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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

John Dunne

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Submission of John Dunne to the Banking Commission

Section 1

Introduction

May I begin by thanking you Chairman, and Committee members, for giving me the opportunity to contribute to your inquiry.

By way of introduction I reference my period of office as Director General of FUE (Federated Union of Employers) later FIE (Federation of Irish Employers) from 1988, and as the first Director General of IBEC in 1992 following the merger of the CII (Confederation of Irish Industry) and FIE. I retired from IBEC in 2000 at age sixty in accordance with the terms of my contract of employment.

At the beginning of 2000 I was appointed to the Board of the IDA and subsequently in June to the position of Chairman, I was re-appointed Chairman in 2005 and retired in 2010.

I believe that my role within IBEC and perhaps more especially in the successful conclusion and operation of the merged organisation was a significant factor in my being asked to join the Board of the Irish Financial Services Regulatory Authority, and subsequently of the Central Bank. My CV did not include any specific banking or financial experience but the challenges and successful outcomes of the creation of IBEC were, I believe, viewed as relevant and useful in what was the decoupling of the regulatory functions from the Central Bank and the Department of Enterprise Trade and Employment and the establishment of the Financial Regulator within the context of the CBFSAI.

The Committee will note my retirement from IBEC in 2000. I was appointed to the Board of the Financial Regulator – the Authority as it was called - as a Non-Executive Director in 2003 and am therefore unable to comment from an IBEC perspective on any of the issues raised in the Committee's terms of reference for my appearance before it. To avoid any misunderstanding on this issue, I confirm I advised the Committee's secretariat of the position immediately on my receipt of the Committee's request for my participation in its work. That caveat excepted, I am anxious to assist the work of Committee in any way I can in the critical national work it is undertaking.

In so doing I wish to make a number of general points. Firstly, I was, as previously indicated, a Non-Executive member of both the Authority of the Regulator and the Board of the Central Bank. I have no interest in seeking to apportion responsibility and/or 'blame' from one organisation to another. Clearly, between these organisations there was a division of responsibilities and there were also 'grey areas' where responsibilities overlapped and /or where outcomes in one organisation impacted on those in the other.

Secondly, and in view of the comments made by another witness to the Committee, I wish to assure members that I have never had any political affiliations and have acted completely independently in my participation in various public sector organisations.

Thirdly, I have never had any connection with banking or financial institutions or anything to do with property interests.

Fourthly, I did not on any occasion discuss the business of the IDA within the CBFSAI or vice versa, other than to note some areas of overlapping interest

The establishment of the CBFSAI

I believe it is relevant to outline some of the issues which impacted on the work of the new organisation. First of all I believe there was a general consensus that emerged amongst Authority members that the construct was flawed and that this had significant negative effects on the operation, in particular, of the Regulator. The Regulator was set up as an independent entity but in certain key respects had 'an umbilical cord' back to the Central Bank. It was housed in the Bank. It had key services, notably HR and IT, provided to it by the Bank. Its remuneration policies were controlled by those of the Bank. Its budget was the subject of consultation with the Bank and required the approval of the Minister of Finance. Cost pressures arose from the operation of the levy which was shared 50% between the Central Bank and the industry. And the staff of the Regulator were mainly drawn from the Central Bank (and in the case of the insurance sector drawn from the Department of Enterprise Trade and Employment). In these circumstances the achievement of real operational independence was a major task.

From the Bank's point of view the main change was a loss of the direct contact in operational areas with financial institutions and its dependence on the Regulator for key information critical to its financial analysis and policy formation. And of course, the new order created grey areas where both organisations may be said to have overlapping responsibilities.

In addition to the above there were policy issues pulling in competing directions. In particular the enhanced consumer protection emphasis, whilst entirely worthy in the overall context, sat somewhat uneasily with prudential regulation and detracted attention and priority from it, particularly in the early stages. There seemed some confusion, certainly externally and indeed in the way the legislation was set up, about the fundamental role prudential regulation had in the overall protection of consumer rights. Another example was the Bank's mandate for the development of the financial services sector and the lack of clarity - notwithstanding the good cooperation and operational M.O.U which existed between the Central Bank and Regulator - over who was responsible for what and, in particular, the underlying division between micro (the Regulator) and macro (the Central Bank) trend analysis, which inevitably overlapped or had significant implications one for the other.

For all these reasons the challenge of building the new body into an effective organisation was always going to be significant. This challenge was made even more demanding for the Regulator by the discontinuity caused by the loss of its initial CEO after only three years and two years later of its Chairman. And of course by the scale of the crisis which later developed internationally and domestically. It was no time for the organisation to be in 'transition' or 'still learning mode'.

The Regulatory System

A critical issue which the Committee has heard about ad nauseam from previous witnesses - particularly from the constituencies of the Bank and the Regulator, and which was fundamental to all that subsequently transpired - was the choice of Regulatory system. It is not my intention to rehearse all the points already made. But I believe it is relevant that at

the formation of the new structure, I can recall no challenge to the adoption by the Regulator of the principles based system. It was in fact already in use by the Central Bank when the new structure was set up and was inherited with the relevant staff by the Financial Regulator. It was consistent with attitudes to good regulation here at the time and was in widespread use internationally. While the role of hard rules was discussed neither I nor, I believe, my colleagues gave serious consideration to replacing the system nor was it suggested that we should. Specific rules were always part of the system and these were added to over time as a result of EU and domestic decisions. The Financial Regulator laid out clearly in its strategy statements that under the system the proper management and control of a financial services provider and the integrity of its systems rested with the Board of Directors and its Senior Management and specified the nature of the monitoring, checks and inspections that the Regulator would undertake.

It was not until the Value for Money Report by the Comptroller and Auditor General in 2007 that internal doubts emerged about the adequacy of the monitoring and inspections being carried out by the Regulator. While agreeing an interim increase in staffing the Board of the Regulator then arranged for a business process review, with a benchmarking of resources with other financial regulators abroad, to be carried out.

There is now no gainsaying, in the light of what happened, that the original principles - cum rules - based system was not adequate and, in any event, had not been implemented intensively or intrusively enough. Regulatory systems internationally have been completely revamped since the crisis. Intensive and intrusive regulation is now the order of the day. The actions of the banks have ensured that this must be the case.

Actions that might have been taken

Various witnesses from both the Central Bank and the Regulator have given detailed accounts of actions which might have been taken and were not, actions which were taken and ongoing problems. I do not believe that I can add to the Committee's knowledge by rehearsing these matters once again.

Unintended Consequences

However, it is I believe also appropriate to acknowledge the very real concern that actions which might have been taken in the case of the Regulator or Central Bank or opinions expressed in the case of the Central Bank's Financial Stability Reports could have had unintended consequences, specifically that they could precipitate the very outcomes in relation to the banking system and the property market which the Regulator or the Bank were seeking to prevent. These concerns were very real in advance of the international crisis that hit us. Even although with the benefit of hindsight it is clear that much more could, and should have been done, these concerns were material in discussions at the time particularly when the consensus amongst domestic and international commentators was for a 'soft' landing. It is worth noting that unintended consequences always have to be part of policy making considerations.

The International Dimension

I have been of the view that the international dimension has not been given sufficient weight in the various inquiries and reports into the crisis and its genesis. This observation is not in any way to diminish the domestic causes which underpinned the situation here in Ireland and which greatly exacerbated our situation in comparison to others. In my responses to the Honahan and Nyberg Investigations, I raised these international issues and the passage of time has not altered the views I expressed to these bodies. I still believe there was a possibility that, without the international financial crises which engulfed us in 2008, a 'soft' landing defined as a 20% (or even slightly greater) reduction in property prices from the peak and a prolonged period of stagnation thereafter may have occurred. The problems in liquidity across the financial markets changed the situation fundamentally. Other witnesses to the Committee have, I believe, made the correct connection between the crises in liquidity dramatically caused by the Lehman's situation, the resultant, to all intents and purposes, closure of the wholesale money markets and the onset of the spectre of insolvency pending fresh injections of capital. The capital requirements which most commentators - both internal and external - believed were adequate in the pre-Lehman's scenario were proved inadequate once the failure of Lehman's happened. All of this was compounded by the almost immediate onset of the recession internationally.

Other Important Matters

There are three issues which have been covered in previous testimony on which my own views as a member of both Boards and as a member of the Budget and Remuneration Committees of the Regulator and Bank may be helpful.

On the issue of contrarian views, I know of no instances where at Board, Authority or Committee levels there was any attempt to shut down such views. On the contrary, every opportunity was provided to Board, or Authority members, to staff presenting at these fora, and to outside consultants presenting reports to be fully forthcoming in whatever views they wished to express. I am not privy to issues of this kind - if there were any - arising below Board / Authority levels.

On the issue of resources, it is a fact that there were cost pressures at work. Within the Central Bank Board, the Department of Finance representative in particular, had quite properly, a keen and continuing interest in this area. So too had the Consultative Panels. In this context the procedures of the Regulator's Budget and Remuneration Committee (BRC) are important to appreciate. The Committee received a draft budget from the Executive compiled from detailed discussion within the various divisions of the Regulator. The proposals were then the subject of rigorous examination by the Committee and discussion between it and the Executive. The outcome was the subject of agreement between the two parties. That outcome was always subject to the requirement that the agreed budget was sufficient for the organisation to carry out its functions and mandate in an efficient and cost effective manner. I was always satisfied that this procedure was sufficiently rigorous to ensure that adequate resources were in place to allow staff to perform the tasks that were asked of them under the system in place at the time. Additionally, as mentioned in other testimony, there were ongoing issues to do with the filling of vacancies by the Central Bank's HR department and the fact that, despite the best efforts of the Authority, full complement of agreed numbers was never reached. This would of course have reflected in part the strength of competition for staff in the strong economy as well as pay constraints in the Bank. And finally on this topic

it should be noted that the BRC and subsequently the Authority as indicated earlier approved of and commissioned an outside review of the resource issue conducted by Mazars aimed at benchmarking staffing levels and skills in the Regulator against those of regulators in other countries and identifying gaps in the efficient use of resources and correcting these so as to help apply existing resources in a much more effective manner.

Finally in regard to the operation of the Authority and Central Bank Board, as a Non-Executive Director I believe both operated well and to their respective remits. I agree that although a number of the Non-Executive Directors had significant banking and/or financial skills and experience there was a case for more specialist input including international banking expertise on the Authority itself (and indeed also in the Bank's Board). This lack of such expertise was perhaps a hindrance in the ability of the Authority to engage fully with the Executive in the detailed way that was necessary particularly as regards the interrogation of credit risk data and the proper interpretation of such data. The main lack, however, was that although in the vast majority of cases the right questions were asked the Authority should have pushed the Executive much more forcefully for outcomes in the face of prolonged obfuscation from some institutions.

I now address the lines of enquiry indicated by the Committee.

Section 2

Lines of Enquiry

R.I.C Appropriateness of the Macro Economic and Prudential Policy.

During the period in question the Government was, generally, following a pro-cyclical economic policy. There was significant growth continuing over a prolonged period and claims from many quarters for actions whose effects would have been to further fuel expansionary tendencies. Low interest rates – a major problem for Ireland - were a function of the stance of the ECB.

Against this background the Macro Economic and Prudential policies advocated by the Central Bank and which formed an important 'conditioning' environment for the Regulator whilst cautionary were generally optimistic.

Overall these policies whilst recognising and publicly pointing to a variety of risks nevertheless consistently pointed to a 'soft landing'. The vehicle used was through the Central Bank's Financial Stability Reports. Here the Bank was confronted by the dilemma mentioned in the introduction to this opening statement – that of triggering events which it was actually seeking to prevent.

The process as I understood it was for the FSR's to be developed by the appropriate units within the Bank. Discussion would follow with the joint participation of the Financial Regulatory Authority and the Central Bank Board.

Final editing was undertaken by the Governor of the Bank and the reports were 'nuanced' to reduce the risk of unintended consequences but without changing their substance.

In hindsight it is clear that from 2005/2006 onwards the policies being pursued were not appropriate to the situation which was developing, and understated the underlying risks in

the growth of credit and related matters. Measures were taken by the Regulator but were not sufficient.

Prudential policy generally used the same assumptions of a soft landing. However, the Authority did introduce capital requirements in 2006, although these had only limited effect in slowing things down. So, whilst this was the correct Prudential policy, it was, as noted by others, too little too late.

R.2. (6) Nature and effectiveness of the operational implications of the Macro Economic and Prudential Policy.

Overall the thrust of the Financial Stability Reports was that the banking system was sound. They acknowledged that while there was significant risks in relation to certain key areas – such as has already been noted in the rate of increase in credit growth and major problems arising from distortions in the property market- the capital position of the system as a whole, and of individual banks, was at a level which could cope with these concerns.

In his evidence the then Governor outlined the range of considerations which in the Bank's view would keep the situation under control. He also set out a number of factors which subsequently altered the scenario originally envisaged, not least the international liquidity crisis and subsequent recession, and rendered the actions inadequate. With hindsight it is clear much stronger action was needed.

R.4.a. Appropriateness of the expert advice sought: quality of the analysis of the advice; and how effectively, the advice was used.

Throughout my period in office a range of external consultancy advice was sought to augment resources.

Those in which I was most involved were the Mazars report on business process, resource benchmarking and the efficient use of resources and the PwC report commissioned in the aftermath of the September 2008 Guarantee into the position of the main Banks at that time.

In both these cases it was clearly appropriate that such advice be sought. In the Mazars case issues around resource levels and allocation and the possibilities for greater effectiveness were I believe self-evident from the earlier discussion relating to staffing levels in the Regulator. The quality of the exercise was I believe at a high level, relevant and based on sound analysis.

Insofar as the PwC exercise was concerned this was clearly necessary in light of the Guarantee. PwC had a large team working on the issues involved.

I have no reason to believe that the assignment was carried out in anything but an extremely professional manner. However the outcome – notwithstanding many caveats – was that the Banks were at that specific point in time adequately capitalised and that they would continue to be in the short term. This conclusion was relied upon by the Regulator as a key indicator of the health of the system at the time. The detailed views of the Bank and Regulator on the P.W.C report were supplied to the Minister of Finance.

R.7.A Assessment of what has been done, Work in Progress and what remains outstanding from previous reports.

Since I retired from any association with the Regulator/ Bank in July 2010 I cannot really comment on this heading. From the outside however it seems much progress has clearly been achieved. There have been major developments in relation to stability oversight and regulatory

systems, and a much more intensive and intrusive approach to the detailed business of regulation together with greatly enhanced staffing levels.

C.4.e Cost of the Crises and sharing of the impact.

I accept the estimate of the cost of the crises made by the current Governor of the Central Bank.

The indirect costs are impossible to calculate in financial detail at this stage but perhaps of more importance are the social implications of the crisis and the acute personal distress which so many people have endured.

It is not clear to me what alternatives existed for sharing the impact of the crises consistent with the need to restore soundness to the financial system, and to promoting renewed growth in the economy with its vital social consequence of rebuilding employment levels.

C.6.d. Role and Influence of the ECB.

This is clearly an issue of substance but I can add little to the sum of knowledge already available.

From an operational standpoint the views of the ECB were clearly relevant to our own Central Bank. The ECB's role in providing E.L.A was obviously critical and positive.

The 'political' issues continue to be the subject of debate.

C.7.a Options for burden sharing.

The options under this heading have also been the subject of intense debate. It seems correct that all practical options be considered and I believe this occurred. Again these are matters which are primarily in the political domain and which I understand are still being actively pursued.

In Conclusion

Finally I should say that I fully accept my own personal share of responsibility and accountability for the events which occurred during my time in office as a Non-Executive Director. I fully acknowledge that whilst I contributed to the best of my ability to the Regulatory Authority and the Board of the Central Bank, in hindsight key issues were missed and I shall be ever mindful of the consequences of this. As mentioned earlier the damage caused to the social fabric of the nation and to individuals has been immense and is a matter of enormous personal regret.