Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Jim Farrell

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

JOINT COMMITTEE OF ENQUIRY INTO THE BANKING CRISIS.
STATEMENT OF JIM FARRELL

Introduction; I was appointed as a member of the Irish Financial Services Regulatory Authority(the Regulator) on 1 May 2003.I was appointed Chairman of the Regulator on 1 May 2008.As Chairman of the Regulator I became an,
ex officio, non executive member of the board of the Central Bank.
The format and content of this statement follows as closely as possible the directions laid down by the Chairman of the Joint Committee in his letter of 24 June 2015.I have attempted to answer as comprehensively as possible the twenty four questions which I have been directed to answer.

1. With regard to the appropriateness of the regulatory regime it has to be stated that it would have been preferable if the Regulator was an independent stand-alone body, with full control of its own budget, personnel policies (not civil service driven) and I.T. expenditure etc. As an independent body it would have been in a much better position to deal with the many challenges posed by its mandate of Prudential Supervision and Consumer Protection. Having to rely on the Central Bank to provide all key resources was far from ideal. It led to difficulties in meeting recruitment targets and I.T. support in particular. This is not to say that the Regulator, or the board, should in some way be absolved in respect of its shortcomings because of these issues. It must still be held accountable as it should have flagged and sorted these matters at a much earlier stage. On the question of the Memorandum of Understanding, I believe it was very useful in clarifying key responsibilities.

2. In my opinion the Regulator did not, initially, have sufficient enforcement powers to take meaningful action against the banks.

3. Promotion of the financial services industry in Ireland was not something that featured at board level as a matter of priority, as far as I can recall. There is a vast difference between promoting the industry in the marketing sense and meeting with potential investors to explain regulatory policy and deal with particular queries. I consider that the latter can be very useful in clarifying policy for investors and also in enabling the Regulator to assess the suitability of investors. Marketing is not the role of a Regulator.

4. The Regulator's initiative to promote better governance requirements on banks (director's compliance statements etc.) was an entirely sensible idea. However, it did not proceed due to intensive lobbying by the banks and IBEC. This pressure led to the Department of Finance writing to the Regulator requesting that the initiative not proceed without first consulting the Department.This was a classic example of the lobbying powers of the banks and a lack of interest in proper governance in the banking sector. It was also an inappropriate intrusion by the Department of Finance into what was a regulatory matter..

5. As far as I can recall the Regulator did not have specific powers to stop the banks paying dividends. However, there were other options available if the Regulator so wished. For example, he could have insisted on higher capital ratios. Then there was always the instrument of "moral suasion" which regulators have used in other jurisdictions. Such actions would undoubtedly have had a market impact. This factor would have to be weighed when making the decision. If circumstances justified a limited or zero dividend then such a decision should be taken.

6. I did not become a member of the board of the Central Bank until May 2008, so my knowledge of the Central Bank's briefings of Government is limited. It was my understanding that the Governor met with the Minister for Finance and the Taoiseach periodically to brief them on the economic and financial matters. Of course, this was only one source of advice and information available to the Government. The weight Government gave to briefings by the Governor is difficult to assess. I am not is a position to make such an assessment.

7. The skills and experience within the Regulator were, initially, the same as within the Central Bank. The Regulator, which was established against the background of major consumer issues within certain banks, did add additional personnel, mainly within the Consumer Protection area. The Regulator had considerable success in dealing with abuses by banks in the consumer area, particularly foreign exchange, overcharging, and mis-selling. A consumer protection code introduced by the Regulator became effective in July 2007.Its main objective was to address aggressive lending by financial institutions in the light of rapidly increasing personal debt levels.

The extent to which Consumer Protection was given priority over Prudential Regulation can be seen from the fact that the Consumer Director was a statutory member of the board of the Regulator while the Prudential Director was not. However, the Regulator ensured as a matter of practice that the Prudential Director attended all board meetings.

With regard to resources, a budget was prepared annually and agreed with the Central Bank. While I was not aware for some time that there were issues, particularly around I.T., it emerged that there was considerable under- investment in I.T. Additionally, the budgeted headcount was rarely,if ever, reached. With hindsight, management and the board should have been more pro-active in ensuring that skills, systems, and headcount were fit for purpose. This was particularly so given the onset of Basel II, and many other additional responsibilities which the Regulator assumed as part of its mandate.

8. The 2007 Financial Stability Report was the first report that I discussed as a member of the Board of the Central Bank. The discussion was comprehensive and was led by the economists from the bank. The growth in house prices and credit were the dominant topics. The level of loan provisions by the banks was also queried. We were told that the provisions were in line with what was allowed under the accounting standards. I recall that the Spanish banks were making larger provisions but this did not have any impact in terms of changing the tone of the report.

While board members seemed to have a clear understanding of the issues, there was much reliance placed on the economists to deal with the many technical and interrelated economic issues. In hindsight, having an economist(s) on the board to argue the finer points might have made a difference. Having said that, there were not many economists outside the Central Bank giving contrarian views. I quote the following very positive views from very respected sources:

a) 2005-2012 ESRI medium term review: "*the fundamental factors driving the Irish economy remain quite favourable*"

b) IMF report 2006: "*The Irish financial sector has continued to perform well since* . . . . *2000. Financial soundness and market indicators are generally strong. The outlook for the financial system is positive".*
c) OECD 2006: *"Ireland has continued its exemplary economic performance, attaining some of the highest growth rates in the OECD."*
d) European Commission 2008: "*Despite the weakening of the budget position in 2007, the medium term objective, which is a balanced position in structural terms, was reached by a large margin"*
e) PWC 2007 report: It concluded that the banks were in a strong financial position to withstand any storm.

9. The supervisory powers of the Regulator were constrained by the absence of meaningful sanctioning powers. Such powers were not available for the Regulator until about two years after its establishment. The Regulator also had major issues with the Credit Unions which were the subject of extensive correspondence with the Department of Finance. The absence of sufficient legally enforceable powers were the root cause of the delays in resolving the issues in the Credit Unions.

10. The Financial Stability Reports were prepared under the Chairmanship of the Director General of the Central Bank. While there were comprehensive discussions on the reports, the changes were relatively minor. On many of the issues raised, their views were supported by external commentators (see 8. above)

11. While there was no quantitative evidence tendered to support a 'soft landing', the main argument as I recall was the growth in population and the demographic profile which were deemed to create ongoing demand for housing. The imbalance in the economy resulting from the dominance of the construction sector and the vast number of housing units being built were deemed to be insufficient counterweights.

12. Sector limits were not enforced by the Regulator as the Central Bank had, I understand, accepted non adherence to them since the mid -1990's, long before the establishment of the Regulator(see Nyberg report 4.3.9 and note 102). Accordingly, there were no discussions on such limits per se. However, Prudential Reports were submitted to the Board on a quarterly basis which, inter alia, gave details of balance sheet growth, funding profiles and large exposures. These reports elicited serious discussion regarding certain institutions on issues such as rapid balance sheet growth,concentration on property lending,lack of stable retail funding and governance. While somewhat higher capital ratios were imposed on some institutions such increases were not sufficient to change behaviour. Having identified the key risks in those institutions, there was no excuse for not insisting that management take more forceful action. All board members, including myself, have to take responsibility for not pursuing those issues more vigorously with the management of the Regulator.

13. The solvency of the banks did not emerge as an issue in 2008. I refer to the external commentary (including the PWC 2007 report) on the banks and the economy. However,there was not sufficient appreciation the fact that a lack of liquidity,if not rectified quickly, would lead to insolvency.

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14, 15, 16). I joined the board of the Central Bank in May 2008 by which time the crisis within the economy and the banks was well advanced. The banks were experiencing significant liquidity pressures throughout the summer months. My view was that the executives from the Department of Finance, the Central Bank and the Regulator were working closely together and with the banks to manage the problem as best they could. Lack of effort in this regard was not the problem. Rather, the problem was that the banking system had grown too large for the economy and there was no way to unwind it in an orderly fashion within a short period of time.

It was well know that certain Central Bank board members had close political connections. I cannot say whether this impacted on the independence of the particular board members or the actions of management.

17. I would fully subscribe to the view that the Governor's Letter to the Minister be subject to challenge by the Department of Finance. I am not aware of what processes the Department had in place to make such a challenge.

18. The comments of the IMF, OECD and ECOFIN on fiscal tightening have to be viewed in the context of their other pronouncements (see 8 above). While I personally believe that fiscal tightening would have been appropriate given the growth in the economy and the boom in asset prices, I cannot say why the Central Bank was not more forceful, except to say that Central Banks are usually very measured in their use of language. Also, it may have been the case that the Central Bank was more forceful in private.I cannot say if this was the case.

19. Morgan Kelly's comments were amongst many comments expressed by many commentators. While the scenario he depicted was certainly worrying, his was a minority view and I am not aware of any discussions held at senior management level at the Central Bank or Department of Finance to discuss Mr. Kelly's views. If such discussions were held, I would not necessarily have been made aware of them.

20. Most of the contrarian views were voiced within the Board of the Regulator which discussed individual banks, as opposed to the Central Bank which had responsibility for the financial system as a whole. I refer to 12 above for some of the comment that were made.

21. The IMF and OECD reports were useful at the macro level in assessing the Irish financial system. However, they could not be regarded as substitutes for thorough assessments of individual banks and the banking system as a whole which were the responsibility of the Central Bank and the Regulator to make.

22. I cannot explain the absence of a bank resolution regime. It is a question that is best directed to the Senior Management at the Department of Finance / Central Bank / Regulator.

23. The Domestic Standing Group provided a very useful forum for the Department of Finance, Central Bank and Regulator to share information, discuss issues and agree actions. It did very useful work in addressing topical issues. However, it could have done

more in areas such as scenario mapping and contingency planning. Its approach seemed more focused on emerging issues at the expense of contemplating extreme scenarios and contingency planning. Of course, it should be noted that virtually nobody contemplated the scenario that eventually emerged.

24. A new supervisory unit was established to monitor compliance with the government guarantee scheme. See page 17 of the Regulator’s 2008 Annual Report.