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Joint Committee of Inquiry into the Banking Crisis

Clarification statement of

John Hurley

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

**Response of John Hurley to the questions in Document 1 enclosed by
letter dated the 28th August 2015**

**Questions 1 (a) to (e) in relation to the Department of Finance paper
titled “Financial Stability Issues-Scoping Paper”**

1. It is my understanding that the paper entitled “Financial Stability Issues-Scoping Paper” was a Department of Finance paper which was discussed at the Financial Stability Committee of the Central Bank. Amendments were subsequently proposed to the Department of Finance and a revised document was discussed by the Domestic Standing Group. I have no recollection of any involvement in its compilation or signing off.

2. I do not know whether this paper was brought to the attention of the Minister for Finance or the route by which this might have been done.

Question 2 in relation to options for dealing with the Banking Crisis

3. In the aftermath of the Northern Rock crisis in the United Kingdom in 2007 work on contingency arrangements was significantly stepped up. The initial focus was on addressing the issues arising from the liquidity pressures which had increased.

4. The other matters pursued, to the best of my recollection, were the more detailed consideration of issues surrounding the provision of emergency liquidity assistance, further stress testing including consideration of test outcomes, the improvement of the Deposit Guarantee Scheme and the desirability of assisted private sector takeover of a troubled financial institution.

5. In addition, legislative issues that might be necessary to deal with financial institutions in difficulties were considered. These included the necessity for draft legislation to facilitate a nationalization of a financial institution, should that be required, and the desirability of establishing a Special Resolution Regime. The Domestic Standing Group met regularly and considered issues to be pursued.
6. While it was decided that draft legislation for nationalizing a financial institution would be prepared, my understanding was that legal issues prevented the furthering of Special Resolution Regime draft legislation.
7. After I returned to the Central Bank in September 2008, post the bankruptcy of Lehmans, the options considered, again to the best of my recollection, included an increase in the deposit guarantee limit (increased to €100,000), the issue of Government bonds to credit institutions in return for assets, the necessity for a broader guarantee, the nationalization of one or more financial institutions, the establishment of a Special Lending Facility (SLS) with funding from Irish public service sources of some €20 billion and the provision of emergency liquidity assistance. The possibility of a Euro-wide initiative of which Ireland could be part was also considered.
8. The extension of the deposit guarantee limit was unlikely to be sufficient to stem the mounting liquidity pressures. It was considered that the introduction of an SLS facility would likewise not prove adequate given the scale of the funds required. The issue of Government bonds in return for assets had significant implications for Ireland's credit rating and was dismissed. An assisted private sector takeover was not possible in view of the pressures facing all financial institutions. It also became clear that a Euro-wide initiative was not envisaged at the time. The options available on the night reduced to a broad guarantee with or without nationalization and supported by emergency liquidity. The considerations involved were addressed in my previous evidence. Options were also considered, including their pros

and cons, in the context of discussions on the Merrill Lynch presentation on 26 September 2008, which the Committee has, including the option of a Good Bank/Bad Bank which would have required a longer time frame.

9. I would reiterate my previous evidence to the Committee that it is my firm conviction that the course chosen was the least worst option in the circumstances that presented themselves at the time.

Question 3: what steps, if any, did the Central Bank take to address these concerns (concerns expressed by Mr. McDonagh to the Committee regarding the apparent lack of information held by the Financial Regulator in respect of the Banks)

Question 5: can you confirm whether or not any in depth examination of the banks was contemplated or discussed by the Central Bank, Financial Regulator or Domestic Standing Group at any time prior to September 2008 ? If so, why was it decided not to proceed with such an exercise ?

10. I was not aware of concerns in relation to the apparent lack of information held by the Financial Regulator in respect of the Banks prior to my departure on sick leave in July 2008.
11. The regulatory powers for financial institutions and the relevant skill sets were transferred to the Financial Regulator as a result of the Central Bank and Financial Services Authority of Ireland Act 2003. The Central Bank subsequently relied on the Financial Regulator for information on individual financial institutions.
12. When I returned to the Central Bank in September 2008 the question of an additional examination of the books of individual financial institutions by PWC was being considered in the light of the deteriorating financial

situation post Lehmans. PWC were subsequently engaged by the Financial Regulator to conduct such an examination.

Question 4: Can you detail all contacts (including attempted contacts) between yourself and the ECB from the 26th September 2008 to the 30th September 2008 ? Subject to the restrictions placed upon you by your obligations of professional secrecy, please provide, as completely as possible, details of all matters discussed and any advices received or given during this period?

13. In the course of my written statement and my evidence to the Committee I dealt with my contacts with the European Central Bank insofar as I could within the constraints of the legal and statutory confidentiality and professional secrecy provisions which continue to apply to me after my retirement.

14. Arising from the intensity of the international crisis, its impact on euro-area financial systems and the necessity for Governors to be in their own countries, the principal means of contact between myself and the European Central Bank from the 26th September 2008 to the 30th September 2008 was by means of teleconferences and telephone calls.

15. As a result of these contacts three key messages emerged:

- a Lehmans - type situation was to be avoided in Europe;
- countries were expected to stand behind their Banks;
- a European initiative, of which Ireland might be part, was not being countenanced and decisions in relation to Irish banks were a matter for the Irish authorities.

Question 6: With regard to the stress test models utilised to assess the ability of the Banks to withstand financial shocks, can you confirm how the robustness of the model (assumptions and outcomes) was tested ?

16. The models applied by the Central Bank were in line with the framework recommended generally by the IMF. My understanding is that the stringency of the scenarios were not out of line with those applied generally by Central Banks and in some cases were stronger. The outcomes of the tests did not reveal any matters of serious concern. Of course in hindsight the scenarios applied by country Central Banks that experienced serious difficulties in the crisis did not anticipate the unprecedented nature and depth of the international financial crisis.

17. In order to put the pre-crisis stress tests in perspective it is worth noting that the first post-crisis stress tests also turned out to be inadequate.

Question 7: In respect of the 2006 stress test exercise was the level of input from European Institutions and the IMF restricted to oversight of the Central Bank model, or was a European or IMF designed model utilised that year ?

18. To the best of my recollection the model used for the 2006 stress test was in line with the recommendations of the IMF for such tests. As far as I am aware the IMF never suggested that the assumptions used for the test should be more stringent than those applied.

Question 8: Governor Honohan referred in his letter of 12 February 2015 to the Committee to the “Powers of the Governor in period up to 2008”. (A copy of the letter has been enclosed for your convenience).

(a) Do you agree that these powers were available to you in the period 2003 to 2008 ?

(b) Did you consider using these powers, or threatening to use them, and/or were any of these powers used during the period ? If so, please provide details.

Question 9: In your evidence to the hearing you suggested that the only power you could use to address the risks in the banks was guidance.

Did you consider issuing such guidance to the Financial Regulator during your period as Governor, and if not, why not ?

19. In his letter dated the 12th February 2015 to the Committee, Governor Honohan *inter alia* stated as follows in relation to the powers referred to by him:

“While these powers existed, it is only right to add that the normal operation of the Central Bank and Financial Services Authority at the time did not entail the Central Bank’s board or the Governor intervening to second-guess the Regulatory Authority or its Chief Executive, who had numerous specific powers.”

20. I agree with Governor Honohan that in practice the Central Bank respected the autonomous role of the Financial Regulator. The Central Bank was divested of responsibility for the prudential regulation of financial institutions and the relevant staff concerned, including inspection staff, moved to the Financial Regulator.

21. The power to determine ratios in the 1971 Act was for the purpose of setting monetary ratios as a monetary authority which the Central Bank was at the time. Such ratios were centrally determined by the ECB post EMU. The use of these powers for prudential purposes when this function was given to the Financial Regulator in the 2003 Act was never considered appropriate by the Central Bank. To the best of my knowledge such powers were not used by other European Central Banks for the prudential regulation of financial institutions.

22. As regards the question of issuing guidelines as to the policies and principles, if the Central Bank had anticipated the severity of the economic and financial reversal emanating from the interaction of our domestic vulnerabilities with the international financial crisis, as I stated

in my evidence to the Committee, the issues involved would have been addressed in discussion with the Financial Regulator. I have no doubt that the necessary action would have been taken by the Financial Regulator without the need for such guidance.

During your tenure as Governor of the Central Bank prior to September 2008, did you communicate any concerns about financial stability to the Financial Regulator, Department of Finance, or Government ministers, other than through the annual Financial Stability Reports ? If so, can you provide details of the concerns identified, and when and to whom these were addressed ?

23. The risk assessment of the Central Bank on financial stability matters was communicated primarily by means of the Financial Stability Reports published by the Central Bank, the Introductory Statements of the Governor at their launch and at the press conferences themselves. They received widespread publicity. The views of the Central Bank were also communicated directly to the financial institutions at the regular Round Table discussions held with them. They were addressed in the regular meetings between the Minister and Governor and in the annual pre Budget letters sent to the Minister for Finance. They were also communicated in meetings between the Taoiseach and Governor.

24. All of the Central Bank's risk assessments were discussed in detail at the joint meetings with the Regulatory Authority on the draft reports. These meetings were attended by the Chairman, CEO and board members of the Regulatory Authority as well as the Secretary General of the Department of Finance. The DSG also became a key channel of communication with the Department of Finance after its establishment in 2007.

25. In addition the Bank's views were communicated by means of its Quarterly Bulletins and its Annual Reports which were submitted to the Government. These reports also received wide media coverage.

26. As I stated in my evidence to the Committee, in hindsight the Bank's risk assessment understated the risks to financial stability because it did not anticipate the speed and severity of the crisis that was to unfold, affected as it was by the unprecedented international events of the time.

Question 11: Can you detail any additional powers or authorisations you feel would have been necessary to enable you and/or the Regulator to act more effectively, both prior to, and during the financial crisis ?

27. The sharper focus of the unified structure of the Central Bank with a single board, that was adopted in the 2010 legislation, would, if in place at the time, have better facilitated the identification and assessment of risks to financial stability as well as the implementation of the appropriate actions including the necessary sanctions.

John Hurley

17th September, 2015