Tithe an Oireachtais
Houses of the Oireachtas

# Joint Committee of Inquiry into the Banking Crisis

## Witness Statement of

## Alan Ahearne

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

**Statement to the Joint Committee of Inquiry into the Banking Crisis**

## Introduction

The following statement is submitted pursuant to the Direction dated 21 May 2015 issued by the Joint Committee of Inquiry into the Banking Crisis. The Direction indicates that my evidence is to be provided in relation to my role as Special Advisor to the late Minister for Finance, Brian Lenihan. I served in that role from 18 March 2009 to 9 March 2011. During this time, I advised the Minister on economic, budgetary and financial policy in responding to the economic and financial crisis. Among other things, I played an advisory role in relation to the three Budgets during this period, the National Recovery Plan, the creation of the National Asset Management Agency and other measures to address the financial crisis.

**Decision to nationalise Anglo in 2009 and a review of the alternatives available and/or considered (C4a)**

Anglo was nationalised on 15 January 2009. I took up my position at the Department of Finance on 18 March 2009 and had no involvement in the nationalisation of Anglo.

**Establishment, operation and effectiveness of the National Asset Management Agency (NAMA) (C4b)**

NAMA was established by the Government to help to deleverage and de-risk the Irish banking system. Asset management companies like NAMA have been used in many countries over recent decades during periods of financial crises to facilitate bank restructuring and to manage and dispose of troubled assets. Examples include the Resolution Trust Corporation in the United States, the Thai Financial Sector Restructuring Agency, Securum in Sweden, Cinda Asset Management Company in China, Korea Asset Management Corporation, Danaharta in Malaysia, and the Indonesian Bank Restructuring Agency.

The preparatory work for the establishment of NAMA was done by the NAMA Steering Group, comprising officials from the Department of Finance, the Office of the Attorney General and the NTMA. I attended several meetings of the Steering Group in May, June, and July 2009 and was provided with the minutes of all meetings as well as relevant background materials and documents. The issues involved in setting up an asset management company were complex, but in my view the Steering Group worked efficiently and effectively, and draft Heads of Bill were ready by early June 2009. Although I am not lawyer, my view is that the NAMA Act 2009, which was passed into law that November, is a hugely impressive piece of legislation.

Regarding the overall effectiveness of NAMA, in my testimony before this Committee on 4 March last, I noted the assessment by Professor Dirk Schoenmaker from the Duisenberg School of Finance in a recent paper about the Irish banking crisis.[1] On page two, he writes:

*"First, the establishment of the bad asset agency, NAMA, serves as an international example of the successful management of bad assets."*

On page 24, he states:

*"The establishment of NAMA was instrumental in the successful management of the Irish banking crisis. It allowed the banks to recognise fully the losses on these loans, and thus removed an important source of uncertainty for the banks. Next, the government set only overall targets for NAMA in its resolution of the bad assets. The relative freedom in running down the bad loan portfolio allowed NAMA to realise a relative good price for its assets disposals."*

Also on page 24, Professor Schoenmaker draws a key policy lesson for other countries:

*"Ireland followed international best practice by setting up NAMA, an asset management agency to run down the bad assets of the Irish banks. Releasing bad assets from bank balance sheets is instrumental in the path to recovery."*

I share Professor Schoenmaker's view that the establishment of NAMA played a critical role in restoring financial stability in Ireland. I would note, however, that an asset management company is not, and cannot be expected to be, a magic bullet to restore damaged banks to full health. No single policy measure on its own can resolve a severe banking crisis. NAMA was part of a set of policies that together have helped to stabilise and restructure the Irish banking system and thereby have contributed to the recovery in the Irish economy. This recovery, along with the dramatic decline in long-term global interest rates, has boosted investor interest in Ireland and supported asset prices. In part reflecting these developments, I understand that NAMA is currently ahead of target in repaying its debt.

A feature of NAMA was that its design and implementation had to be consistent with EU rules on State aid. In particular, the European Commission in February 2009 provided guidance on the treatment of asset relief measures by Member States. These rules, in conjunction with the volume of loans being transferred to NAMA, meant that it was not feasible for NAMA to value and acquire all loans concurrently. As a result, the acquisitions were made in tranches. This was unfortunate, since it meant that a final figure for the haircuts on loans transferred to NAMA was not available to the Central Bank of Ireland in preparing its Prudential Capital Assessment Review in March 2010. The Central Bank's upward revision in September 2010 to the capital requirements of the banks in light of

[1] "Stabilising and Healing the Irish Banking System: Policy Lessons," paper prepared for the CBI-CEPR-IMF Conference, *Ireland—Lessons from its Recovery from the Bank-Sovereign Loop*, January 2015.

revised estimates of the NAMA haircuts undoubtedly contributed to the weakening of investor confidence in Ireland around that time.

**Decision to recapitalise Anglo, Allied Irish Banks (AIB), Bank of Ireland (BoI), Educational Building Society (EBS), Permanent TSB (PTSB) and the alternatives available and/or considered (C4c)**

The Minister for Finance regarded the two main banks, Allied Irish Banks and Bank of Ireland, as core retail banks that would play important roles in Ireland's economic future. The banks required capital to remain in operation. The capital requirements were set by the Financial Regulator, not by the Minister. The banks' capital positions were being eroded during 2009-2011 by loan losses and therefore the banks required recapitalisation.

The Minister wanted to minimise the burden on the State of ensuring that AIB and BoI were well capitalised. For that reason, he afforded the banks the opportunity to raise private capital, for example, through rights issues involving shareholders. That approach meant eschewing a policy of pre-emptive, statutory nationalisation of the two main banks. Ultimately, Bank of Ireland was successful in finding private sector solutions. AIB, however, was not able to attract capital from the private sector. Therefore, to keep AIB open the Government had no alternative but to inject public capital into the bank. The scale of these equity injections meant that the State ended up owning 99.8 per cent of the bank.

In the case of Anglo, the priority was to deleverage and de-risk the bank without damaging the rest of the banking system. The Minister had an open mind as to whether a small "good bank" could be carved out of Anglo, as proposed by the bank's management. Anglo had been included in the blanket bank guarantee scheme, and therefore the Government had to recapitalise Anglo to avoid a call by creditors on the guarantee. Moreover, Anglo required injections of capital to retain its banking license and thereby maintain access to Central Bank funding. In addition, Anglo held large amounts of Irish deposits.

The Government invited bids in 2010 from a number of private sources for EBS, but ultimately a bid for the Building Society from overseas investors was deemed not sufficiently commercially attractive to the State and EBS was merged with AIB in 2011.

**Credit Institutions (Stabilisation) Act 2010 ('CISA') – effectiveness of the actions to merge AIB and EBS, Anglo and INBS and deposit transfers (C4d)**

The accelerated timetable of bank restructuring and recapitalisation measures agreed with the Troika in late 2010 necessitated new powers for the Minister for Finance. These powers were provided in the CISA.

EBS was a monoline mortgage lender and therefore unlikely to survive post-crisis as a stand-along institution. When the sales process described earlier collapsed, there was little choice but to merge the Building Society into AIB to protect both depositors and the overall stability of the financial system.

The Minister decided in autumn 2010 to wind down Anglo. The merger of Anglo and INBS and the transfers of deposits was a reasonable approach agreed with the Troika to achieve this objective. Ironically, I had identified as an option the transfer of deposits from Anglo to AIB in a newspaper article I wrote in January 2009.[2]

**Cost of the crisis and sharing of the impact (C4e)**

The crisis had a very negative effect on the economic welfare of the citizens of Ireland. People were profoundly affected by unemployment, wage reductions, tax increases, cuts in welfare benefits and public spending on goods and services, business failures, and an overhang of high indebtedness in the household and small business sectors.

During my time at the Department of Finance, Minister Lenihan introduced three Budgets. Analysis from the ESRI using the SWITCH model indicates that these budgets were progressive, in that the highest losses in income as a result of the budgets fell on those households in the upper income deciles.

In relation to the direct cost to the State of recapitalising the banks, the upfront costs were large by international standards (€64 billion or 40 per cent of GDP). The Minister was confident that the State would recoup some of these outlays and wanted to spread the cost of the crisis over as long a period of time as possible. It is worth noting that although the cost of recapitalising Anglo and INBS added markedly (about €35 billion) to measured government debt, the burden of servicing this debt is relatively low because the debt is largely held within the State sector, is long-term, and can currently be refinanced in the market at very low interest rates.

**European Union (EU)/ International Monetary Fund (IMF)/European Central Bank (ECB) programme of assistance (C5a)**

During the second half of 2010, the cost to the State of borrowing on international markets rose to unsustainable levels. Around the same time, funding in debt markets for the Irish banks dried up and the banks experienced large outflows of deposits, especially corporate deposits. The decline in market confidence in Ireland and its banks reflected a combination of factors:

- Analysts began to mark down their forecasts for global economic growth, including growth in Ireland, in the summer of 2010. With slower growth forecast for the coming years, the task of closing the budget deficit began to look even more daunting.
- The scale of banks' losses and recapitalisation requirements continued to rise.

[2] "Winding up Anglo would not put deposits or borrowing in danger," Irish Independent, 22 January 2009.

- The euro area sovereign debt crisis exploded, with Greece entering a programme in May 2010.
- The Deauville agreement in October between Angela Merkel and Nicolas Sarkozy to bail in sovereign debt for a Member State that applied for an offical programme spooked investors.
- Market participants were uncertain about whether the Eurosystem would continue to fund Anglo. I met with investors who expressed these concerns to me.

The EU/IMF/ECB programme of assistance provided the State funds that were needed to finance the budget deficit and provide a functioning banking system. Large sections of the programme were based on the National Recovery Plan 2011-2014.

**Basel III (CRD IV) and the impact on capital and liquidity of Irish banks (C6a);**
**Banking Union (Single Supervisory Mechanism, Single Resolution Mechanism, Deposit Guarantee Scheme) (C6b);**
**Other – Fiscal Compact Treaty, Sovereign Debt Restructuring Mechanism (C6c);**
**Role and influence of the ECB (C6d)**

The global financial crisis clearly showed that the global rules on capital and liquidity requirements for banks were in need of reform. From that perspective, the new regulations in Basel III are welcome. All but one of the Irish banks passed last year's ECB Comprehensive Assessment. Central Bank of Ireland Governor Patrick Honohan has said publically that Irish banks may need more capital before 2019 when Basel III comes into effect.[3]

The CRD IV Framework also includes a set of macro-prudential tools to be applied in all Member States. The Central Bank of Ireland last year published a Macro-Prudential Policy Framework for Ireland aimed at increasing the resilience of the domestic banking sector.

Banking Union is an essential component of a properly functioning currency union. The institutional arrangements in Europe to guard against and, if necessary, resolve sovereign debt and banking crises have changed radically over the past few years. Unfortunately for Ireland, many of the arrangements now in place in Europe (e.g. BRRD) were not available prior to and during the crisis.

The ECB and the Central Bank of Ireland provided invaluable liquidity assistance to the Irish banking system during the crisis. That said, I believe that the ECB in 2010/2011 misjudged the systemic nature of the crisis in the euro area. The ECB was overly anxious in the latter part of 2010 to reduce the amount of emergency loans that the Eurosystem had extended to the Irish banking system. There are also question marks about the ECB's communications with markets about individual Member States.

[3] "Irish banks likely to need more capital before 2019, Central Bank governor predicts," Irish Times, 1 May 2013.

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

The inclusion of existing senior bonds and (dated) subordinated debt in the blanket bank guarantee categorically ruled out imposing losses on these instruments over the two-year guarantee period. In the months following the expiry of the guarantee scheme, subordinated debt holders were bailed in. This course of action has been indicated by the Minister in his statement on banking on 30 September 2010:

"*The principle of appropriate burden sharing by holders of subordinated debt, however, is one with which I agree. As can be seen from the figures outlined above, the losses in the bank are substantial and it is right that the holders of Anglo's subordinated debt should share the costs which have arisen. In keeping with this approach, my Department in conjunction with the Attorney General is working on resolution and reorganisation legislation, which will enable the implementation of reorganisation measures specific to Anglo Irish Bank and INBS which will address the issue of burden-sharing by subordinated bondholders. The legislation will be consistent with the requirements for the measures to be recognised as a re-organisation under the relevant EU Directive in other EU Member States. I expect the subordinated debt holders to make a significant contribution towards meeting the costs of Anglo."*

However, no losses were forced on senior bondholders.

I discussed around April/May 2010 with a senior official at the Department of Finance the possibility of bailing in senior unsecured bondholders in Anglo post expiry of the guarantee. We concluded that if the bank were to be split into a so-called "good bank/bad bank" post September 2010 (this proposal was under consideration at the time), one option might be to put these bonds into the bad bank where they would be exposed to losses.

I recall a discussion with the Minister in the summer of 2010 in which he expressed the view that, in principle, losses should be imposed on unguaranteed senior bank bonds, especially bonds issued by Anglo Irish Bank and INBS.

In early October 2010, I accompanied the Minister to the annual IMF/World Bank Autumn meetings in Washington DC. During that visit, I met with senior staff members from the IMF team monitoring the Irish situation and we briefly discussed the roughly €4 billion in unguaranteed, unsecured senior bonds issued by Anglo Irish Bank and INBS that had not yet reached maturity. My IMF interlocutors were of the view that, in principle, these bonds should be discounted.

The issue of banks' senior bonds came to a head in late-November 2010 during negotiations between the Irish authorities and members of the Troika (ECB, EU Commission and IMF). In conversations with the Minister around that time, the Minister told me that IMF staff in Dublin favoured the bailing-in of unguaranteed, unsecured senior bank bonds to reduce the burden on the Irish taxpayer of recapitalising the banks, but that the ECB and European Commission opposed such a move. The Minister said that the Troika would not make official financial assistance available to Ireland if the Government insisted on bailing-in senior bank bondholders.

I recall reading a memo later that year or in early 2011 which included a summary of a meeting in Frankfurt between senior officials from the Department of Finance (accompanied, if I recall properly, by an official from the NTMA) and a member of the ECB's Executive Board. It was clear from the memo that the ECB remained opposed to bailing-in senior bank bonds. At that time, the Eurosystem was providing huge financial support to the Irish banking system, including to Anglo.

**Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used (R4a);**
**Appropriateness of the advice from the Department of Finance to Government and the use thereof by Government (R5b);**
**Appropriateness of the relationships between Government, the Oireachtas, the banking sector and the property sector (R5d)**

During my time at the Department of Finance, I interacted with many external expert advisors, including experts from:

- Attorney General's Office.
- Central Bank of Ireland.
- NTMA.
- Rothschild, who provided investment banking advice to the Department from mid-2009.
- Arthur Cox, who provided legal advice to the Department in relation to general banking matters.
- IMF, who visited the Department in 2009 and 2010 as part of the regular Article IV surveillance.
- I read papers prepared by HSBC who were advisors to NAMA on valuation methodology, but don't recall meeting people from that bank.

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