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# **Joint Committee of Inquiry into the Banking Crisis**

## **Clarification Statement of**

**Tony Grimes**

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

## Issues Raised by the Inquiry in its letter of 2 October 2015

### Introduction

1. The responses to the first three Witness Questions are contained in my Response to the Statement of Frank Browne dated the 23<sup>rd</sup> October 2015 accompanying this document.

### Question 4

2. I fully agree with Alan Grey's statement that the option of issuing a guarantee arose from extensive analysis by the Department of Finance, the Central Bank and the Regulator. I list below the times and sources of this analysis. The issues of a guarantee was never considered as the 'main' option: it was always expected that the most appropriate policy response would depend on the particular circumstances.

#### *Department of Finance: Financial Stability Issues – Scoping Paper, 24 January, 2008*

3. While the question of ELA is one for the Central Bank, the Minister For Finance could quickly become involved if this became public in order to manage the broader financial stability issue. There could be pressure to give assurances that the State was prepared to support the bank in difficulty or provide guarantees to its depositors (see details of types of guarantee below). If ELA became known to the market it may be necessary, as in the UK, to issue a guarantee to depositors to stem outflows. In circumstances in which the whole financial system is under threat the confidence of the international markets in the Irish system as a whole may be undermined. The evolution of the Northern Rock crisis highlights the case for a pre-emptive response at the earliest possible stage. The implications of various legal issues were to be examined. If a financial institution is considered 'too big to fail', it is likely that the State will intervene in order to maintain

financial stability. When public confidence is low almost any institution could be considered too big to fail. The Central Bank is legally prevented from extending ELA to an insolvent institution so that a State guarantee of its liabilities would be required. Letters of Comfort are not sufficient for the Central Bank; so specific legislation would be required. In order to prevent moral hazard, legislation should be prepared *ex ante* but only enacted when required. But this could cause problems if the time required is short and the Dail is not in session. It should be enough that the Minister announces the intention to provide the required guarantee with the approval of the Dail in due course. Nationalisation was also discussed as an option. This section shows the extent to which guarantees of various sorts were discussed in early 2008.

*Department of Finance Presentation, 8 February 2008 (PAC document 36)*

4. If confidence is fragile then even small institutions could trigger systemic difficulties which suggest that all institutions are too big to fail. But solvency assessment could often be an abstract /contentious exercise reflecting such issues as information gaps and valuation uncertainties, shaped by strict accounting/legal definitions, influenced by market conditions and particular assumptions.
5. While there are risks, it would be prudent to examine some of the lessons from Northern Rock:
  - The announcement of Bank of England support triggered a bank run and risked a systemic crisis;
  - The Deposit Guarantee Scheme (DGS) did not maintain public confidence;
  - It resulted in very substantial exposures (Bank of England loans, HMT guarantees);
  - It highlighted the risk in those circumstances that to maintain financial stability the State is left with no option other than to provide open ended guarantees.

6. The issue is whether the scale of measures adopted by the United Kingdom would be credible in Ireland e.g. the scale of State guarantees. It was agreed that a covert private sector takeover would be preferable, but it was not clear if this was legally feasible in Ireland.
7. Three primary solutions (market based solution, examinership and nationalization) should ideally be available before issues are in the public domain. As a matter of public policy to protect the interests of taxpayers, any requirement to provide open ended/legally binding State guarantees which expose the Exchequer to the risk of significant losses are not regarded as part of the toolkit for successful crisis management and resolution. The Minister for Finance does not have the authority to issue a guarantee and so legislation would be required subsequently. Accordingly, the draft legislation should be prepared.
8. Clarity was required regarding different types of State guarantee, including:
  - Conditional deposit guarantee as in Northern Rock;
  - Guarantee in respect of Central Bank liquidity support. If the institution is insolvent, a government guarantee of the institution's liabilities is required;
  - State guarantee to underwrite a bank's solvency (could only be justified in circumstances in which otherwise the entire financial system is at risk of collapse)

***Department of Finance Presentation, 8 April, 2008 (PAC document 35)***

9. ELA is likely to trigger a requirement for open ended State guarantees and possibly wider systemic problems. Liquidity problems can quickly trigger solvency problems. It is necessary to maximize options for early interventions to pre-empt ELA by which time banks' financial positions are unlikely to be



retrievable. While open ended State guarantees are not regarded as part of the tool kit, there are circumstances where such guarantees may be unavoidable to maintain confidence in the overall financial system. Nationalisation is sub-optimal, but may need to be considered as a last resort to pre-empt a requirement for an extended period of ELA and attempted public market rescue carried out in the public domain.

10. Financial assistance, including guarantees, not provided on commercial terms *prima facie* likely constitute State aid. It is in the interest of the public that the situation is solved before it enters the public domain in order to prevent contagion.

*Paper on 'Crisis Resolution Options' discussed by DSG in mid-2008*

11. This paper considers options in the event of a liquidity crisis. The simplest option is a blanket guarantee of bank liabilities. This would include senior and subordinated debt of all maturities and currencies. The option understates the taxpayer interest concern and also the moral hazard issue. But banks would be able to get term funding. This scheme is easy to implement. However, there are three disadvantages: firstly, the final cost to the taxpayer is not clear, either in the ST or LT; secondly, it could create moral hazard issues in the future, and; thirdly, it would punish banks that were not imprudent in their lending. The paper also considers other options including State funding vehicles for bank liabilities, State vehicles for bank assets, and an actively managed portfolio for bank assets as well as ELA and swap operations. ELA is considered useful as long as the public remain confident in the institution. However, in the event of a run on the institution ELA is unlikely to deal with the underlying problem. If not, ELA will only delay the inevitable.

12. It is clear from the above that the possible issue of a State Guarantee received extensive analysis from early 2008 and that it might be inevitable in the event of a systemic crisis.
13. I disagree with Brendan McDonagh's comment that the guarantee 'almost came out of nowhere'. Both in its role as an advisor to the Department and the fact that the NTMA became part of the DSG framework sometime in the summer of 2008, it is likely that the NTMA would have been exposed to the Crisis Management Options papers which, *inter alia*, examined the role of a guarantee, prepared at that time.
14. Finally, there is a minute of a meeting of 18 September 2008 chaired by the Minister which shows that Mr. McDonogh also attended (PAC document 14). This meeting discussed the possible role of a guarantee.

#### **Question 5**

15. I have no record of the meeting of 24 September 2008 attended by the Minister for Finance, the Department of Finance, the Central Bank, the Financial Regulator and the NTMA. I would have thought that the Department would have been the best source of an account of this meeting.

#### **Clarification of an opinion given at my appearance before the Inquiry on 27 May 2008**

16. During my attendance before the Inquiry on 27 May 2007, I was asked by Deputy McGrath (p. 36), Senator Barrett (p. 42), Senator MacSharry (p. 47) and Deputy O'Donnell (p. 55) about the implications of the unwinding of the contracts for difference relating to shares in Anglo. It is clear from my testimony (p.36) that I had not anticipated this line of questioning. When asked by Deputy McGrath whether it was a significant issue potentially that could affect the stability of the

financial system, I replied that I thought it was. I also stated that the main concern of the Central Bank was the impact of the possible unwinding on Anglo's share price and on the liquidity of Anglo and the other banks. When asked a similar question by Deputy O'Donnell I replied that there might have been stability issues if there was an avalanche of shares put on the market at short notice. I would now like to clarify that when I agreed that there were stability issues, I do not now consider that, while significant, they were likely to have been of such magnitude as to put the survival on the entire domestic banking system at risk. In particular, in the light of the already substantial decline in the value of Anglo's share price, an additional sharp price fall, resulting from the disorderly unwinding of the contract for differences positions, might well be understood by the market to relate to specific Anglo issues and so would be less likely to have a major contagion effect on the other domestic banks.

Tony Grimes  
23<sup>rd</sup> October 2015