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Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Gerard Danaher

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BANKING ENQUIRY

My name is Gerry Danaher. I was a member of the Board of the Central Bank from 1998 to 2010 and of the Financial Regulatory Authority from 2003 to 2010. I am a Senior Counsel.

I have prepared this statement by reference to the questions posed to me by the Joint Committee in Appendix 1 to the Chairman's letter of July 15th, 2013.

No. 1

The CBFSAI structure that emerged for maintaining financial stability, conducting prudential supervision and ensuring consumer protection was not appropriate. There was a fundamental tension between prudential supervision and consumer protection as indeed is being demonstrated today by the difficulty in reconciling the necessity for adequate funding for the banks with the unfairness of what this means for those who are paying abnormally high variable mortgage interest rates.

Equally, discharging a duty to contribute to financial stability could best be done by a body which had direct responsibility for prudential supervision.

It is well known that the CBFSAI "twin pillar" structure that emerged was a compromise between two opposing views, i.e. as to whether a "Greenfield" structure completely independent of the Central Bank should be created or whether both financial stability and prudential supervision should remain with the Central Bank and with consumer protection being allocated to a new body solely dedicated to that issue.

At the time the debate on this issue was conducted, a number of factors contributed to the outcome. The Central Bank had not emerged well from issues such as the DIRT, bogus non-resident accounts and Ansbacher scandals. It was, unfairly in fact, also blamed for the overcharging perpetrated on their customers by some Irish banks. It was not responsible for consumer protection. On the other hand, the Central Bank's position as a part of the ECB meant it could not be stripped of responsibility to contribute to financial stability. From the outset, the structure that emerged was nobody's "first choice".

There were unfortunate practical consequences.

Some issues arose consequent upon the Central Bank being the provider of IT and HR but, in the overall scheme of what happened, these were not of great significance.

The most unfortunate consequence was that the division of a staff that previously had all been in the Central Bank apart from, basically, the intake of insurance regulators into those who previously were engaged in prudential supervision (now Financial Regulator) and those responsible for financial stability (still Central Bank) was not conducive to producing "joined up thinking".

Equally, there was an inherent risk that as long as no undue alarm was being sounded as regards prudential supervision, reassurance would be derived in respect of financial stability and vice versa.

The Memorandum of Understanding on Financial Stability reflected the desire to clarify each sides' respective responsibilities and obligations.

It did make it clear that while the Bank retained responsibility for analysing the macro-prudential and even, where appropriate, the micro-prudential health of the financial sector, prudential supervision was left to the Regulator. In practice this meant that using the vestigial power remaining with the Governor to investigate the business of an individual bank[1] was never considered.

Also the seemingly laudable objective of minimising duplication of work may in practice have caused each side to over-rely on the work of the other.

That said, the Memorandum of Understanding was also intended to minimise friction between the two sides and in that it did succeed.

In addition, the consumer protection linked scandals referred to above resulted during the early years in the Financial Regulator being very significantly focused on consumer issues. As late as 2006, the Financial Regulator's Annual Report was subtitled "Consumer Protection with Innovation, Competitiveness and Competition". The importance accorded consumer protection in contrast to prudential supervision was reflected by the fact that the Director of Consumer Protection was a statutory member of the Authority whereas the Director of Prudential Supervision was not, although from the outset he attended all meetings of the Authority by invitation.

While Nyberg (Note 99, Page 63) was of the view that a perusal of Authority papers and Minutes of Authority meetings did not reflect an imbalance between the importance attached to consumer protection as opposed to prudential supervision, my own recollection of Authority meetings between 2003 and 2005 is that there was much more focus on the former than on the latter.

Finally, as regards the principles led system of regulation operated by the Financial Regulator, it was already in place in the "old" Central Bank, appeared to be in accordance with the Basel Committee Core Principles and was also the approach adopted in the UK and many other, but not all, possible comparators.

I do recollect discussions on the subject at Authority meetings (whether formal or not, I do not recollect) when the reasons for it, as opposed to a rules based system, were set out to the Authority by the management. I do not recollect anyone, whether inside or outside the CBFSAI and including myself, ever seriously challenging it until its shortcomings had become all too clear.

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[1] Section 17A of the Central Bank Act, 1971

However, even when a principles based approach was not applied to banking supervision, notably in the US, the model of rules based supervision that was applied there did not prevent the Lehmans Brothers collapse. The model of rules based supervision which might have been considered in 2003 would almost certainly have borne little resemblance to the type applied today.

No. 2

The Financial Regulator did not seek significant additional powers in relation to the banks and never fully availed of the powers it had.

For example, the increases to capital ratio requirements and the imposition of heavier capital weights on certain mortgages could have been made greater and should have been made earlier. It was not a lack of power to do so but excessive caution which, in my view, led to the steps in question being too little and too late.

However, taking even those limited measures made the Financial Regulator one of the few such entities that took such steps at the time.

Also, introducing or reintroducing and applying sectoral credit limits could have been done.

"Administration sanctions" are also relevant in this context.

While it had taken until July 2005 for the Financial Regulator to acquire and then put in place the power to apply such sanctions, it is clear from looking at those who were sanctioned that, with one late and notable exception, in practice the system was mostly used against small players and/or for consumer related breaches.

It is also the case that the Authority never tried to restrain the application of sanctions by the Regulator.

No. 3

In theory, there was nothing wrong with mandating CBFSAI to promote the financial services industry provided that its achievement would not be at the expense of the effective discharging by the Regulator of its responsibility for prudential supervision.

It is clear that the prudential supervision of the banks was not effectively conducted.

The view has been put about that prudential supervision was ineffective as a result of some misguided attempt to make Ireland more attractive for "cowboy" financial services providers. This is not what occurred.

What I believe did happen was as a consequence of a number of factors, e.g. the CBFSAI structure itself, the continuation of the principles based approach to supervision and a lack of scepticism at both Authority and staff levels regarding the effectiveness of the internal supervisory machinery of the banks.

It is true that there was a conscious effort to promote Ireland as the best country in which to set up as a financial services provider.

The duty imposed by Section 5A(1)(b) and 6A(2)(b) did result in the Financial Regulator being proactive in endeavouring to ensure the most efficient and competitive carrying out of such functions as authorising financial products, prospectuses, etc.

Resources were also devoted to meeting with potential investors, explaining the regulatory framework, addressing queries, etc.

In theory, there should be no incompatibility between achieving both objectives. In practice, I believe it likely that the pressure to ensure that Ireland remained competitive as a location for financial services against a background where the banks were apparently in a healthy state must to some extent have diverted some focus and resources away from prudential supervision.

However, I do not recall that the promotion of the financial services industry in Ireland was ever much of an issue at Authority level.

Nos. 4 & 9

In the context of principles based supervision, the efforts to impose Directors' Compliance Statements and Corporate Governance Guidelines were worthwhile initiatives.

Fit and Proper Requirements for banks had been in place for credit institutions from 1995; the Authority sought to and did introduce updated requirements applicable equally across all financial sectors. I do not recall any influence being exerted in this regard by the Department of Finance.

As regards the failure to implement such initiatives as originally proposed, it is inevitable that, in a system which allows for consultation, some changes will be made following that process.

However, in my opinion, too much importance was attached to the industry view. For example, as regards Directors' Compliance Statements, many arguments were advanced by the industry, e.g. that directors of banks should not be subject to more arduous requirements than other directors, that there would be adverse competitive consequences, that directors could not ever credibly state that every person in every part of an institution was entirely compliant, etc.

Nevertheless, it is equally true that if the directors of the key components of the banking industry were averse to giving appropriate compliance statements then the basis of principles led supervision should itself have been questioned.

The Regulator's initiative was of course taken against the background of a debate about Directors' Compliance Statements generally, legislation enacted but not commenced (Section 45 of the Companies Act, 2003), deliberations by the Company Law Review Group and a process whereby it was not until last year that a "mitigated" Section 45 was enacted.

In fact, the Financial Regulator had a specific power under Section 21 of the Central Bank Act, 1997 as inserted by the CBFSAI Act, 2004 and which had a greater scope for flexibility than Section 45.

The assistance of the Department of Finance was presumably invoked by the industry to at least the extent that in November 2006 it requested the Financial Regulator not to proceed with the consultative process regarding compliance statements and in early 2007 announced a review of the financial services regulatory framework.

The intervention was neither helpful or appropriate.

As regards Corporate Governance Guidelines, this initiative also stalled and was ultimately "delayed" pending developments at EU level. Again there was industry "blowback" during the course of the consultative process. I do not recall Department of Finance involvement.

All in all, the Authority of which I was part should have much more forceful, should have ensured that these initiatives were seen through expeditiously and should not have been diverted or fobbed off by management reluctance, by drawn out consultative processes or by the promise of statutory review or pending EU developments.

I do not recall any influence being exerted by the Department of Finance as regards initiatives to change regulatory capital requirements.

No. 5

On the face of it, if the necessary statutory pre-condition was met in any particular case then the Financial Regulator did have powers which could in effect have enabled him to prevent the payment out of dividends in that particular case.

Section 10 of The Central Bank Act, 1971 gave the power to impose any additional condition to a banking licence which, in the opinion of the Bank, would be "calculated to promote the orderly and proper regulation of banking".

The reason I assume that, in this context, the Financial Regulator might want to prevent a bank from paying out a dividend would be to increase its retained profits thereby increasing its liquidity buffer.

However, the question is begged as to why such an oblique method should be used given the power to achieve such results directly, especially as invoking Section 10 in this way would unnecessarily prompt an adverse market reaction.

Section 21 of the 1971 Act gave power to direct a bank not to take any deposits or to make any payment which had not been authorised by the Regulator. However, the power was conferred only if the Regulator was of the opinion that the holder of the licence had become or was likely to become unable to meet its obligations to its creditors.

I do not believe that, on a correct interpretation, Section 21 could be said to allow the Regulator to issue a direction stopping the payment of dividends but not stopping the taking of deposits. Also, the issuing of such direction would not be compatible with a credibly viable future for any bank the subject of such a direction.

Of course, dividends should only be paid provided there are distributable reserves after adequate provisioning and also providing for any future growth in the balance sheet. As there is no suggestion that at any relevant time the Financial Regulator challenged the banks' accounts or, specifically, the adequacy of their provisioning (apart apparently from an allegation that there was a challenge to EBS's assessment of potential future losses in 2008/2009 and which, if it happened, would not, in my opinion, have been appropriate), Mr. Neary's suggestion that the Financial Regulator had this power seems somewhat moot.

No. 6

Apart from the annual "governor's letter", the Governor met periodically with the Minister for Finance and the Taoiseach at which meetings, I would assume, the Governor would not have felt as constrained as governors have to be either in the context of public comments or what they are willing to put in writing. The Secretary-General of the Department of Finance *ex officio* sat on the Board of the Central Bank and presumably, without breaching confidentiality requirements, kept the Minister briefed as regards all discussions which took place at Board meetings concerning the macro-economic situation and trends. Also, presumably, the Department of Finance would have been given access to any relevant studies conducted by the Central Bank.

No. 7

I am not aware of any significant complaint that the Financial Regulator failed to carry out its tasks as regards "consumer protection" in the narrow sense of that expression, the introduction of the IFRC/Capital Directive or its other statutory duties apart from prudential supervision. It would therefore seem that, apart from any IT deficiencies in those areas, the Financial Regulator was sufficiently staffed and resourced to discharge those functions.

The Financial Regulator was always somewhat short of its full budgeted compliment of staff and this had an impact on its discharging of its functions, including prudential supervision. However, the real issue seems to me to be not one of insufficient staff or resources to discharge prudential supervision via a principles based system but rather the decision to continue with that system rather than one which would have been much more intrusive and rules based.

In this regard, I believe that the cost of adopting a rules based system was at least a factor in the decision to continue with the principles based approach.

With the benefit of hindsight, this was clearly a "penny wise, pound foolish" consideration.

No. 8

It now seems to be commonly maintained that there was a shortage of economic expertise in the Central Bank. It did not occur to me at the time. Equally, not many economists outside the Central Bank seemed to differ much with the economic analysis emanating from the Central Bank.

Among the staff, there was no shortage of people with expertise of supervising banks, i.e. from a public service background. It would have been prudent to have imported more people and sooner with actual commercial banking experience but the Joint Committee will be well aware of the constraints originally imposed by the structure adopted in 2003. In fact, during the initial years I believe there was some outflow of staff from CBFSAI to the private sector.

As for the members of the Board and the Authority, they came from many different backgrounds. Some had a greater knowledge of the technical aspects of banking and economics than others. They seemed to me to have sufficient knowledge and expertise to be able to draw their own conclusions on financial stability aspects. I believe the reason why incorrect conclusions were drawn arose more from an overreliance on external and internal assurances regarding financial stability rather than any inherent lack of knowledge or expertise. In that regard, I do not believe that there was any particular correlation between the degree of professional knowledge of banking or economics and the level of perspicacity demonstrated by members.

No. 9

See No. 4 above.

No. 10

Possible changes to the reports, etc. were usually discussed during Central Bank Board meetings and, in the case of the Financial Stability Reports, at joint meetings of the Board and the Authority also attended by Central Bank executives involved in the drafting of the Financial Stability Reports.

While clearly those reports, etc. had gone through a drafting process, only the final drafts made it to those meetings and what changes, if any, would have been made during the drafting process would not have been known to the Board members. Clearly changes made at Board meetings would have been final.

From recollection, suggestions of changes to the reports almost invariably came from Board members; in fact I do not recollect suggestions for changes to the drafts produced at the meeting ever emanating from management. In other words, such changes as were ever made resulted, to the best of my recollection, from or in response to contributions by Board members.

The problem, as I saw it from 2006 onwards, was not that Board members always agreed with proposed changes (as if such changes were emanating from executives) but rather that members did not insist on more changes in order to express a less benign view of the risks acknowledged in the reports.

There seemed to me to be a pervasive concern to avoid sounding in any way "alarmist". Had a greater note of alarm been sounded in the reports and had it provoked a reaction (e.g. a fall in house prices) then, depending on the year one is talking about, the actual crisis when it came might have been ameliorated. However, there seemed to me to be more concern about what could happen in the immediate future if the alarm was too loudly sounded than about the prospects of what might happen "down the road" if it was not. The so-called "soft landing" expectation provided comfort for this approach.

Up to 2005/2006 I was as blind as almost everyone else to the full extent of the threat that existed. However, certainly from late 2006, I mistrusted the data which supposedly showed only very modest falls in house prices and which data I believed reflected only a tiny number of sales in a market that was ceasing to function in any real sense.

It seemed clear to me that this had to pose a much greater threat to the Irish financial system than the overall tone of the reports suggested.

I regret that before 2006 I did not sufficiently challenge the benign tone adopted and that, subsequently, I was unable to bring about a more alarmist one.

No. 11

I do not recollect when exactly I first heard the expression "soft landing" used in this context. Leaving the terminology aside, during 2004 and into 2005 concerns were expressed about the increase in house prices, the high level of personal indebtedness and the expansion of the banks' balance sheets. Some of those concerns were somewhat abated when, in early 2005, house prices temporarily went into decline.

However, the upward trend recommenced encouraged by higher loan to value products and notwithstanding the fairly modest increases in the capital ratios required by the Financial Regulator.

As I recall discussions at the Authority, the members were very much in favour of those changes.

In or about August 2006, when the "question" of whether the State actually needed the income generated by stamp duty was raised and this led to a public perception that stamp duty might be massively reduced after the following general election, the housing market effectively froze. I was certainly aware of that at the time and attached considerable significance to it.

I believe that there was a widespread view in the Central Bank that housing prices would fall but the potential extent and consequences of a "burst", as predicted by Morgan Kelly, was wholly underestimated. In addition, a view that held a lot of sway was that, provided unemployment could be sustained, the effects could be ridden out. Considerable stress was laid on forecasts of ongoing growth.

If Governor Honohan could not find quantitative analytical evidence to support the "soft landing" scenario, I am sure this is because it did not exist.

Central Bank management and the Department of Finance are best placed to explain their rationale for predicting a "soft landing". As regards Board members, I believe they relied on the internal and external reassurance that was available as well as their own knowledge and experience.

Certainly, no one including myself envisaged the systemic shock on an international scale that followed the collapse of Lehman Brothers.

We will never know what would in fact have happened had that collapse not occurred and if that bank not been allowed to fail. I personally felt at the time, and without anticipating an imminent Lehman's type event, that the "soft landing" scenario was too optimistic.

No. 12

While the "old" Central Bank had previously imposed sectoral and individual lending limits, those limits were effectively dropped by the Bank prior to the establishment of the Financial Regulator. Such limits were not applied to IFSC banks and the rationale, albeit a somewhat dubious one, seems to have been that therefore they should not be applied to the domestic banks either.

Nevertheless, the previous limits were known and the increasing amount of bank exposure to the property market generally and the parallel concentration of exposure to individuals was well monitored and was the subject matter of numerous discussions, particularly in the context of the quarterly prudential reports. Exposures were considered both in the context of individual credit institutions and domestic lending as a whole. The increasing and internationally abnormal concentration on construction/property related lending was well known and the risk inherent in having "too many eggs in the one basket" was appreciated.

Nevertheless, the seemingly healthy state of the banks in terms of capitalisation, the lack of reservations by bank auditors, the perceived risk of triggering a problem while trying to head it off, the fact that so many jobs and so much of our growth derived from the sector resulted in only marginal steps and excessively cautious comments being taken or made.

I believe that apart from the failure of the staff to advocate a much more robust response, the Board should have pressed much more vigorously for such a response.

No. 13

If one regards ability to pay one's debts as they fall due as the liquidity test and the ratio of debt to equity as the solvency test, then the reason for the Guarantee was the fact that Anglo was not liquid and, if it went down, it would take the other Irish banks with it.

The position of the banks and, applying IFRS as they did, their auditors together with the Regulator and the Central Bank which relied on them and also their own stress tests was that the banks were solvent.

Of a combined total loan book of €426.5 billion, about 70% was property related in some way.

Just under half of that comprised home mortgages. Recent years had seen a very sharp jump in loan-to-value ratios among new mortgagors which, as a class, were likely to be the most exposed to unemployment in the event of a downturn. The house market was effectively frozen with more and more people facing negative equity.

Approximately €62 billion was lending for land banks and developments. In many cases, interest was being rolled up (also allowed by IFRS) and there was very high leveraging. Some borrowers were already facing cash flow issues. Almost €13 billion was loaned in respect of property without planning permission. As in the housing area, the market had frozen.

All in all, the banks' own assessment of their likely losses was completely unrealistic. When I read the PWC report in late 2008, it was my opinion, which I expressed, that its worst case prediction, albeit that in the round it was about double that of the banks themselves, was also likely to fall short of the probable outcome. PWC itself made it abundantly clear that, amongst many other caveats, it was basically relying on what it had been told by the banks themselves.

In short, regardless of the technical reasons which could be and were advanced for saying banks were solvent, in reality at least five of them were almost certainly insolvent.

No. 14

There always seemed to be a good relationship between the Central Bank and the Department of Finance. I suppose this was hardly surprising given that, until Governor Honohan was appointed, all governors had previously been senior officials in the Department of Finance. I am unaware of what level of contact, formal or informal, existed between the staff of the two organisations prior to the establishment of the Domestic Standing Group in 2007 but I am sure that it existed.

I also suspect that the ending of the Central Bank's monetary policy function removed what might previously have been a possible area of contention between the two bodies.

No. 15

As I understand it, "constructive ambiguity" in the context of central banking refers to a central bank's "policy" of not adopting a clear positon as regards what precise level of liquidity or other assistance might or might not be available to any particular credit institution in any particular situation.

The basis seems to be an assumption that if an institution knew the level available then the "nature of the beast" could or would be to push up to the margin.

In the present context, I assume the relevance relates to the increasing amount of ECB funding which had to be made available to Irish credit institutions. The desirability of the policy, if perhaps not its effectiveness, may have been demonstrated when, if I recollect correctly, a senior executive of one institution publically commented on the availability of such funding.

While I do believe that the realities of the liquidity and solvency situations of the banks was obscured, I do not believe that the fault lay with "constructive ambiguity", at least as I understand it.

It more lay with such factors as the banks' auditors signing off on their accounts which in turn significantly reflected the switch to the International Financial Reporting Standards as opposed to the Generally Acceptable Accountancy Principles for auditing banks, a reliance on data in relation to house prices which I felt was misleading, a lack of analysis of or concern about the commercial property sector until it was too late and a failure by CBFSAI to take action in relation to the sectoral and individual exposures of the banks.

No. 16

I do not believe there was undue "deference" by the Central Bank Board to the government of the day.

I do not know and never knew the political orientation of several of the Board Members I met over the years. Insofar as some had obvious connections, past or extant, to bodies external to the Bank they were more to some of the then "social partners" or State bodies such as the Irish Congress of Trade Unions, IBEC, the IDA, the NTMA and the Revenue Commissioners, etc.

In my own case, by profession I was a Senior Counsel.

As such, I was in a position to contribute at the Board on such legal issues as arose. While I was not a specialist in banking law, I did have an interest in statutory interpretation which was useful especially given the legal complexity of many of the issues relevant to the Bank and later the CBFSAI. I was also keenly aware of the statutory duties and obligations of membership of the Board.

In addition, my job as Senior Counsel has particularly equipped me to master at least a very good working knowledge of many areas of expertise other than the law. Obviously, when very technical aspects of economics or banking arose, I deferred to the experts.

I assume that my political orientation to Fianna Fail was a factor in my being appointed.

As regards the specific question, I do not believe that I felt or showed any great, let alone undue, deference to the government of the day. I saw my role as I would being a member of any board, i.e. to act independently and honestly.

In this regard, I did not agree with the "twin pillar" approach adopted by the government in 2003 and openly expressed my misgivings.

Also, from 2006 onwards I adopted a position as regards the house price issue which, if it had been adopted by the Central Bank, would have been quite at variance with the Government assessment going into the 2007 election.

I believe there was undue deference, in the sense of a reluctance to challenge, shown by both the Authority and the Central Bank Board to their respective staffs and by many of the latter to the financial institutions and financial services providers.

No. 17

As far as I know, no institution, bar one, claims to be infallible.

Certainly, central banks, whether at the Irish or a vastly more significant level, could never make such a claim.

It follows that letters from the Central Bank governor or reports of the Central Bank should be subject to challenge from the Department of Finance.

This is even more the case when the Secretary-General of the Department of Finance sits on the Board of the Central Bank and is at least as well placed to be fully aware of its institutional strengths and weaknesses as any other Board member.

Obviously, the Secretary-General was as constrained as all other Board members by the confidentiality restrictions of which the Joint Committee will be well aware but that should not have prevented any concerns at a macro level (or even, generically, at a micro level) being made known to the Department of Finance and prompting any action or discussion considered appropriate by the Department.

I do not know what processes, if any, the Department of Finance had in place to challenge information provided to it by the Central Bank.

No. 18

As acknowledged by the IMF (Staff Report, 2006) the general government fiscal positon had been either close to balance or in surplus for the previous decade. In 2006, the OECD said the fiscal position was "healthy" noting low gross debt, one of the highest government savings rates in the OECD, a surplus when account was taken of the high rate of public investment and infrastructure, etc. (OECD Economic Surveys Ireland 2006). Equally, the IMF, OECD and, I assume although I do not specifically recollect it, ECOFIN did recommend the building up of a cushion in anticipation of a possible downturn (IMF) and to leave sufficient room for manoeuvre in that event (OECD).

It is also worth noting some of the precise steps which were suggested, e.g. a property tax (OECD), payments by consumers for water (OECD) and broadening the tax base (IMF). The view of the "authorities" regarding the political feasibility of such measures is also recorded in the reports.

On reviewing some of the documents, I find what was actually said in writing somewhat at odds with what I recall of the tone of discussions on the issue at the time.

My recollection is that the consensus view in the Central Bank from *circa* 2004 was that the Government's fiscal policy was too procyclical. I also note that Governor Hurley's evidence to the Joint Committee was that the Bank did continuously advise in terms of tighter fiscal policy. However, I also note that this was often couched in terms of suggesting a neutral policy or, in 2004, a mildly restrictionary one. I do not know why this was the case and can only assume that it was another example of the Bank's innate sense of caution as regards what was said publically or in writing. I do not know what tone may have been adopted in private by the Governor when he met the Taoiseach or Minister for Finance.

No. 19

Morgan Kelly certainly helped inform my views on the housing market and which I expressed at Board and Authority meetings. At, I believe, the meeting at which the 2007 Financial Stability Report was discussed, I brought along an article by Morgan Kelly; I am not sure if it was the one referred to in the report. During the discussion about house prices in which I participated quite vigorously, I recall being asked by one executive what document I was quoting from or referring to; clearly, I had not identified it expressly. When I said Morgan Kelly was the author, the reaction was dismissive of Mr. Kelly.

The fact that an article by Mr. Kelly was referred to in a paper appended to the 2007 Financial Stability Report shows that Mr. Kelly's views were at least considered by bank staff. However, I do not believe that, overall, they were taken seriously. They were certainly not taken seriously enough.

I do not know how his concerns were viewed in the Department of Finance but I never heard anything at any CBSFAI meeting that suggested they were taken very seriously there either.

No. 20

Only Mr. Nyberg could really elaborate on who and which time period he had in mind when he referred to "*a small number of contrarians at board level*".

For my part, from 2006 I was very alarmed by what seemed to me to be a collapsing residential property market. I was also concerned about the implications of the astounding rise in site acquisition costs and speculative bank lending.

I should say that, prior to 2005, I had no greater concerns than the vast majority of my colleagues about the economy in general and the stability of the Irish banking system in particular. I do recall increasing concerns being expressed at Board meetings well prior to 2005 regarding the rise in credit growth and house prices as well as the expansion of the banks' and particularly Anglo's balance sheets. However, it will be recalled that 2005 saw something of a correction in housing prices and it may have been at that point that the idea that the market was set for a "soft landing" first emerged.

Reverting to the "contrarian" issue, one CBFSAI Board member consistently expressed his dissent from the view of many economists that the millennium had somehow ushered in a new era of inevitable and unending financial stability, efficient financial markets, low interest rates, abundant liquidity, etc.; in short, a "crash-free" economic and banking utopia. He was already on the Board in 1998 when I joined and, as far back as I can recollect, consistently dismissed those sorts of broad assumptions and quite persuasively emphasised the lack of any historical precedent for them. Although I found his arguments persuasive, particularly given my own interest in history, the lack of specific clouds on the horizon that would have underlined this colleague's foreboding led me to stick with the generally benign view of the future of the global financial markets and banking system.

I also recall that, well prior to 2005, a colleague on the Financial Regulatory Authority persistently expressed very deep reservations about the growth in Anglo's balance sheet. While there was concern at the general level of the expansion of lending, these reservations were much more prescient and should have prompted a greater response from the Authority and the Regulator.

From 2006 I personally did not buy into the view that a "soft landing" for the property market was probable and I voiced that view repeatedly.

I also felt and repeatedly said at Authority meetings that the reaction of the Regulator to later disclosures regarding what had been going on in some of the banks was excessively cautious and timid. Indeed when at one meeting a decision was taken to make it publicly clear that the Regulator would respond robustly in one such case, the decision was reversed by the executive without any prior notification to me.

No. 21

The opinions voiced by the IMF and the OECD are important. In effect they can either offer reassurance if their broad thrust is in line with one's own assessment or can ring alarm bells if they are not.

During the period 2004 – 2006, the IMF repeatedly highlighted the boom in the housing market, the oversize of the construction sector and the risks arising therefrom but also the expectation of "an orderly slowing in the housing market" (Financial Systems Stability Assessment Update, 2006, Page 13) and of a "smooth" contraction of the construction sector (Staff Report, Ireland, 2006, Page 15). Also, having examined the stress test that had been carried out in relation to the major domestic lending institutions and while advising further improvements, the IMF stated that they *"confirmed"* that those institutions had adequate capital buffers to cover a range of large plausible hypothetical shocks which reflected the macro-risks that the IMF had identified.

The OECD (Economic Surveys, Ireland, 2006), while stating that a "soft landing was not guaranteed", also said that most forecasters expected a gradual adjustment to the rate of house construction and that the most likely scenario was that house prices would level out.

Turning to bank regulation and supervision, the overall thrust of the IMF assessments was favourable. I do not recollect the basic supervisory framework ever being challenged and many of the recommendations were aimed at improving the capacity to implement international regulatory developments and to address increasingly complex financial products.

That having been said, ultimately the responsibility for banking regulation and supervision is that of the body in whom that responsibility is vested, now the ECB but then the CBFSAI. It was not a failure to take sufficient account of external bodies that caused the failure. Most if not all of the risks identified by those organisations were acknowledged by CBFSAI itself. In significant part, the problem was an inability to strike the right balance between addressing those risks and not triggering a crisis.

No. 22

I ceased to be a member of the Central Bank Board in 2010.

The only specific legislation relating to bank resolution at that point was that limited to Anglo, i.e. the Anglo Irish Bank Corporation Act, 2009 which in effect nationalised that bank.

Until the Lehman's Brothers collapse, I do not recall the necessity for a special bank resolution programme being a concern at the Central Bank Board or anywhere else in Ireland for that matter.

The IMF mission in 2009 did indeed refer to the lack of a resolution regime; as far as I know it did not do so before then. Obviously, by mid 2009 the UK had learnt enough to know that such a regime was desirable.

I personally know no more about why a resolution regime was not introduced in the period 2008 – 2010 than what I learnt from Nyberg, i.e. that it was felt that it would take time, might face legal challenge, that a leak that one was being considered might have a further destabilising effect, etc. I do not recall the matter being an issue at either Board or Authority at the time.

In addition, the Authority became increasingly bogged down by the emergence of serious regulatory issues which have been well ventilated in the press and elsewhere.

No. 23

Although throughout 2007 the consensus view at both the Central Bank and the Financial Regulator and, insofar as the Secretary-General can be said to have represented its views at the Central Bank Board, the Department of Finance was that "*the Irish financial system remained well placed to cope with emerging issues*" (see Central Bank Report 2007, page 30), there was sufficient concern to prompt the establishment of the Domestic Standing Group.

I am not sure from which organisation the idea for this emanated. However, it did not bring any new voices to the table. The DSG made formal provision for meetings of, and coordinated action by, basically the same executives who already inputted to the Central Bank, the Financial Regulator and the Department of Finance. Executives from the Central Bank already comprised the Financial Stability Committee (FSC) and relevant staff from the Financial Regulator attended meetings of the FSC by invitation. The establishment of the DSG did create a formal structure through which the three organisations could work together. I understand that meetings of the DSG were also often attended by representatives from the NTMA.

As regards monitoring the sector for early signs of distress, there was stress testing in 2008 but I assume this would have occurred with or without a DSG. Equally, as regards putting in place a contingency plan, Nyberg noted that the Department of

Finance had prepared a scoping paper in early 2008 which considered the circumstances in which either a guarantee or nationalisation might be necessitated while Bank staff produced a draft document which considered possible options if an individual institution were to encounter difficulty. I am not sure to what extent this work was consequent to the establishment of the DSG.

In fact, a systemic collapse was not anticipated and, while options for various types of contingencies were considered, a "national" plan was not prepared and it has to be added that the preparation of one would not appear to have been specified in the Memorandum of Understanding setting up the DSG.

Looking back, apart from creating a structure for routine, formal and perhaps easier cooperation between the component parts, the setting up of the DSG would not appear to have changed very much.

I have to confess that I have never heard of the "Financial Sector Stability Group".

No. 24

Following the introduction in September 2008 of the guarantee to the covered institutions, a new supervisory unit was established in order to monitor compliance with the objectives of the Government Guarantee Scheme by those institutions.

New staff with banking experience were recruited. Some were allocated to the institutions themselves. Others were placed in a supervisory department with a specific brief to ensure compliance with the objectives of the Scheme.

The Regulator was given the new responsibility of preventing competitive distortion or abuses of the scheme and, as far as I am aware, reported on its activities to the Minister/Department of Finance.

I believe it will be clear from the above answers that I accept that during the period I served in CBFSAI that there was a failure on the Board's and Authority's part to ensure effective prudential supervision of the banks, to assess correctly the risks emerging in the banking system and to take sufficient and timely steps to address the situation. As a member of the Board and Authority and therefore collectively responsible for those failures I fully accept and regret my share of the blame.

Signed: ____________________
Gerry Danaher SC