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Joint Committee of Inquiry into the Banking Crisis

Clarification Statement of

Frank Browne

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REPLIES TO WITNESS QUESTIONS

Question 1

- A. *What were the events or considerations that led to the preparation of the McQuinn paper on fundamental house price valuation in 2004?***

This paper was prepared in the EARP Department. I am not aware of the events or considerations that led to the preparation of this paper.

Question 2

- A. *Who specifically were you referring to when you mentioned "Senior Management" in your Statement and Appendix?***

I was referring to the Governor, the Director General and Deputy Director General of the Central Bank, the CEO of the Financial Regulator and all Assistant Director Generals (ADGs), or ADG equivalents, in the Central Bank and Financial Regulator. I understand that the above personnel were members of the Joint Management Board (certain ADGs e.g., the ADG for Currency Operations and Central Services can be excluded from the definition of senior management for current purposes.)

Question 3

- A. *Did you, as Chairman of the WGFS, not have independence in the assessment of the financial stability warning grade for these sectors?***

I am satisfied that, as Chairman of the WGFS, I had sufficient independence in the assessment of the financial stability warning grades as reached by the WGFS. This independence was reflected in what was presented to senior management, the FSC and the Board in 2004. However, when the FSC took ownership of the FSR in 2004, it could accept or reject some or all of the content of papers/presentations, it could exercise editorial control and formulate any policy decisions stemming from these papers/presentations.

- B. *When the light for housing was downgraded from red to amber by senior management, did you have a discussion about this or try to change this decision?***

In 2005, Deputy Director General informed me that senior management was unhappy with our assignment of a red traffic light to the housing market and that it had decided to downgrade the assignment from red to amber, saying that it did not consider that the problems in the market warranted a red light. I countered this by pointing out that the red, amber and green light warning indicators were determined by our then bearish overall financial stability risk assessment as agreed by the FSC and as presented to the Board in 2004. Nevertheless, I was informed that senior management had already decided on this change. In the foregoing circumstances, it was presented as a fait accompli.

This change in the “traffic light” warning status was consistent with the view that emerged at senior management level at about this time to the effect that the risks were low and that a soft landing was in prospect.

Question 4

- A. *When changes were made to the Financial Stability Reports, were the original authors consulted on the changes and given the option to comment on the changes?***
- B. *Was the consent of the original authors required to make the changes?***

By way of context, FSRs were typically divided into the following parts:

1. Executive Summary; this consisted of the general conclusions based on the overall risk Assessment.
2. Overall risk Assessment; this was the main body of the report and was devoted to an assessment of a range of financial stability indicators.
3. Thematic article; this article conducted an in-depth analysis of specific topical financial stability issue.
4. Signed technical papers dealing with some specific aspects of financial stability.

In July 2004 the FSC took ownership of the FSR "the aim being to refine the Summary and Overall Conclusions texts...." and stated that there would be agreement on the “overall conclusions and message of the report”.

Since thematic articles were unsigned and were the property of the Bank, it was within the gift of the FSC and senior management to reject or make changes to such articles as they deemed appropriate. In my own case, the FSC/senior management rejected two of my papers for inclusion in the 2005 and 2007 reports as thematic articles.

Signed technical papers were accompanied by a disclaimer noting that the views expressed in these papers were the personal responsibility of the author and were not necessarily held by the Bank. I cannot say whether original authors were consulted in relation to any amendments that may have been made to these papers.

Question 5

A. As Chairman of the Financial Stability Working Group and Head of the Monetary Policy and Financial Stability Unit what powers did you have and how did you use them?

My mandate was to propose the work programme, to have it approved by senior management and the FSC, to conduct the agreed research and analysis and to present the results to senior management and the FSC. Specifically, I had no powers in relation to policy matters, either of a monetary policy or financial stability nature. I had no executive or editorial role in relation to the Bank's publications.

Question 6

A. Did you think that, considering your position as Chairman of the Financial Stability Working Group and Head of the Monetary Policy and Financial Stability Unit, you had adequate input in the process of selecting themes and articles and into the final editing of the Financial Stability Reports?

The work in MPFS was governed by the work programme which proposed themes and articles which I and other members of the WGFS and the MPFS considered relevant.

As noted, the work programmes were approved by senior management and the FSC. I had adequate input into selecting themes and articles in the work programmes. By contrast, I had little or no say in the final editing of the FSR.

Question 7

Were you involved in any discussions about these changes, and if so, could you give your thoughts why you were not consulted?

I was not involved in discussions concerning changes to the FSR in 2006 and 2007. I do not know why I was not consulted.

Question 8

In 2006 and 2007, did you take any steps to complain about changes to the Financial Stability Reports?

The finalisation of the FSR was, during that time, exclusively within the preserve of senior management. Since all members of senior management seemed to be *ad idem* on financial stability issues, any complaints about the FSR would effectively constitute a complaint *to* senior management *against* senior management.

As noted in my written statement to the Inquiry, I was not aware in real time that the results of two research studies pointing to substantial misalignment in house prices were deleted from the 2007 FSR.

Question 9

Can you explain Tom O’Connell’s role in relation to preparation of the Financial Stability Report, and your interaction with him on this matter?

Tom O’Connell had no formal role in relation to financial stability prior to mid-2005 when he became ADG for economic services and a member of the FSC.

I am not aware of the precise nature of his role in the preparation of the FSRs post mid-2005 but I do note he had a designated role which involved overseeing the Bank’s publications. This may have involved him in an editorial role in relation to the FSRs as might be inferred from his testimony to this Inquiry. I don’t recall any engagement with Tom O’Connell on substantive financial stability matters in relation to papers and presentations produced by the MPFS Department.

Question 10

A. Was the plan used or any part of the plan in the crisis management actions taken in 2007 and 2008?

I was not involved in the actual crisis management operations in 2008 but it appears to me that the crisis management procedures as outlined in the Black Book (BB) were not used in the context of the actual crisis in 2008. In a review of crisis management at the FSC meeting held on the 12 of November 2008, the Director General noted that “actions taken during the crisis had not adhered to crisis management principles as set out for example in the Crisis Management Manuel (or black book).”

B. What procedures if any were used by the Central Bank and the Financial Regulator in 2008?

As noted above I was not involved in the actual crisis management operations in 2008 and do not know what procedures were used.

Question 11

A. Can you comment on discussions that took place on illiquidity, and the potential for insolvency as a result?

There was no discussion on liquidity of which I am aware on foot of my presentation to the Board in December 2002.

As noted in my written statement to this Inquiry I did put the liquidity issue on the agenda in March 2005 but the matter was rejected without discussion by senior management at that time. Again in 2007, a completed thematic article on liquidity was rejected for publication without discussion on the substantive issues, after a presentation of the paper to the FSC.

A Working Group on Liquidity was set up in September 2007. I was not on that committee and I am not aware if discussions took place on the potential for insolvency.

In the context of a discussion on the Banking sector at the FSC on 12 November 2008 I noted that “the key issue was the interaction between the financial sector and the real economy with a very real risk of a negative feedback loop between credit availability, impairments and economic performance.” Depending on the severity of this mechanism there was a clear potential for insolvency. However, there was no in-depth discussion on the matter.

B. *Did discussions take place with senior management?*

I am not aware of any discussion on these issues with senior management.

Question 12

A. *Can you advise on how the overall status was agreed in 2004?*

I do not know how this conclusion was reached. The 2004 FSR contained evidence to the effect that house prices were misaligned and an overall bearish conclusion about the prospects for financial stability in Ireland. So it is puzzling how the overall risk status could have been deemed to be low.

B. *Was this confirmed by expert parties?*

This was not to my knowledge confirmed by expert parties.

C. *Do you mean that a lesser focus and sense of urgency occurred in 2007 and 2008 due to lower rating assessment?*

The Financial Stability authorities may have been less focused as a result of the low risk assessment.

D. *If the rating had been higher risk would this have made any difference in your opinion?*

It should have led to more appropriate prudential policy measures being put in place. And, once such measures were in place, then it could, and should, also have featured in Central Bank publications thereby putting this issue in the public domain.

Question 13

A. *Were these common principles adopted and used as a guide to decisions used by the Central Bank?*

The Guiding Principles were listed in the original BB but were not transferred to the Red Book (RB) when this was drawn up in the first instance. They were reviewed by the FSC at its meeting on the 14 November 2006 and it was agreed that they were appropriate and should be included in the RB.

However, they were not, to my knowledge, invoked in the decision making process during the actual crisis in 2008. In a review of crisis management at the FSC meeting held on the 12 November 2008, the Director General noted that “actions taken during the crisis had not adhered to crisis management principles as set out for example in the Crisis Management Manuel (or black book). Rather actions taken had been primarily decided upon in small ad hoc meetings, usually between representatives of the Department of Finance, Central Bank and Financial Regulator. This reflected the fact that decisions usually needed to be taken at very short notice and previous plans had not necessarily appreciated the speed at which events would unfold.”

However, it is not obvious to me why immediate exigency should trump the application of the guiding principles in good crisis management procedures.

Question 14

Can you comment if in your view “monetary policy and financial stability analysis and research” were relegated to a lower priority, given a lack of adequate focus on resources by senior management?

From the inception of the MPFS Department in 2002, the level of resources devoted to the monetary policy and financial stability functions was inadequate when compared, firstly, with comparable figures for other central banks and, secondly, when compared with the resources currently assigned to these two functions by the Central Bank of Ireland in the wake of the financial crisis.

The battle for resources reinforced my belief that senior management did not have a sense of the real importance of financial stability, especially in the new financially liberalised environment both internationally and domestically as I noted in my statement to the Inquiry.

Tab 10 in my statement to this inquiry reflected the need for further resources in 2003.

This point is further illustrated in the attached e-mail and Memo in relation to the Manpower plan for 2005. The Director General is noted as saying: “..the increase in numbers is too high in Economic divisions (+7.5), and can’t have the overall increase in complement across CB (+5.5) accounted for by one dept (MPFS). The Governor won’t allow this size of increase, given the pressure on the Eurosystem governors to reduce numbers. (We argued –

as did others –that we started off with a low cost base and did not need to go through the kind of slimming-down underway in other NCBs, and we still needed to carry the same range of tasks with smaller numbers and no economies of scale).” In the event, 3 rather than 5.5 were offered (see attached).

Question 15

A. *Can you advise what you mean in this paragraph by “the long-established position of the central bank on constructive ambiguity”?*

Central banks have long subscribed implicitly to the unwritten but fundamental principle of constructive ambiguity in relation to their lender-of-last-resort, or emergency lending, policy in a financial crisis. A central bank could not have a pre-announced or pre-published policy position in relation to emergency lending in some future crisis since this would tend to invite dangerous moral hazard behaviour on the part of the banks which could threaten financial stability. Nor could the provisions in emergency lending be embedded in law without it becoming common knowledge with the same potential negative consequences. The speech by the Chairman of the Financial Regulator could have jeopardised this principle (for my further views on this see my reply to Question 9 of the original written Questions posed to me by the Inquiry).

B. *Was it normal practice to write to the Board?*

I wrote to the Secretary of the Board hoping that he would take up the matter with the Chairman of the Regulator and who was also a member of the Central Bank and Financial Services Authority of Ireland Board. I don’t know if the message ever got to him since I received no feedback from the Secretary. It was not normal practice to write directly to the Board. I had never written to the Board or to the Secretary to the Board, previously.

Question 16

A. *As head of financial stability can you comment on why you were not invited to join other committees?*

I do not know why I was not asked to join the committees.

B. *Why did the FSC (not the DSG as in the question) only meet 4 times and not monthly in 2008?*

In August 2007, a new Director General was appointed and became Chairman of the FSC. It was within his power to call as many meetings as he wished. He called only 4 before the 28 September 2008 and one on 12 November 2008.

C. *Were other committees and other issues prioritised?*

It is not a matter on which I can offer a categorical view but it is possible that other committees and other issues were prioritised.

Question 17

A. *Did you think that any Irish financial institution was illiquid and insolvent in September 2008 from your analysis and research carried out?*

My views on bank insolvency are detailed in my reply to Question 8 of the original written Questions posed to me by the Inquiry.

Question 18

A. *Was any further action taken to examine the insolvency regime for banks?*

I was not a member of the DSG but I understand the issue was discussed at a DSG meeting and it was decided to refer the matter to the Office of the Attorney General.

I understand that the advice was that an SRR could interfere with property rights as enshrined in the Irish constitution and could also require that primary legislation would have to be amended accordingly. It may have been this advice that brought work on this proposal to a halt.

In addition, Peter Nyberg, in his testimony to this Inquiry on 17 December 2014, noted that both the Central Bank and the Financial Regulator considered the banks to be solvent and that therefore there was not really a problem (page 35). Furthermore, according to Nyberg, the DoF considered an SRR would require complex legislation and that it was felt that it would take “too long and was too complex to do something, so it was left”.

Despite this, in April and June 2008 I again raised the issue of a SRR and noted the benefits of having such a regime. But I am not aware of any further work being requested or undertaken on this issue in 2008.

B. Was it delegated to any party to complete and report back to the DSG?

I am not aware of any delegation to any party either in the Department of Finance, the Central Bank or Financial Regulator to continue work on this issue.

Question 19

A. Was it normal that meetings were minuted and circulated to participants?

I was not a member of the DSG. I do not know if minutes were taken and circulated to participants.

B. Were minutes of the meeting completed and regarded as secret

I am not aware if this was the case.

Question 20

A. Who was tasked with completing additional workload (on an SRR), and do you know why no further work was completed over the summer months?

I do not know who, if anybody, was tasked with completing additional work on a SRR. I do not know why further work was not conducted on this issue over the summer months of 2008. It may have been due to what was perceived as legal difficulties (see reply to Question 18 above).

Although I was not requested to work on this issue, I nevertheless noted at the DSG in January 2008 that an SRR would be a worthwhile tool having in the crisis management toolkit. In a presentation to senior management in April 2008 in the Bank, I again favoured the idea of having an SRR. I did a preliminary exploration of the issue and presented same to senior management (Tab 117 of my statement to this Inquiry). In a June 2008 paper, which I co-authored with others, we argued that difficulties which could be presented by other resolution options “would increase the case for examining a special insolvency regime in the

near term..." (Tab 118 of my statement to this Inquiry). However, I was not involved in any decision making in relation to this issue either then or thereafter.

B. *What action do you take?*

Not all SRRs across countries are the same but they tend to have common features. Without further discussion and analysis at the time, it is not clear what would have been the precise configuration of the SRR that would best suit the needs of the Irish banking system. Some of the features of such an early intervention mechanism are noted in my written statement to the Inquiry (page 58). Implementing the legal and operational framework for a SRR would have been a major resource intensive undertaking. Any decision to go ahead would have to have been taken at the highest level.

Question 21

A. *Can you comment on the insertion in the guarantee to propose to cover "both senior and subordinated debt"?*

As noted in my written statement (page 57), my view on a blanket guarantee, if it were deemed that one was necessary, is that it should be confined to deposits, which are the payments medium in the economy. Perhaps those involved in the practicalities of crisis resolution at the time (I was not involved) had access to more information than was available to me but I cannot see a reason for a blanket guarantee of all, or virtually all, creditors.

B. *Who was likely to have inserted this wording in your view, and are there any records of any discussion on the matter at the time?*

I do not know who would have inserted the wording in the Guarantee. Nor am I aware of any record of any discussions in this respect.

Question 22

A. *You refer to "suppressing information" and "toning down" communications. Was this a normal process by senior management in the CBFSAI, and who had responsibility for this?*

Toning down occurred fairly consistently. I have instanced several examples in my written statement to this inquiry. Estimates of house price misalignment were omitted altogether in 2007. I believe senior management was responsible for this.

Question 23

- A. *What in your view was the rationale for the “financial stability function was severely under resourced”?***
- B. *Was this driven mainly by cost considerations, or a fundamental lack of understanding of their financial stability brief?***

I think that senior management did not devote sufficient resources to Financial Stability. There may have been cost considerations although financial stability staff were a very small percentage of total staff numbers. In my view, senior management did not have a sense of the real importance of financial stability, especially in the new financially liberalised environment both internationally and domestically (see also my reply to question 14 herein).

The Central Bank and Financial Services Authority of Ireland’s consistently bullish belief in the fundamental stability of the system may have deflected its attention away from the catastrophic scenario and the cost to the economy of this being realised. Even ascribing a relatively small percentage probability to the collapse scenario would have prompted more resources to be devoted to the pessimistic eventuality which would have helped in the preparation for crisis management.

Question 24

- A. *While understanding there may be different views on particular subjects, were contrarian views normally accepted, and did reasoned discussions take place?***

From my own experience, views that were not aligned with the consensus of senior management were not welcomed and were either ignored, when they took the form of written communication, or evoked a negative reaction when they took the form of verbal communication at internal meetings within the Bank. This has been noted in my written statement to the Inquiry. In my view, reasoned discussion did not tend to take place on substantive financial stability issues. I can recall no engagement with any member of senior

management on the substantive financial stability issues in the papers or notes drafted by myself.

I have noted cases in my written statement to the Inquiry where my presentations or interventions at internal meetings was received unfavourably, particularly my views on the role of liquidity in financial instability.

B. Did the senior management team function in an autocratic fashion, and a group think mentality?

In my view, yes. It was a situation that was compounded by the absence of economist expertise at senior management level particularly after June 2005.

Question 25

A. Can you explain why you think “analysis that the risks of a crisis were low and that a soft landing was the most probable outcome” and who made this decision?

To eliminate any ambiguity in this question I would like to clarify that I did not think a soft landing was the most probable outcome. Recall the draft Executive Summary which I circulated to the FSC on 9 June 2004. In this, I and my MPFS co-authors noted that “Unless some cogent arguments can be offered for why Ireland should be exempt from this past international pattern, the prospects for a soft landing for Irish house prices is not favourable.” This was noted in my written statement to the Inquiry (page 15).

I do not know who made the decision that the risks of a crisis were low and that a soft landing was the most probable outcome.

B. Would this have been recorded in any management minutes and/or discussions?

I am not aware of any such minutes or discussions other than those mentioned in my written statement.

Question 26

A. Noting from your comments, are you suggesting that “FSR Executive Summaries and the Governor’s messages” were inaccurate, and distorted the evidence being provided to senior management?

It is my view that the Executive Summaries and Governor's messages were based on a selective reading of the evidence as furnished by the results of research and analysis conducted within the Bank.

I have cited in my statement several instances where research and analysis conducted between 2004 and 2007 pointed to a property bubble and increased liquidity problems.

It is common case that the FSR Executive Summaries and Governor's Messages during this period did not address or highlight these fundamentally important issues notwithstanding such research and analysis. To that extent, one cannot avoid the conclusion that such FSR Executive Summaries and Governor's Messages were selective, inaccurate and distorted.

John Hurley has acknowledged to this Inquiry that the Bank's risk assessments, did, in hindsight, understate the risks to financial stability.

It must be observed that these failures occurred in circumstances where the research and analysis indicated above were properly put before senior management and the FSC.

In my view, vulnerabilities in the system were not confined to property price misalignment (although this was the most dangerous single vulnerability). There were multiple other misalignments and disequilibria. I note many of these in my written statement to the Inquiry (page 23), briefly: property price misalignment; growing bank exposure to property; interest rates too low; ubiquitous excess liquidity; banks' large and growing funding deficit; narrowing bank interest rate margins; dangerous user cost of capital configuration; absence of a self-stabilising mechanism.

Work on all of the above issues was conducted and presented to senior management and the FSC but the worrying implications for financial stability emerging from the results of this research and analysis was not taken on board by senior management and therefore did not inform policy decision making as would be appropriate.