managed the surplus on this fund since 2001 and during 2009 transferred €2.9 billion back to the Department of Social and Family Affairs).
(g) Emissions Trading (the NTMA was designated as the National Purchasing Agent for the purchase of carbon credits on behalf of Ireland in accordance with the Kyoto Protocol).

In summary, at end 2009, the NTMA had €21.8 billion in liquid assets to fund the Exchequer into the future and €22.3 billion in the National Pensions Reserve Fund. Its total staff at end 2009 was 169.

By the time the NTMA was brought into the deliberations on the banking crisis, there were no easy solutions. However, by virtue of the fact that the NTMA existed, and had prudently managed its operations, the State was in much better condition financially to tackle the crisis than would otherwise have been the case.