

**MISJUDGING RISK: CAUSES OF THE SYSTEMIC
BANKING CRISIS IN IRELAND**

**REPORT OF THE COMMISSION OF INVESTIGATION
INTO THE BANKING SECTOR IN IRELAND**

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Executive Summary

Introduction

Systemic financial crises, like the recent Irish one, require a great number of institutions, enterprises and individuals to simultaneously follow unsound policies or practices. Each one is, of course, responsible for their own actions and inactions contributing to the accumulation and realisation of risks in financial markets. Nevertheless, responsibility for such a crisis is likely to be widely distributed. The Commission has, in keeping with its Terms of Reference, evaluated how various institutions contributed to the Irish financial crisis.

This Report explores what the Commission considers to be the most important policies, practices and linkages that contributed to the financial crisis in Ireland. A very large amount of documentation was analysed and many relevant people were interviewed. In explaining the simultaneity of the failures in Irish institutions, the Commission frequently found behaviour exhibiting bandwagon effects both between institutions (“herding”) and within them (“groupthink”), reinforced by a widespread international belief in the efficiency of financial markets. Based on this, the Report finally offers some lessons that could help avoid future similar occurrences in Ireland and elsewhere.

Much points to the development of a national speculative mania in Ireland during the Period, centred on the property market. As in most manias, those caught up in it could believe and have trust in extraordinary things, such as unlimited real wealth from selling property to each other on credit. Even obvious warning signs went unheeded in the belief that the world had changed and that a stable economy was somehow automatically guaranteed. Traditional values, analysis and rules could be gradually less observed by the banks¹ and authorities² because their relevance was seen as lost in the new and different world. When it all ended, suddenly and inexplicably, participants had difficulty accepting their appropriate share of the blame for something in which so many others were also involved and that seemed so reasonable at the time.

Preconditions for the Crisis

The international developments that facilitated the excesses in Ireland have been exhaustively documented in previous scoping reports. Entry into the euro area markedly reduced Irish interest rates. Banks had increased access to market funding, where cheap and abundant credit was already available owing to monetary policies in major countries as well as the increasing use of securitisation.³ Globalisation of markets and EU membership increased foreign competition in the Irish financial

¹ Throughout this report the term ‘bank’ will generally be used to refer to both banks and building societies and should be construed as such.

² Throughout this report the term ‘authorities’ will be used to refer to the Irish Financial Services Regulatory Authority (the Financial Regulator), the Central Bank of Ireland and the Department of Finance or to any one or combination of these.

³ The practice whereby banks sold off their loans to investors (often non-bank financial firms) by creating a security with these loans as collateral. The proceeds could then be used for providing additional loans that, in turn, could be securitised. Since banks but not the investors needed minimum capital, the same capital base could be used for substantially greater lending than before.

market, putting pressures on bank margins. A number of new, potentially high-risk retail products were introduced to the Irish market by new entrants (for example, tracker mortgages, 100% mortgages for first-time buyers). Last but not least, the paradigm of efficient financial markets provided the intellectual basis for the assumption that financial markets, left essentially to themselves, would tend to be both stable and efficient.

International developments, however, did not in themselves cause the crisis though they helped precipitate it. The problems causing the crisis as well as the scale of it were the result of domestic Irish decisions and actions, some of which were made more profitable or possible by international developments. Though eventually unsustainable financial risks were made attractive by outside factors, there simply was nobody abroad forcing Irish authorities, banks or investors to accept such risks. The way Irish households, investors, banks and public authorities voluntarily reacted to foreign and domestic developments was probably not very different to that in other countries now experiencing financial problems. However, the extent to which large parts of Irish society were willing to let the good times roll on until the very last minute (a feature of the financial mania) may have been exceptional.

Contagion

The willingness of banks to accept higher risks by providing more and shockingly larger loans primarily for commercial property deals was an important reason for the gradual increase in financial fragility in Ireland. This willingness occurred because of the emergence of strong foreign and domestic competitors within both the residential and commercial property lending markets. By mid-decade, Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS) were growing strongly on the basis of relationship banking, providing loans to a limited number of entrepreneurs operating in the riskier parts of the property market. Anglo in particular was widely admired domestically and abroad, and lauded (by many investors, consultants, analysts, rating agencies and the media) as a role model for other Irish banks to emulate.

This seems to have led to a gradual adoption of lower credit standards by a number of Irish banks (and it appears to the Commission that this was also the case for foreign-owned banks, as evidenced by reported losses) as a method to sustain market share and profitability. In some covered banks this strategy was consciously adopted by the board and was properly delimited. In other banks, boards seem to have simply decided on higher target growth rates, with little apparent realisation of the attendant risks; implementation (and risk policy) was implicitly left to staff.

Bank loans seem to have expanded so rapidly because neither banks nor borrowers apparently really understood the risks they were taking. Many banks were increasingly led and managed by people with less practical experience of credit and risk management than before. Property-related lending was seen as “really the only game in town” for growth-oriented banking. The purchase of second or more properties by individuals was seen as “a no-brainer”. Rapid loan growth could not be funded by retail and corporate deposits; consequently, banks turned to the wholesale market.

The long upswing in the property market, accompanied by relentless media attention, eroded the risk awareness both of banks and their customers in Ireland. Banks, citing the long sequence of good years,

generally saw little problem in expanding their lending by allowing credit quality and risk management to gradually erode. Likewise, households and investors had seen their incomes and wealth increase markedly for a number of years; easy access to credit further encouraged belief in a never-ending boom. In essence, both sides of the market assumed that the other side knew what it was doing. This helped ensure continued growth, profitability and funding in the market in the short term. However, this also meant that risk-related brakes on the growth of credit and leverage were weak and were growing weaker over time.

As banks increasingly funded the apparently profitable property market, a widespread and accelerating credit-financed boom in residential and commercial property developed from the first half of the decade. A self-reinforcing spiral developed: higher prices and values caused increased speculative buying of housing and land; evaluators based their estimates on these higher prices; this increased the demand and collateral for bank lending, which in turn raised prices as more funding was provided. This development ended as housing prices reached their peak at the end of 2006 and construction in early 2007. Furthermore, as bank funding dried up, the credit-driven property development sector started to experience liquidity problems. From then on, the link between property prices and funding accelerated the downturn and reduced banks' perceived creditworthiness, particularly as international accounting standards had prevented more prudent provisioning for possible future losses during the growth phase of the cycle.

Consensus

A majority of the people interviewed by the Commission indicated that they saw no major problems except lack of liquidity until the end of 2007, at the earliest, and autumn 2008, at the latest. The reasons given were usually very similar, the most prevalent being: property prices in Ireland had never decreased markedly; everybody expected a "soft landing" at worst; loan portfolios appeared sound; property credits were diversified by country or county or class; peer banks abroad did the same thing; and "nobody told them" there was a potential problem.

A minority of people indicated that contrarian views were both difficult to maintain during the long boom and unhealthy to present to boards or superiors. A number of people stated that had they implemented or consistently supported contrarian policies they may ultimately have lost their jobs, positions, or reputations. Other signs were also noted pointing to sanctioning of diverging or contrarian opinions as well as self-censorship because of this. The apparent strength of these expected sanctions is difficult to judge, but the absence of opposition, barring only a handful of identified vociferous contrarians, may have made it easier for institutions to accept toning down the application of vital, tried and traditional prudential practices.

The Commission suspects that this conformity of views and self-limitation of responsibility would have tended to reduce the perceived need for monitoring, checking and thinking about what was really going on. There would have been little appreciation – both domestically and abroad – of the fact that Irish economic growth and welfare increasingly depended on construction and property development for domestic customers, funded by a growing foreign debt.

The Commission considers that this pervasive pressure for consensus may explain why so many different parties in Ireland simultaneously were willing to adopt specific policies and accepted practices that later proved unsound. At the same time, the apparent consensus of banks and authorities around the view that markets remained sound and prospects remained positive gave further comfort to both. A number of banks essentially appear to have followed the example of peer banks in a “herding” fashion; there is little evidence of original critical analysis of the advantages and risks of the policies. Widespread lack of critical discussion within many banks and authorities indicates a tendency to “groupthink”; serious consideration of alternatives appears to be modest or absent. A tendency to favour silo organisation and submissiveness to superiors strengthened this effect, particularly among the public authorities.

In designing the constraints and rules for banking in the future, full account will need to be taken of the failure of private and public institutions to appreciate the emerging risks and to take action. If responsible authorities are affected by the prevailing paradigms, they cannot be expected to uncover its risks and weak points. Financial systems should, in that case, be designed to be as stable as possible even in the absence of unfailingly vigilant and prescient regulators and central banks.

Flawed lending: Anglo and INBS

Anglo and to a much lesser extent INBS are important for the wider crisis because they were both seen as highly profitable institutions to which other Irish banks should aspire. As other banks tried to match the profitability of Anglo in particular, their behaviour gradually, and even at times unintentionally, became similar. Accordingly, when the crisis broke, large losses were realised not only in Anglo and INBS but in other banks as well.

Contrary to public perception at the time, lending at Anglo and INBS had proceeded with insufficient checks and balances during the Period. Relationship lending, high-growth strategies and rapid credit decisions meant that their balance sheets increased as the projects of preferred customers grew. Traditional risk evaluation procedures and risk mitigants were not implemented in practice. Additionally, these banks were very dependent on wholesale funding due to their rapid asset growth and a lack of sufficient growth in customer deposits. As wholesale funding tends to be much more volatile than customer deposits, they were particularly vulnerable to any doubts regarding their own solvency or that of their borrowers.

Governance at these banks also fell short of best practice. While procedures and processes in Anglo existed on paper, in certain cases they were not properly implemented or followed in practice. It appears that, at least in the latter years, only a handful of management was aware of all activities of the bank. At INBS, a number of essential, independent functions either did not effectively exist or were seriously under-resourced.

The Financial Regulator(FR) was clearly aware of many of these problems in the two banks. Prior to the commencement of the Period, and consistently throughout, it raised significant concerns regarding governance at INBS. It also submitted a comprehensive list of procedural and portfolio problems to Anglo. It furthermore raised minimum capital ratios for both banks. However, such remedies did not prove effective to ensure sufficiently greater prudence and accountability in either of the banks. The

system-wide increase in capital charges on certain property loans in 2006, while appropriate in principle, proved too modest in a situation where property lending appeared hugely profitable.

As a result, to outsiders, the two banks may have appeared to operate in ways broadly acceptable to the FR. This may have increased their importance as role models for other Irish banks. It must also have given comfort to leadership in the two banks themselves and encouraged them to continue with these practices.

The Herd: Other Banks

Bank management and boards in some of the other covered banks feared that, if they did not yield to the pressure to be as profitable as Anglo, in particular, they would face loss of long-standing customers, declining bank value, potential takeover and a loss of professional respect. The few that admitted to feeling any degree of concern at the change of strategy often added that consistent opposition would probably have meant formal or informal sanctioning.

Bank management and boards generally gave in to this pressure, in the bigger banks more so than in the smaller ones. Strategies chosen included concentration on retaining market share, increasing earnings growth and protecting the banks' franchise. The implementation of these strategies as well as comprehension of what they meant for the bank's risk profile varied between institutions. At their most prudent, limits were placed on credit volume to riskier markets and customers were selected based on prudential characteristics. At the other end of the scale, boards adopted general high-growth credit volume or profit targets without apparently really understanding how they would be implemented in practice by staff. It seems to have been quite generally accepted that – traditionally volatile – market funding would continue to be available to enable the achievement of growth targets. The relative level of prudence of the banks, on both the asset and liability side of the balance sheet, was eventually reflected in the extent of the losses suffered by each institution.

Unfortunately, in many cases the documentation of discussions among board members over the Period was, in the view of the Commission, insufficient. A number of members interviewed indicated a strong preference for consensus on boards as well as among managers. It appears to have been difficult for individual members, especially those without banking experience, to express and maintain a view contrary to the majority view on the board. In some cases, members indicated that their approach was to initially register their opposition to a particular decision, but to then adopt the majority view. Contentious issues or strategies were, probably also in the interest of efficiency, seldom revisited unless it was jointly agreed to do so. Over time, managers known for strict credit and risk management were replaced; there is no indication, however, that this was as a result of any policy to actively encourage risk-taking though it may have had that effect.

In addition, there were some indications that prudential concerns voiced within the operational part of certain banks may have been discouraged. Early warning signs generated lower down in the organisation may in some cases not have reached management or the board. If so, the pressure for conformity in the banks has proven to be quite expensive.

The Silent Observers: External Auditors

The auditors, like other professionals in the banks, had the skills, opportunity and procedures required for detecting and evaluating asset and funding risks. While not working full-time in banks, by long tradition auditors have full access to bank documentation and pronounce on the accuracy of the historic accounts on the basis that the bank will remain solvent a year forward. Within their specific remit auditors provide often voluminous reports to their clients.

Auditors have a number of ways to inform bank leadership of any concerns. In addition to the public audit opinion they give the Audit Committee a more detailed report on their findings on the business and provide a letter setting out any weaknesses identified in the bank's reporting systems. They are also required to provide the FR with copies of these reports. Auditors' commentary, however, regularly focuses only on issues which they consider relate to the accuracy of the historic accounts. In practice, this means that auditors look primarily backwards and at technical issues that may influence the accuracy of the accounts. Nevertheless, auditors are also required to assess whether a bank will remain a going concern for the next year; this seems to require them to make a judgment on at least the short-term sustainability of the bank's business model and strategy.

The auditors clearly fulfilled this narrow function according to existing rules and regulations. They did not, however, generally report excesses over prudential sector lending limits to the FR. Even if they had, it appears unlikely that anything would have been done about it as in general the FR was already aware of such limit excesses.

A judgment on whether the bank is a going concern for the next year would appear to depend *inter alia* on the quality of governance in the bank. It might be reasonable to argue that a bank's governance and procedural problems may, over time, be reflected in the quality of its loan book or in the stability of its funding, particularly when inherent risks in these are growing rapidly. For banks, closure usually comes because liquidity dries up; only later may it turn out that the bank's assets also are impaired and have caused its creditworthiness to decline. It may be difficult to accurately judge exactly when this occurs. In fact, this is what happened in Ireland, where banks had to be rescued from closure by the Government Guarantee in some instances not more than six months after being given clean audit opinions.

The problems in the Irish banks were building for several years before the crisis. These were problems of credit quality, sustainable lending practices and adequacy of internal procedures; they were not generally operational problems related to the IT systems or the mechanics of loan documentation. Auditors, therefore, did not feel that commenting on the implications of such business model problems fell within their proper remit. In fact, it may be questioned whether they even saw them as problems since very few others appear to have seen them either. On these issues, they appear generally to have stayed silent.

The problem of clean audits followed by a threat of closure a short time later is not new nor is it limited to Ireland. As a result of the global financial crisis several initiatives are under way to explore ways of making audits conform to the "watchdog" expectations which are both in the market and among the

public. It would be useful if the Irish authorities, building on their own experience, would take an active role in these deliberations.

The Enablers: Public Authorities

The Central Bank (CB) and the FR noted macroeconomic risks and risky bank behaviour but appear to have judged them insufficiently alarming to take major restraining policy measures. Among all the authorities a very limited number of individuals, either in boards or among staff, saw the risks as significant and actively argued for stronger measures; in all cases they failed to convince their colleagues or superiors. Thus the authorities largely continued to accept the credit concentration in the property market and avoided forcing action on the failings in the banks. The Government actively supported the market over an extended period against the apparently fairly weak but clear opposition of the Department of Finance (DoF).

The CB had a pivotal position, itself contributing to overall financial stability and being able to direct the FR. In the view of the Commission, macroeconomic developments were already exhibiting signs in 2005-2006 that reasonably should have caused concerns in the CB. However during the Period in question, it did not take forceful measures but largely confined itself to providing reminders of existing risks. This did little to alert banks or other authorities to the growing foreign debt or to potential stability risks from the property boom and the overheating economy. The need to avoid spooking the market appears to have been an increasingly common reason to do and say little; however, this cannot explain the lack of clear confidential warnings to other authorities. There may have been a state of denial in the CB; warnings of stability risks appear to have been sidestepped internally or, when made public especially in the Financial Stability Reports, toned down in the policy conclusions. Trust in a soft landing was consistent and, though not very well founded, continued up until and including the crisis management phase of the Period.

The CB was not powerless; it had the right to direct the activities of the FR and it could advise the Government. There are, however, no records of such direction or advice or even efforts at such. These institutions worked separately and their respective independence was repeatedly stressed; however, this was counteracted by their partly common board members. Until the crisis, many of the staff of the CB and the FR apparently did not cooperate in a sufficiently meaningful way in assessing financial stability. This, together with the determined optimism and caution of senior management, may help explain why so few staff were seriously concerned about stability issues at the time. It appears that each of the authorities ultimately assumed that the other conscientiously fulfilled its prudential tasks. Thus, less was done than either of them assumed.

The problems in Anglo and INBS in particular, were not hidden but were in plain sight of the FR and the CB. The funding strategy of Anglo was obvious from its balance sheet and the concentration to the more speculative part of the market was generally known. Similarly, INBS's expansion into development lending was also clearly documented and the governance problems in the bank were widely known by the authorities. While these issues were repeatedly addressed by the FR, only modest results were eventually achieved as their later losses indicate. While the poor state of loan documentation in INBS and insufficiency of collateral in both would have required closer inspection, such information was readily available to the FR. Had they considered it necessary or appropriate, there

was sufficient information to have allowed the authorities to take more decisive action than was the case.

Surprisingly, since the FR saw itself as regularly meeting with the banks, interviewed bank management and board members could not recall any meaningful engagement with the FR on prudential issues (except technically, as part of the Basel II process).⁴ According to bank management, prudential issues were tick-the-box checks that formal procedures were in place, not checks on how they worked in practice. On the contrary, when prudential sector concentration ratios were exceeded, the FR did nothing to demand any limitation in risk exposure despite being fully informed. The FR's passiveness with regard to sanctioning, as a matter of urgency, the weaknesses in governance and risk management in Anglo and INBS has been set out above. Consumer issues were exhaustively, publicly and actively dealt with by the FR, however.

The DoF and the Minister for Finance were regularly provided with a Financial Stability Report, officially jointly written by the CB and the FR. In practice, the FR appears to have participated primarily at board level.⁵ The report occasionally made reference to the frothiness of the Irish property market but did not explicitly infer serious risks to the banks from this emerging bubble. The banking sector considered the overall tenor of the report to have been benign and comforting. Being conscious and supportive of the independence of both the CB and the FR, the DoF provided very little comment or input to this process,⁶ nor did it assess how they fulfilled their duties until very late in the Period.

Neither the CB nor the DoF seem to have considered the implications of a possible interruption in the flow of foreign funding. If such a scenario had been considered, the link between such funding, property market developments and bank solvency could perhaps have been uncovered.

Generally, international organisations (IMF, EU, and OECD) were, at most, modestly critical and often complimentary regarding Irish developments and institutions. This gave the authorities and the banks additional reason to assume that all really was well. Domestic doubters were few, late and usually low-key, possibly because it was thought that expressing contrarian views risked sanction; in addition, a long period of good times had reduced the numbers of those willing to continue to go against the prevailing and apparently proven consensus.

⁴ Given that the FR did send post-inspection letters to banks requiring serious action, this view is difficult to explain. In one late case, it appears that the letter was not distributed to the Board. In other cases, it may be that FR contacts were made by "too low-level" officials or that the issues were seen as technical rather than strategic in importance. Finally, it may be that issues that the senior FR officials considered substantive in a prudential sense were seen by bankers as formal or technical only.

⁵ This was explained to the Commission as the combined result of *inter alia* bad relations at times between leadership and staff in the two institutions, time constraints by regulatory staff, the lack of economics skills in the FR and difficulties in achieving mutual comprehension (the different professional languages of economists and accountants). To the Commission it seems that this lack of cooperation is stemmed largely from lack of leadership at various levels in both institutions. Cooperation problems may have been compounded by a solid lack of understanding of stability issues at most management levels.

⁶ The Secretary General would provide comments as a member of the Board of the CB. His membership could, for its part, possibly also reassure DoF staff that the CB and, to the extent that stability issues were raised by the FR at the CB Board, that also the FR was doing an adequate job.

Policy with Insufficient Information: the Guarantee

The lack of suspicion and the absence of sufficient information on the underlying quality of the banks' balance sheets is likely to have had a significant impact on the alternatives that were considered reasonable on September 29, 2008. Proper information is a precondition for any crisis management based on reality. As it turned out, decisions were made on the erroneous assumption that all banks were and would remain solvent. Only on that assumption could the decision to simply provide a broad guarantee be understood.

Given the information available and the imminent liquidity problem at the time, the Commission understands the pressing need to ensure access to liquidity for the banks the next morning. The broad and legally binding guarantee did, however, represent a considerable risk to the sovereign in the case of any negative surprises. Moreover, there appears to have been some market perception that Irish banks were excessively exposed to the property market and the consequent risk of bad debts. It could, therefore, have been useful to consider using other available financing for a few days, using the time to assess ways of limiting the Guarantee and to urgently scrutinise the state of some banks. Given market sentiment at that time, however, the risk of further destabilising the situation would have been substantial. In any case, whilst alternative forms for the Guarantee were contemplated, they were not seriously considered since they, in the judgment of the authorities at the time, posed greater risks than benefits.

If accurate information on banks' exposures had been available at the time it seems quite likely to the Commission that a more limited guarantee combined with a state take-over of at least one bank might have been more seriously contemplated. Indeed, on the basis that such information had been available, banks could have been directed to raise substantially more private capital well before end-September 2008. As it turned out, however, the Government was advised that banks' insolvency risks were small relative to liquidity risks and it was eventually decided not to consider nationalisation. This proved to be only a temporary reprieve, however. After a series of insufficient government actions and initiatives, Anglo was nationalised on January 19, 2009 following the disclosure of significant governance failings. Shortly afterwards, the solvency implications of several banks' excessive property exposures started to emerge.

Some Lessons

Since the international financial crisis started, regulations have been tightened and institutional arrangements changed both in Ireland and in a number of other countries. A large number of groups, both national and international, have provided insightful analysis and recommendations on how to enhance the prospects for financial stability.

It is not the intention of the Commission to insert this Report into that wide arena. However, the Commission's work has highlighted some potential lessons from the banking crisis in Ireland that appear relevant from the point of view of reform; it seems only reasonable to offer them for potential wider consideration.

A main lesson is the need to make sure, both in private and public institutions, that there exist both fora and incentives for leadership and staff to openly discuss and challenge strategies and their

implementation. It must become respectable and welcome to express professionally argued contrarian views; neither this crisis nor many others have been or will be foreseen by the consensus view of professionals or managers. One way might be to regularly assess “worst case” scenarios relating to proposed strategies and forecasts, with a strong emphasis on using historical and international experiences. Additionally, lower-level staff could be more frequently consulted on implementation issues and their implications.

To help promote an even greater awareness of risks, such analyses need to be shared with all relevant parties; while this should lead to remedial action it need not, however, necessarily require open public discourse. In part because they must form a view on banks’ financial sustainability, bank auditors should have a regular, compulsory dialogue with its client’s senior management and boards on the bank’s business model, strategy and implementation risks. The result of such discussions should also, at least when clearly relevant, be communicated to the FR.

Furthermore, authorities as well as bank boards and management need to remain particularly vigilant and professionally suspicious during extended good times. Nevertheless, history indicates that this is unlikely to be the case, in practice, for a number of reasons. Thus, it seems unlikely that regulatory or governance reform alone will prevent a future crisis. This argues for structural changes in the banking sector, appropriately reducing and delimiting at least the part of the banking system that may be subject to the various types of government support. The economic size of the country and the sovereign as well as moral hazard considerations should affect the extent of such constraints. In addition, in order to slow a renewed “procedures creep”, banks should consider establishing internal, hard voluntary lending limits which they would make difficult to change or circumvent.

Also, the selection of management and board members in both responsible authorities and banks may need even more attention than before. It is the impression of the Commission that long, preferably practical, experience in financial markets has a tendency to promote not only competence but also financial prudence. Banks might do well, in the long run, to ensure that their senior management has, or at least has close access to, extensive lending and risk management expertise; more banking experience in boards would also prove useful. Authorities might also do well to make even greater use of experienced practitioners, domestic and foreign, in various roles.

Additionally, cooperation between all relevant authorities needs to become less formal but more comprehensive and should include professional staff. While accountability requires clarity on who makes a decision, the need for good decisions would seem to require regular, open, professional and constructive discussion among all relevant institutions. In that regard, much remains to be done in Ireland and elsewhere. For instance, it seems particularly vital to urgently and substantially increase staff with financial market expertise in the DoF for it to be able to actively fulfil its part of the stability mandate, including cooperating closely and professionally with the CB and internationally.

Finally, it appears to the Commission that little seems to argue against policies to markedly limit (even properly structured) bonus and pay for management in both banks and authorities, in Ireland and internationally. A consistent message of the bankers interviewed by the Commission has been that money is only part of their work incentive. For people serious about professional public service, money should be even less of an incentive.

ABBREVIATIONS

AIB	Allied Irish Bank
Anglo	Anglo Irish Bank
ALCO	Asset and Liability Committee
BoI	Bank of Ireland
C&P	Construction and Property (Sector)
CB	Central Bank of Ireland
CBFSAI	Central Bank & Financial Services Authority of Ireland
CEBS	Committee of European Banking Supervisors
CFD	Contract for Difference
CRO	Chief Risk Officer
CSO	Central Statistics Office
DOE	Department of Environment , Heritage and Local Government
DSG	Domestic Standing Group
EBS	Educational Building Society
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
ESRI	Economic & Social Research Institute
EU	European Union
FR	Financial Regulator
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Programme
FSR	Financial Stability Report
GDP	Gross Domestic Product
GNP	Gross National Product
HBOS	Halifax Bank of Scotland
IA	Internal Audit
IAASA	Irish Auditing and Accounting Supervisory Authority
IAS	International Auditing Standards
ICAI	Institute of Chartered Accountants Ireland
IFRS	International Financial Reporting Standards
IFSC	International Financial Services Centre
IL&P	Irish Life and Permanent
IPD	Investment Property Databank
IMF	International Monetary Fund
INBS	Irish Nationwide Building Society
IT	Information Technology

LTC	Loan-to-Collateral
LTV	Loan-to-Value
MIS	Management Information Systems
MTR	Medium Term Review
NAMA	National Asset Management Agency
NED	Non-Executive Director
NPRF	National Pensions Reserve Fund
NTMA	National Treasury Management Agency
OECD	Organisation for Economic Cooperation and Development
ONS	Office of National Statistics (UK)
PwC	PricewaterhouseCoopers
RBS	Royal Bank of Scotland
QEC	Quarterly Economic Commentary
SI	Statutory Instrument

Chapter 1- Mandate, Method and Background

1.1 Mandate

- 1.1.1 On September 21, 2010 the Government established a Statutory Commission of Investigation into the Banking Sector in Ireland, under the terms of Section 3 of the Commissions of Investigation Act, 2004 (the Act). A copy of the Order establishing the Commission, S.I. No. 454 of 2010 (as amended by S.I. No. 590 of 2010), which sets out its Terms of Reference, is at Appendix 2.
- 1.1.2 The Commission's mandate concerned the period 1 January 2003 to 15 January 2009 (the "Period"). The Report aims to provide answers on why a number of institutions, both private and public, acted in an imprudent or ineffective manner, thereby contributing to the occurrence of the Irish banking crisis.
- 1.1.3 The Commission was given substantial freedom to decide on its methodology. It was given six months in which to prepare its report. Six covered institutions were examined as well as three public authorities.⁷ While well aware of the covered institutions' lending activities abroad, the Commission concentrated its work on their activities in Ireland.

1.2 Previous Scoping Studies

- 1.2.1 The Commission was free to rely on the information and findings contained in two earlier scoping reports commissioned by the Minister for Finance. The report of Klaus Regling and Max Watson⁸ deals with macro-economic developments internationally and in Ireland, as well as monetary and fiscal policies in the period leading up to the crisis. The report by Governor Patrick Honohan⁹ concentrates on the role of the authorities (the Financial Regulator (FR) and the Central Bank (CB)) in relation to regulatory and financial stability policy prior to the crisis, as well as the events leading up to and surrounding the Government Guarantee decision of September 29, 2008.
- 1.2.2 Both of these reports noted the need to understand the failures in the management and operations of Irish credit institutions which led to the crisis. The Honohan report also suggested that the role of audit and accounting bodies was worthy of investigation.

⁷ Postbank Ireland Limited was a "covered institution" for the purposes of the Credit Institutions (Financial Support) Scheme 2008, which came into effect on 30 September 2008 and expired on 29 September 2010. However, the Commission decided not to examine it for several reasons: it existed only from April 2007; it only accepted deposits and did not lend into the Irish market; it did not receive substantial exceptional financial support from the State; and it is not part of the Eligible Liabilities Guarantee Scheme that was introduced in December 2009. Furthermore, as at 31 December 2010 it ceased trading and closed all accounts. Therefore it was decided that it would not be worthwhile reviewing its policy and procedures.

⁸ Klaus Regling & Max Watson: *A Preliminary Report on the Irish Banking Crisis*, May 2010

⁹ Patrick Honohan: *The Irish Banking Crisis and Regulatory and Financial Stability Policy 2003 – 2008; a Report to the Minister for Finance by the Governor of the Central Bank*, 31 May 2010.

- 1.2.3 The Commission could, by and large, take as given a substantial part of the analysis presented in the two previous scoping reports; in particular, it has avoided duplicating similar material as much as was feasible. It also notes that the issues identified as needing further clarification are, in all essential respects, included in the Commission's Terms of Reference.
- 1.2.4 Both reports agree on the failure of both the FR and the CB to foresee or prevent the financial crisis. The report by Regling & Watson, besides highlighting the importance of international developments and fiscal policy, stresses the role and activities of the FR. It was unclear to the authors what the FR knew and when, and also why the supervisory response was not more forceful. The Honohan report addresses this aspect as well, emphasising the way in which the principles-based approach to regulation was implemented. It also notes and discusses the modest policy activity of the CB despite its responsibility to promote the overall stability of the Irish financial system.
- 1.2.5 Furthermore, the two scoping reports indicate that financial institutions did not adhere to sound practices. Explanations of these failings are offered - among them lack of will, insufficient understanding or lacking resources as well as competitive pressures. The Commission largely supports these explanations but is not fully convinced that they are sufficient; in particular, they do not explain the simultaneous occurrence of the failures in the various institutions.

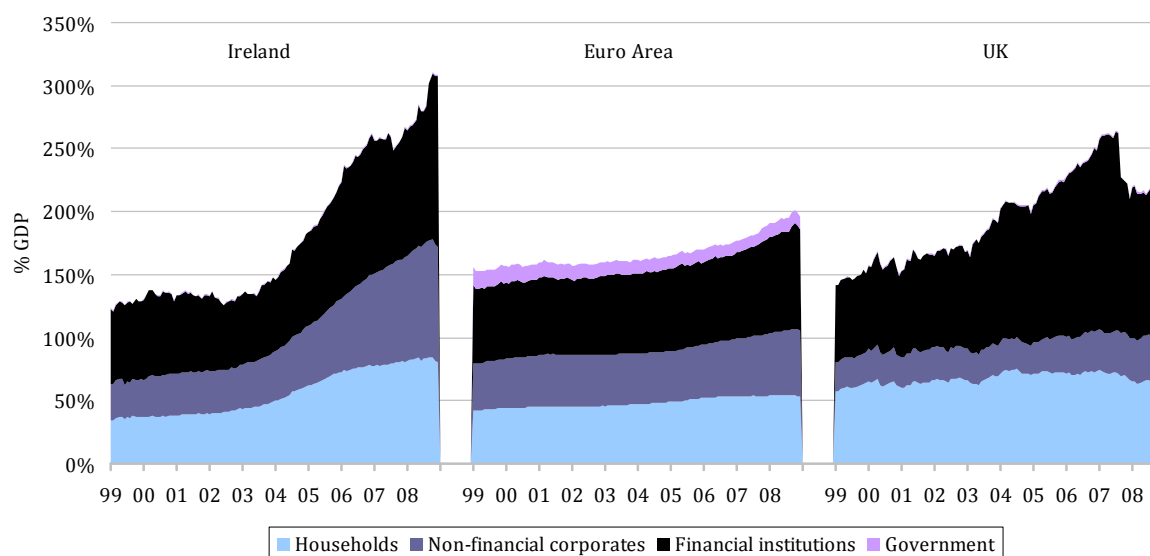
1.3 International Developments

- 1.3.1 International developments in the period leading up to the crisis posed significant challenges for all the private and public institutions involved in the Irish financial system.¹⁰ Monetary policies abroad were characterised by pervasive and excessive ease that helped support large underlying global financial imbalances. From the late 1990s, low interest rates, abundant liquidity and free capital movements facilitated a strong global expansion of credit, illustrated in figure 1.1 for Ireland, the Euro Area and Ireland's largest trading partner, the United Kingdom. Investors were able to fund asset acquisitions through increased debt. The international credit boom contributed to rising asset prices and created apparent capital gains, thus creating taxable receipts and increasing "paper" wealth in many countries simultaneously.¹¹ For many participants – public and private – these developments were seen as a "new global norm".

¹⁰ Regling & Watson, p. 11ff.

¹¹ A number of these assets were consumables and real investments, causing an increase in employment and wage income. Together with increased social expenditure financed by rising tax receipts, this temporarily raised the welfare of a large part of the Irish population.

Figure 1.1: Lending by sector in Ireland, Euro Area and the United Kingdom 1999-2008



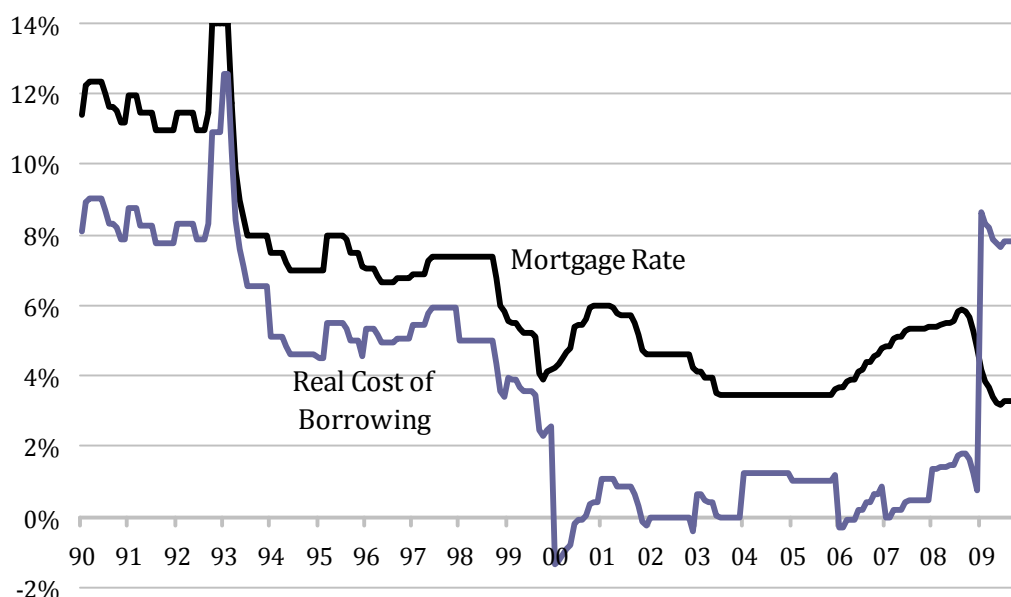
Source: ECB

Note: Financial Institutions includes Central Banks

1.3.2 The Irish economy and Irish financial institutions were, furthermore, exposed to the expansionary financial incentives associated with membership of the Euro area. The disappearance of exchange risk and the absence of euro-wide inflationary pressures caused a significant reduction in interest rates, compared to the Irish Punt historic rates, while there was virtually unfettered access to funding from European and other capital markets (Figure 1.2). At the same time competition increased via new non-Irish entrants into domestic financial markets.¹²

¹² It appears that few observers or practitioners in Ireland or elsewhere realised that the foreign exchange risk did not disappear but only changed form. As was later realised, foreign exchange risk was transformed into credit risk. Instead of currency decline or devaluation in highly indebted or low-productivity countries, the risk became one of company defaults and unemployment, eventually impacting sovereign creditworthiness as well.

Figure 1.2: Standard Mortgage Rate and Real Cost of Borrowing 1990-2009



Source: DOE & CSO

1.3.3 Financial market and regulatory policies during the Period were influenced by the efficient market hypothesis. This paradigm was widely accepted, particularly in the US and UK, and provided the intellectual underpinning for financial innovation and reduced regulation. One important consequence of the concept was the assumption that self-regulating financial markets tended to remain stable.¹³ If the paradigm was accepted without regard to the simplifying assumptions underlying the original theory (a naïve interpretation), quite radical conclusions for policy could be drawn. For instance, strict or intrusive regulation would generally not be needed and could, instead, reduce financial innovation and efficiency; a light-touch approach to regulation was the obvious recipe. Furthermore, it could be argued that normal financial activity was benign almost by definition; anything that could attract funding could be seen as acceptable in the absence of specific proof to the contrary. Thus, financial expansion, resulting in increased use of debt and financial innovation, would not necessarily be seen as increasing financial fragility, despite many previous experiences to the contrary.

1.3.4 As demonstrated by the previous scoping reports, although clearly affected by external conditions as set out above, the Irish crisis was in all essential aspects home-grown.¹⁴ While external conditions facilitated financial excess in Ireland, only Irish institutions, investors and households themselves could decide to indulge in financial risk. During the 2000's, public

¹³ See for instance, Paul de Grauwe: *The Banking Crisis: Causes, Consequences and Remedies*, University of Leuven and CEPS, November 2008.

¹⁴ In the final analysis, this is likely to be true of all crises. For instance, the extent to which European banks had US sub-prime mortgage instruments on their books was due to the banks' own decisions and the implicit acceptance of their domestic supervisor.

policies either came to support or tolerate increasingly frothy domestic growth financed by foreign debt routed through increasingly fragile Irish banks. This occurred despite a number of international examples of how similar developments had ended unpleasantly.¹⁵ These should surely have served as warning signs.

1.4 Main Issue of this Report

1.4.1 In the view of the Commission, the main issue that needs to be addressed is the following:

Why did so many professionally adept Irish bankers and public servants (as well as politicians, entrepreneurs, experts, media and households) simultaneously come to make assessments and decisions that have later proven seriously unsound in a number of ways?

1.4.2 Systemic financial crises – both in Ireland and elsewhere – are uncommon because they require such a large number of simultaneous institutional and judgmental failures. If even a couple of these failures are absent, the systemic crisis is short-circuited and will morph into a more modest form.

1.4.3 For a systemic financial crisis to occur, at least the following factors must be present (although the last two may not be as essential as the others):

- a sufficiently large number of households and investors who, at some point, start making serious mistakes in judging the value and liquidity of their major assets, holdings and projects;
- banks that provide financing, large in relation to their own capital, for these investments without thoroughly and sufficiently evaluating their prospects and the creditworthiness of borrowers in the longer term;
- providers of funds to such banks (often banks themselves but also depositors) that do not monitor bank soundness with sufficient diligence, in the case of private providers, possibly because of perceived implicit public support for at least important banks;
- a banking regulator that remains unwilling or unable to detect or prevent banks from engaging in excessively risky lending or funding practices;
- a government and a central bank that remains unaware of the mounting problems or is unwilling to do anything to prevent them;
- a parliament that remains unaware of the mounting problems or concentrates its attention on other things perceived to be of greater immediate importance; and
- media that are generally supportive of corporate and bank expansion, profit growth and risk taking while being dismissive of warnings of unsustainable developments.

1.4.4 Each of these failures could be further divided into subcategories. For instance, various features of bank governance relating to insufficient credit evaluation could be listed (as indeed is done later in this Report). However, at this conceptual level of analysis it would complicate the

¹⁵ Developments in Scandinavia during the early parts of the 1990's as well as in South-East Asia during the latter half should have been well within the professional memory of decision-makers in both banks and public institutions in Ireland during the 2000's.

picture without necessarily adding to its explanatory power. Such inclusions would also not, by themselves, assist in explaining simultaneous failures.

1.5 Assigning Blame

- 1.5.1 The Commission recognises that the desire to assign blame is a natural and understandable response to a crisis and that it is often a necessary requirement in the prevention of similar events in the future. However, the Commission's remit is to identify the causes for failures, rather than to assign individual blame or responsibility. During the Period leadership as well as lower-level management and advisors changed repeatedly in most private and public institutions discussed; this makes apportioning individual responsibility for strategic or longer-term developments impractical. Most important, the nature of systemic banking crises rarely allows blame and responsibility to be confidently allocated. To understand why this is so, it may be instructive to, once again, consider the list of necessary contributors (paragraph 1.4.3 above) to a systemic banking crisis. Since all of these factors need to be present to generate a systemic crisis, stressing the impact of only one or two contributors would lack balance.
- 1.5.2 It is important to note that none of the elements mentioned above requires bad faith; lack of sufficient knowledge, analysis or foresight is quite enough as is, unfortunately, simply staying silent about one's concerns. Essentially, a systemic banking crisis requires a widespread lack of understanding and/or suspension of good judgment or critical discourse in large parts of society. Nevertheless, people in positions of responsibility in financial institutions and public authorities should even in such circumstances be expected to act with regard to the responsibilities entrusted to them.
- 1.5.3 People in a position to make decisions are and must be ultimately responsible for them regardless of what advice or suggestions they have received. The higher and more influential their position, the greater their responsibility. For instance, holders of public office are and must be responsible for directly and indirectly influencing others' conduct within their, often large, remit. They, no less than everybody else including borrowers, are, of course, also responsible for knowing what they are saying and doing.¹⁶ Public commentators with trusting audiences ("media") had a relatively large influence on how pre-crisis developments were perceived, discussed and acted upon.

¹⁶ A common argument among private and public decision-makers (both in Ireland and elsewhere) has been that "they were not told", implying that responsibility actually resides elsewhere. However, it is an essential part of the job of a decision-maker to make sure of being well informed. Accepting one's own ignorance or inefficiency does not transfer responsibility onto others; instead it puts an extra demand on the decision-maker to obtain good advice. Similarly, it is sometimes argued that lenders share responsibility for the financial difficulties or default of a borrower. Whether and to what extent this is true is determined by courts when individual cases are disputed. In general, lenders could be considered responsible if they (i) knew or suspected the coming financial difficulties of the borrower; (ii) provided loans on unreasonable or unclear terms; or (iii) provided loans to borrowers or classes who realistically did not have the capacity for repayment. The borrowing Irish banks went to great lengths to assure lenders and regulators of their solvency, in which they themselves believed. Furthermore, they were themselves seasoned lenders used to assessing lending terms. It therefore seems rather unlikely that the three general conditions above would apply in the Irish case.

1.5.4 Because of this necessary link between position and responsibility, the Commission considers it proper that only organisations are identified by name in this Report. The very tight time schedule provided for the Commission's Report also argues for this. Thus, when referring to action or inaction by the "Financial Regulator (FR)", for example, the text means the actions of the organisation as well as the impact of such actions on financial stability in the Irish market. Further specification is added only where necessary. The same applies to all other public and private institutions.

1.5.5 The Commission decided at an early stage that in so far as possible this Report should not contain evaluations or details of named individuals, their actions and inactions. The Commission relied on three important considerations for this decision. Firstly, the Commission's Terms of Reference strongly stress the need to explain why systemic failures happened. Obtaining meaningful information on this is much easier if individuals do not, at the same time, have to worry about how this information will affect their public image. Secondly, the Commission did not wish to prejudice, in any way, any possible future investigation into the actions of any individual. Finally, the Commission considered that, by virtue of their position, it was already clear that decision-makers and leadership in the various institutions must carry a large part of the immediate blame for the crisis.

1.6 Herding and Groupthink in Financial Markets

1.6.1 It is clear that a widespread consensus formed in Ireland around trends, assessments and policies that participants should have realised to be unsustainable or unsound. This section briefly presents two concepts ("Herding" and "Groupthink"¹⁷) that may help understand why and how so many institutions in Ireland simultaneously made imprudent decisions.

1.6.2 On the whole, it appears that actions taken by various institutions in the run-up to the Irish crisis did exhibit the kinds of behaviour generated by the "herding" and "groupthink" hypotheses described below. These concepts have been used in some previous financial market studies. While these behaviours may be seen as a combination of a number of basic human psychological biases which are not confined to economic issues, it is clear that, when present particularly in the financial sector they may be important underpinnings of systemic disturbances.

1.6.3 "Herding"¹⁸ refers to the willingness of investors and banks to simultaneously invest in, lend to and own the same type of assets, accompanied by insufficient information gathering and processing. While often superficially resembling the normal process of competition, herding

¹⁷ See Irving L. Janis: *Victims of Groupthink*, Houghton Mifflin, 1972

¹⁸ There is not necessarily any great difference in the assessments and behaviour of banking executives and the corporate financial officers that form an important part of their customer base. Thus, in Australia "...corporate executives shared a decision framework with core features similar to those of financiers that are thought to have contributed to the (global financial crisis), particularly permanently increasing asset prices, easy liquidity and safety in powerful risk management techniques." See Les Coleman & Sean Pinder: *What were they thinking? Reports from interviews with senior financial executives in the lead-up to the GFC*, Applied Financial Economics, 2010, pp. 7-14.

implies lack of rigorous analysis by members of the herd. Some of the participants in a herd have only a partial idea of the economic advantages and disadvantages of a particular course of action – for instance, investing or property lending. However, they assume that others have a clearer view and follow them, thus demonstrating what is commonly referred to as a bandwagon effect.

- 1.6.4 Herding implies that management groups in different banks implicitly follow each other with little or only modest analysis and discussion. Several possible motives exist. The most obvious, relevant for Irish banks as shown later in Chapter 2, may be the need to achieve similar profitability as competitors, either as a result of shareholder pressure, expected management returns or need for recognition or professional approval. Another reason, valid when there are perceived economies of scale or scope, may be to avoid erosion of profitable market share. Finally, a reason frequently mentioned in economic literature is that there may be a wish, particularly among larger banks, to increase the prospects of rescue in case of insolvency; if several banks follow similar policies and thus are insolvent at the same time they are, for systemic reasons, unlikely to all be closed.
- 1.6.5 Groupthink occurs when people adapt to the beliefs and views of others without real intellectual conviction. A consensus forms without serious consideration of consequences or alternatives, often under overt or imaginary social pressure. Recent studies indicate that tendencies to groupthink may be both stronger and more common than previously thought.¹⁹ One consequence of groupthink may be herding, if the views in question relate to institutional policies, but this need not be the case.
- 1.6.6 Within boards, for instance, groupthink would cause alternative solutions to remain insufficiently considered. Broadly speaking, board members would be likely to avoid opposing an already existing preferred strategy (for instance, one proposed by a chairman or managing director, particularly in the case of a dominant personality), where they feel a social bond with the rest of the board (for instance, through long and lucrative membership) and where they do not feel sure of themselves (for instance, in the case of difficult issues of a new financial environment or time pressure). In groups, moreover, views have been shown to converge to the extremes of those expressed rather than to the average private views of its members (implying that few members may actually privately fully support the final public decision). These features may be further strengthened by the presence of external adversarial groups (such as bank competitors, hostile bidders or financial commentators).
- 1.6.7 Since strategic decisions have to be implemented, for herding to be realised also requires that staff in the participating institutions follow and do not question the decisions made. Even if the decision appears materially questionable, a form of groupthink may still ensure willing staff cooperation. Much more than for board members and managers, staff prospects for advancement and remuneration depend on their perceived standing with their superiors. Superiors often form a view of a staff member from the views and proposals they forward to

¹⁹ See Robert S. Barron: *So right it's wrong: Groupthink and the ubiquitous nature of polarised group decision making* in *Advances in Experimental Social Psychology* vol. 37, 2005, pp. 219-253.

them. This feeds a tendency among staff to suggest and support proposals that their superiors are known to prefer, hoping to gain a favourable reputation.²⁰ This results in a bandwagon effect and a tendency to conform to superiors' views as well as those of colleagues. Those challenging their superiors' proposals may risk sanctions and would thus need to feel particularly confident in their preferred alternative.

- 1.6.8 The financial paradigm originating in the US and UK and referred to in paragraph 1.3.3 probably became, as soon as it was accepted by management, a basis on which superiors formed their views of subordinates. This would have had the effect of gradually streamlining thinking on financial issues not only within but also between institutions. Furthermore, it would have streamlined thinking not only between institutions in the same country but internationally as well, creating peer institutions that reinforced mutual trust in the paradigm.
- 1.6.9 Some observers see both herding and groupthink as contributing also to the passive role of regulators in their efforts to detect and prevent the global financial crisis.²¹ Clearly, groupthink could easily exist in public institutions, with a publicly mandated and thus strongly empowered leader gradually eliminating independent critical analysis among staff.
- 1.6.10 Herding and groupthink may even be key drivers of financial instability. In particular, if periods of prolonged prosperity increase the willingness, particularly among bank shareholders and executives, to accept financial risk, good times tend to generate unstable financial markets.²² This would particularly be the case if (i) riskiness is assessed on the basis of recent history, (ii) financial institutions and supervisors tend to act in a herding manner, (iii) groupthink and conformism is present within these institutions, and (iv) the media and the political system take a supportive rather than a challenging role. In this case, good times would gradually lead to increasing acceptance of risk, increasing leverage in banks and indebtedness among borrowers, rising credit-fuelled asset prices, declining lending standards and declining concern about refinancing risks. Any event that then increases the assessed riskiness of the markets could be the start of a financing and banking crisis. This downturn could be exacerbated if decision-makers are prone to take risks to either avoid or recover potential losses.
- 1.6.11 One issue to be clarified then is whether critical views were presented or discussed within the relevant banks and public authorities. If presented, it would be relevant to look at why they were not acted upon. If not, it would be an indication that herding and groupthink could have been at work also among the great number of accomplished professionals, explaining why they did not see the problems and risks accumulating in the system.

²⁰ W.Boot, T.T.Milbourn & A.V. Thakor: *Killing the Bearer of Ill Tidings: A Theory of Consensus-Provision Moral Hazard*, IFA working paper 274, London, 1998.

²¹ For example, Nicholas Dorn: *Ponzi Finance, Regulatory Capture and the Credit Crunch*, draft March 2009, Erasmus University, Rotterdam, who explains the general inactivity of the regulators as a consequence of them using the same data and models as the supervised entities (regulatory capture).

²² See particularly Hyman P. Minsky: *The Financial Instability Hypothesis*, The Jerome Levy Institute Working Paper no. 74, 1992.

1.7 Method of Work

- 1.7.1 The Commission investigated all relevant public and covered institutions in essentially the same manner. Each institution provided the Commission with a very substantial number of documents relating to the issues to be addressed. These were held on the Commission's high security central data system. The documents were examined by teams of Commission staff, discussed within the Commission or with relevant institution staff if required, and eventually assembled into a sourced draft report which was updated continuously until the final report emerged. Time constraints made it necessary for Commission expert staff to focus particularly on those areas most relevant to the crisis.
- 1.7.2 At the same time, a number of formal interviews were conducted with present and past leadership of the relevant financial institutions and public authorities in order to complement the documentary evidence when writing the report. These interviews, which form part of the evidence of the Commission, were audio recorded and are held securely. A copy of the recording was offered to all interviewees and issued to them, on request, on encrypted compact disk. Issues raised in these interviews included the variety of strategic alternatives considered and the rationale for strategic decisions, as well as many operational and control issues and the existence or otherwise of active contrarian views.
- 1.7.3 The external auditors of the banks were requested to provide copies of their most recent engagement letters, management reports and audit plans in addition to other relevant documentation for the Period. Auditor representatives were interviewed to explain, where relevant, if the issues identified by the Commission were identified or commented on by auditors.
- 1.7.4 In all, the Commission accessed approximately 200,000 documents from the authorities, financial institutions and other sources. It conducted about 140 interviews with 120 individuals and the rest representing various institutional teams; only 5 of the interviews were by telephone and 20 of them were held outside Commission premises. Properly mandated Commission staff also had a large number of clarifying technical discussions with staff of the various institutions.
- 1.7.5 Peter Nyberg was appointed by the Minister as the Sole Member of the Commission and is fully responsible for the contents of the Report. The Commission's expert investigation team consisted of: Jan de Chaumont, Lisa Marie Deegan, Donal Donovan, Thomas Foley, Jim Higgins, Conor Holmes, Sean Kinsella, Mary Lawlor, David McGee, Michael Monaghan, Tom Noonan, Matthew O'Driscoll, Pat O'Mahony and Denis O'Reilly. Sheana Farrell was the Commission's solicitor and the administrative support team comprised Lorraine Fitzsimons, Hilary Fox, Avril Lyons, Sandra McGurrell and Kieran Sheedy. From the outset the Sole Member and his team committed to delivering the Report on time and within budget.
- 1.7.6 The Commission has been well supported by the Department of Finance in preparing for its work. It received good cooperation from all institutions. The effort required by many

institutions to provide the requested documentation was significant.²³ The Commission wishes to thank all those involved in the procurement of this documentation as well as those it interviewed concerning events that have turned out to be difficult for them professionally.

- 1.7.7 The mandate of the Commission did not include investigating possible criminal activities of institutions or their staff, for which there are other, more appropriate channels. Under the Act, evidence received by the Commission may not be used in any criminal or other legal proceedings. The Commission has not investigated any issues already under investigation elsewhere. Instead, the Commission used its limited time and resources to investigate, as its Terms of Reference specified, why the Irish financial crisis occurred.
- 1.7.8 Even with the benefit of hindsight, it is difficult to understand the precise reasons for a great number of the decisions made. However, it would appear that they generally were made more because of bad judgment than bad faith. Indeed, a fair number of decision-makers appear to have followed personal investment policies that show their confidence in the policies followed by “their” institution at the time. Such faith usually produced large personal, financial and reputational losses.

²³ Despite the unequivocal mandate and terms of reference of the Commission, urgent access to relevant documents or interviews was not always fully unproblematic. For a small minority of those organisations and individuals choosing to be represented by lawyers,, there were some protracted engagements, indicating that future Commissions may need stronger mandates to ensure that substance is not eclipsed by legal form or excessive protection of single institutions or individuals.

Chapter 2 - The Problems with the Banks

2.1 Introduction

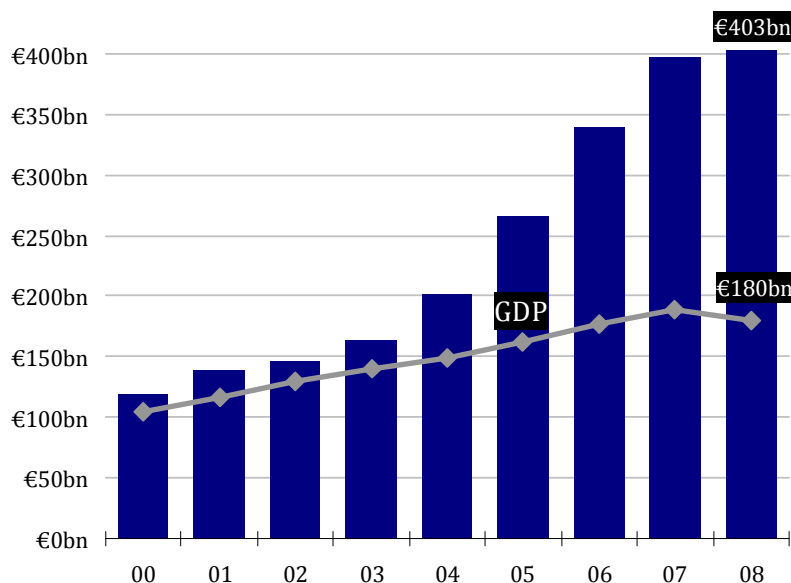
- 2.1.1 This Chapter addresses the issue of why the covered banks operated in a way that eventually made substantial State support necessary. The process leading up to this result took several years, with loan growth accelerating during the latter years of the Period. This progression also required that a number of functions and units within the banks allowed, ultimately, imprudent practices to develop.
- 2.1.2 The Commission has not and could not assess the actions or inactions of single individuals in organisations and did not think it was appropriate or fair to do so. Firstly, the time limit set for the investigation does not allow for that level of forensic scrutiny. Secondly, major changes in banks tend to take place as a consequence of complex interactions between a number of people; isolating any one influence would be very difficult. This is particularly true of units within a bank, such as Committees or the Board. In the view of the Commission, it is not generally possible to infer, from an investigation of how a certain unit in the bank functioned, how its members operated individually. Therefore any reference to a bank, its Board or any of its Committees or functions is not intended as a reference to any individual.

2.2 Setting the Scene

High growth in lending delivering reported bank profit and market value uplifts

- 2.2.1 For much of the Period, Ireland's banking sector and the covered banks were characterised by rapid balance sheet growth driven primarily by property lending in Ireland.
- 2.2.2 Figure 2.1 below illustrates the scale of growth in lending by the covered banks, rising from a stock of €120bn in 2000 to almost €400bn by 2007. The three years ending in 2006 marked the highest sub-period of sustained growth, with loan assets more than doubling overall, growing at a compound rate of almost 28% per annum. This rate of growth significantly outpaced growth in Gross Domestic Product (GDP). By the end of 2007, total loans and advances to customers stood at over twice GDP, up from 1.1 times GDP in 2000.

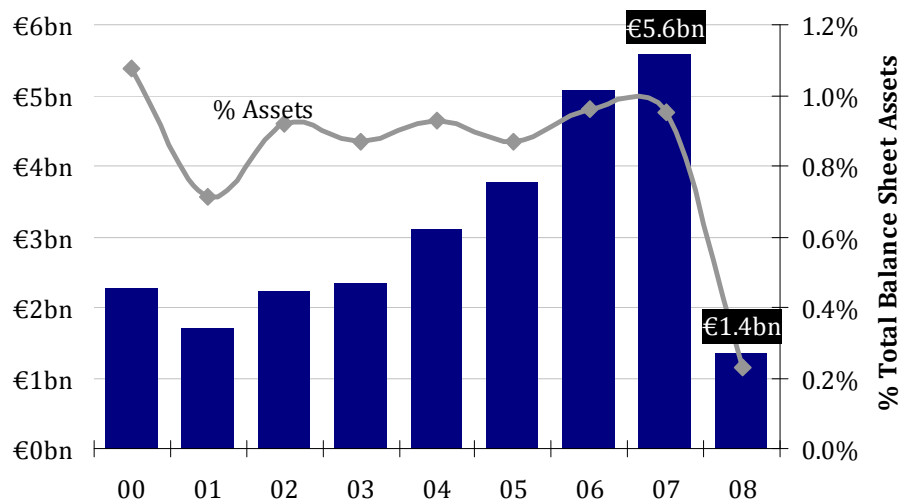
Figure 2.1 Covered Banks – Loans and Advances to Customers 2000-2008



Source: Annual Reports & Eurostat

2.2.3 Figure 2.2 below shows reported profits up to 2008 for the covered banks. Up to 2007, reported return on assets was broadly maintained appearing to indicate that asset quality was consistent with previous periods. Within the combined figures set out below, Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS) reported very substantial growth in profits after tax of 826% (€899m) and 535% (€260m) respectively between 2000 and 2007.

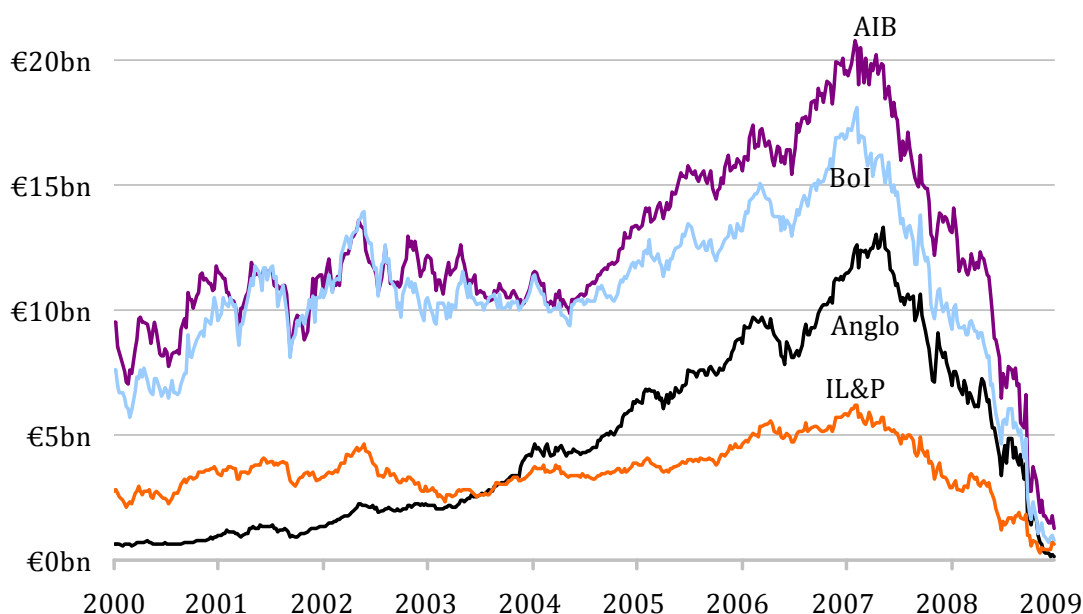
Figure 2.2: Covered Banks – Aggregate Profit After Tax 2000-08



Source: Annual Reports

2.2.4 The growth in reported profits of the covered banks was reflected in the significant upward movement in the share prices and resultant market capitalisations of the four listed banks (Figure 2.3). From January 2000 to its peak in February 2007, the combined market capitalisation of the four banks rose from €20.4bn to €57.4bn. Anglo's market capitalisation is particularly notable, growing over 2,000% from €0.6bn in 2000 to a peak of €13.3bn in mid 2007.

Figure 2.3: Individual Market Capitalisations of Listed Covered Banks 2000-Jan-2009



Source: Irish Stock Exchange

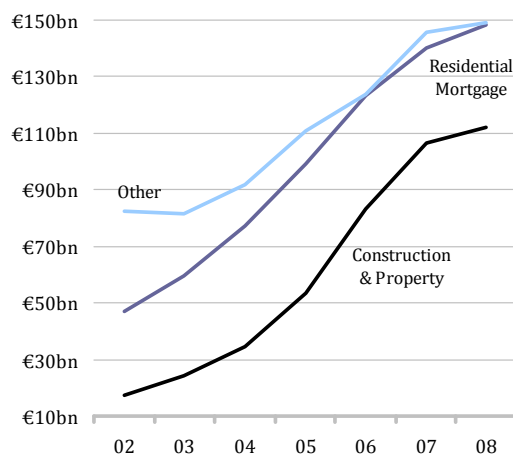
Components of Overall Lending Growth

2.2.5 Lending growth was very uneven between sectors. Figure 2.4 below illustrates the growth in components of domestic private sector credit, i.e. lending to Irish resident businesses and citizens, over the period 2002 to 2008. What clearly emerges is the extent to which property-related segments, i.e. residential mortgage lending and lending to the construction and property (C&P)²⁴ sector, significantly out-paced growth in all other sectors combined. In absolute terms, over the period 2002 to 2008, domestic property-related lending increased by almost €200bn which represents 80% of all growth in credit. This raised the share of property-related lending from under 45% of total credit in December 2002 to over 60% in December 2008.

²⁴ Within Loans and Advances to Customers, "Construction and Property" was the categorisation used by some banks to cover lending for investment property as well as site purchase and development (i.e. not including residential mortgages). For ease of reference, in this chapter we will describe property generating a recurring income as Investment Property and use the term development finance to describe lending for building related funding to both the residential and commercial sectors, including site finance.

2.2.6 In the key period of high growth from 2004 to 2006 (see Figure 2.5 below), net lending to the C&P sector increased at a compound annual rate of almost 45%, enough to treble exposure in this sector over this period.

Figure 2.4:
Private Sector Credit 2002-08



Source: Central Bank of Ireland

Figure 2.5:
Annual growth in selected components 2003-08



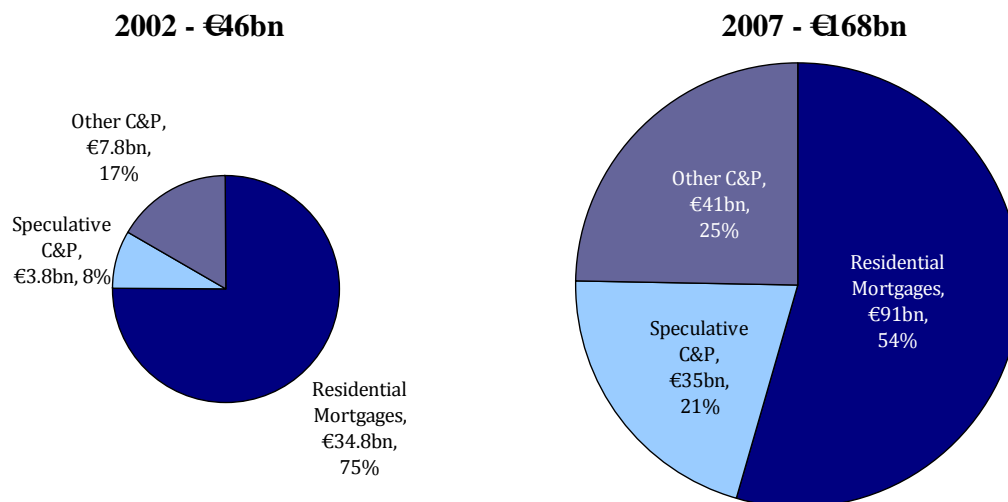
2.2.7 Over the period 2002 to 2008, aggregate domestic lending to residents in Ireland fluctuated within the range of 64-68% of the covered banks' loans and advances to customers, indicating no significant diversification away from Irish resident borrowers.

The Covered Banks

2.2.8 The covered banks accounted for over 65% of the overall growth in property-related lending in Ireland over the period 2002 to 2007. Their domestic property lending to Irish residents grew by 262% to €168bn by December 2007 (see Figure 2.6 below). In addition to the very strong overall growth, there was a dramatic change in the distribution of this lending between Residential Mortgage, Speculative C&P lending²⁵ and Other C&P lending. The proportion of loans for speculative C&P projects increased from 8% to 21% of all loans by December 2007. The proportion of residential mortgages fell from 75% to 54% but still more than doubled in size.

²⁵ Speculative C&P lending (a subset of overall C&P lending) is in respect of C&P projects where no construction or rental contract is yet in place.

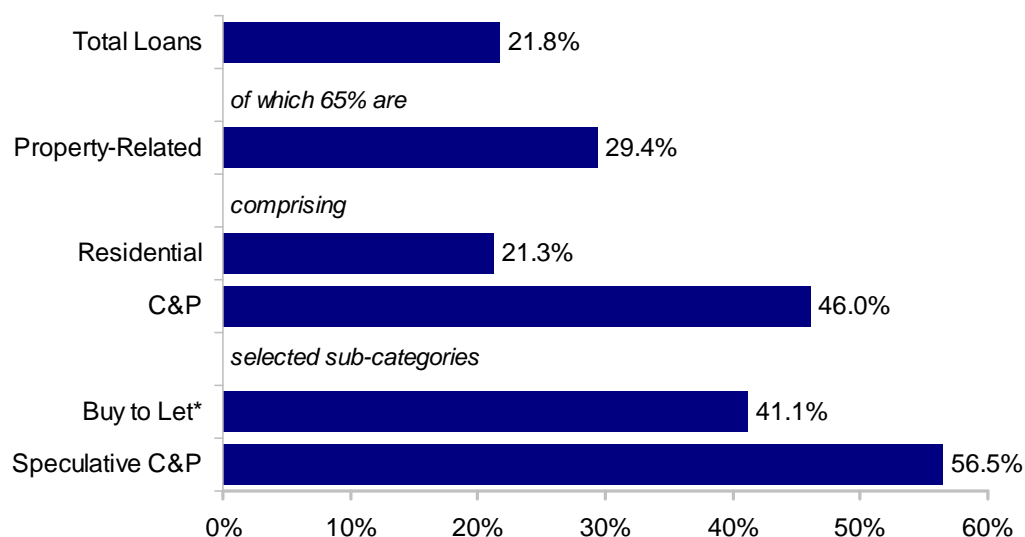
Figure 2.6: Components of Aggregate Domestic Property Lending Stock to Irish Residents by the Covered Banks



Source: Central Bank of Ireland

2.2.9 The compound annual growth in overall lending and the shift towards speculative C&P lending on the part of the covered banks is illustrated in Figure 2.7 below. Total loans to customers grew by an average of 21.8% annually during the period. Property-related lending grew even faster and the fastest growth of all was in speculative C&P lending which grew by an average of 56.5% each year. Lending to this category increased nine-fold between 2002 and 2007. Similarly, in the Residential Mortgage sector, the more commercial-related buy-to-let lending was increasing at almost twice the rate of lending for owner-occupied housing.

**Figure 2.7: Domestic Lending by Covered Banks to Irish Residents:
Compound Annual Growth Rates for selected Sectors 2002-07**

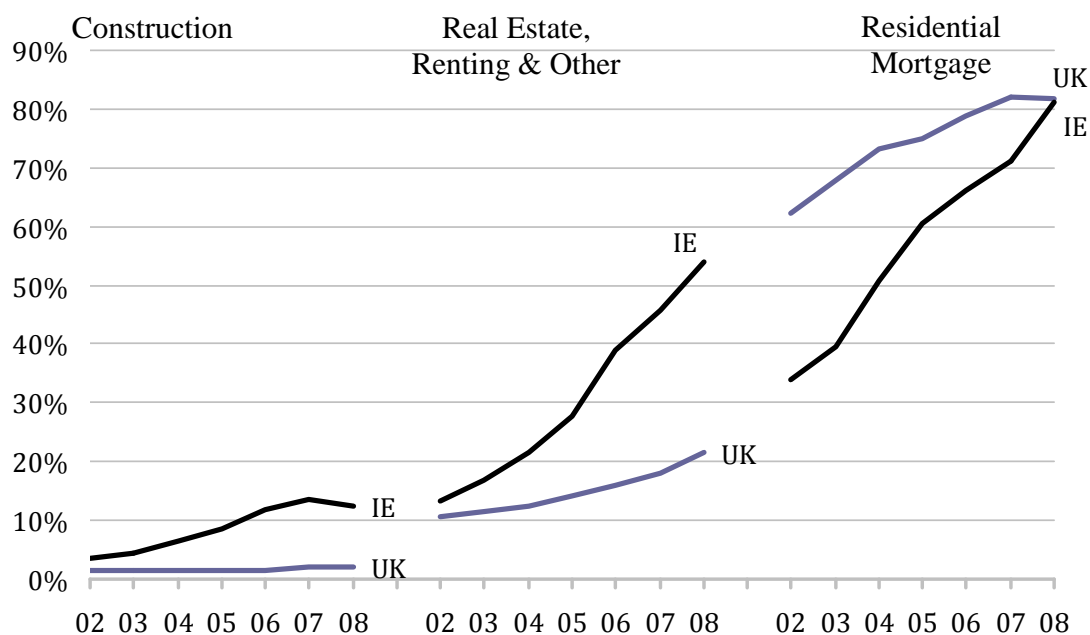


Source: Central Bank of Ireland
*2003-2007

2.2.10 From Figure 2.7, it is clear that the covered banks collectively (and to varying degrees individually) were increasingly concentrated in property related lending to Irish residents and had rapidly grown their exposure to domestic C&P in particular.

2.2.11 The rate of increase in property lending was markedly more rapid in Ireland than, for instance, in the UK relative to GDP. The aggregate of the property-related lending to residents by domestic banks, the components of which are illustrated in Figure 2.8 below, stood at over 147% of GDP at the end of 2008, compared to less than 106% of GDP for the UK domestic banking industry. Lending in the three identified property related segments increased at faster rates than the equivalent segments in the UK, particularly in C&P lending. The covered banks' exposure to C&P lending had grown to over 48% of GDP by 2008, up from 11% in 2002. In the case of residential mortgage lending, the UK was relatively more indebted at the start of the period, but Irish lending had matched the UK in relative terms by the end of 2008.

Figure 2.8: Domestic Property Related Lending as % GDP: Ireland & UK Comparison



Source: Central Bank of Ireland, CSO, Bank of England & UK ONS

2.2.12 As credit to the property sector grew, real commercial property values increased between 1995 and 2007 by about 200% (see Figure 2.9 below). Residential prices rose by more than 180% over the same period. Figure 2.10 below shows housing completions and real price increases between 1976 and 2008. The sustainable level of house construction, which was predicated on continued economic growth and immigration, was estimated in 2005 to be in the region of 60-70,000 units per annum²⁶. The upper level of this range had been exceeded for the first time in 2004.

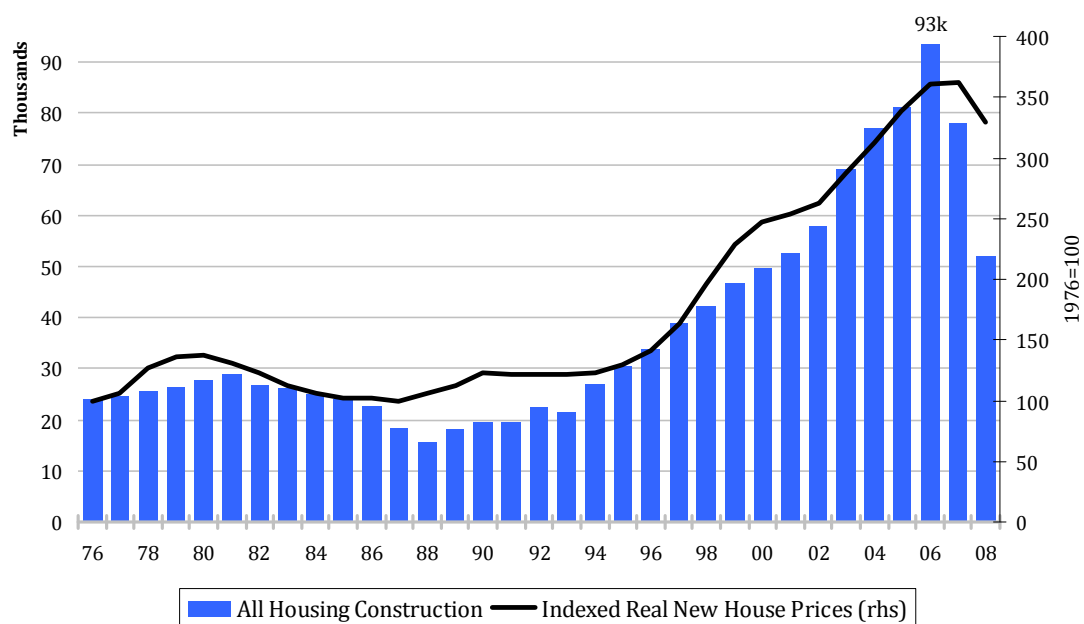
²⁶ ESRI Medium Term Review 2005-2012, published December 2005.

Figure 2.9: Real Indexed Commercial Property Values – Combined Office, Retail & Manufacturing



Source: Investment Property Databank

Figure 2.10: New House Prices (Real) & Housing Construction, 1976 – 2008

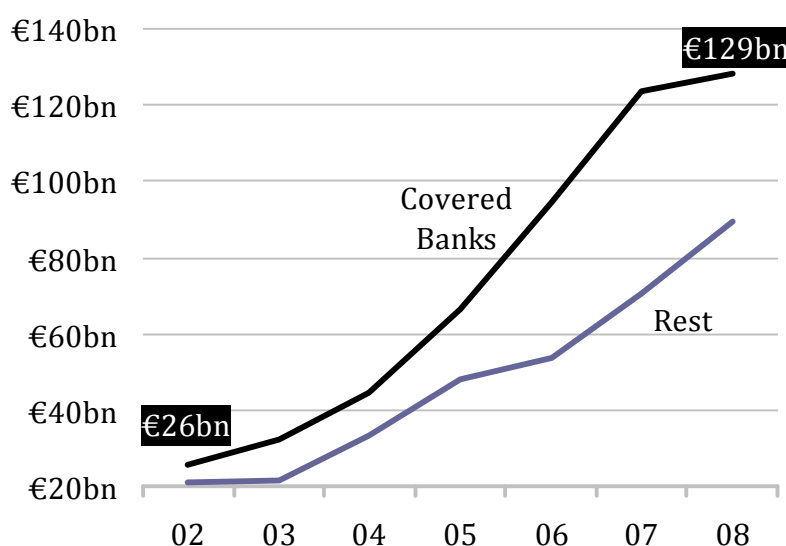


Source: DOE & CSO

Funding the Covered Banks' Lending Growth

2.2.13 As the covered banks' domestic lending grew so substantially, retail and corporate deposits could not provide sufficient funding. Figure 2.11 below illustrates how the funding gap developed for both the covered banks and those of the domestically active non-covered banks between 2002 and 2008. The covered banks' requirement for non-deposit funding increased almost fivefold over the period from €26bn to €129bn and grew at a particularly high rate from 2004 to 2007. The rest of the banks had a similar though generally smaller funding gap. This funding gap was financed by wholesale market funding and largely represented increasing foreign borrowing by the banks. This foreign debt was used largely to fund the domestic property market.

Figure 2.11 Funding Gap – Excess of Domestic Lending to Residents over Deposits



Source: Central Bank of Ireland – 31-Dec of each year

2.2.14 In summary, by the middle of the Period, investors were piling into residential and other real estate projects and property prices were rising, causing demand for financing to increase markedly. Banks were fuelling this demand by expanding their loans books at very high annual rates of growth. The banks were, in turn, willingly financed in the funding markets by domestic and foreign investors. As it eventually turned out, this process gradually fulfilled the first three conditions (as set out in paragraph 1.4.3 above) for the occurrence of a systemic financial crisis. The rest of this Chapter examines in more detail how the covered banks responded to the growing demand for property finance and how their internal governance, rules and procedures were adapted to reflect changing strategies.

2.3 Market Shares Threatened

2.3.1 In the years leading up to the beginning of the Period, competition in the property lending markets increased as the Irish banking sector became subject to increased foreign competition.

Competition in the residential mortgage market was traditionally intense with each of the covered banks (with the exception of Anglo, which did not offer residential mortgages) fighting for market share. The entry of Bank of Scotland into the Irish mortgage market in 1999 led to increased lending competition and reduced profit margins as it offered mortgages at substantially lower interest rates than domestic banks at that time. Furthermore, the acquisition of First Active by Ulster Bank (part of the RBS Group) in January 2004 increased its share of residential mortgages to 15%, giving Ulster Bank the scale to be a significant lender. The foreign-owned institutions competed aggressively with the domestic players for market share offering not only more attractive terms but also new residential mortgage products (e.g. high/100% loan-to-value mortgages, interest only mortgages, tracker mortgages etc).²⁷ These new products, however, also posed new risks for both the borrower and the lender.

- 2.3.2 Leading up to and during the Period, competition in the commercial property lending market also intensified. A number of foreign owned banks, but also Allied Irish Banks (AIB), escalated their commercial property lending activities with the main objective of growing earnings and retaining or increasing market share. These banks were soon followed by Bank of Ireland (BoI). This increased competition would have threatened the market shares primarily of the banks already concentrated on property lending. However, as the credit-induced growth in the property sector in Ireland continued and as property values increased, each bank could simultaneously increase lending for (and reported profits from) property without much market share change.
- 2.3.3 It was against this backdrop that the covered banks pursued strategies which would lead to higher growth, higher reported profits and higher bank valuations. A primary reason appears to have been to prevent a predatory takeover by another bank (either domestic or foreign) and thus maintain independence. However, in a number of cases, professional pride and a desire to catch up with or stay ahead of the competition (i.e. playing to win) also seem to have been important.
- 2.3.4 The new strategies were based on the assumption that property demand would remain strong and values would continue to increase. Great comfort seems to have been taken from the specifically Irish experience from earlier years; previous slowdowns had not resulted in property crashes and price declines, if any, were relatively modest (see again Figures 2.9 & 2.10 above). Furthermore, a great number of credible authorities and experts were stressing that

²⁷ Mortgage intermediaries began to emerge as a force in the residential mortgage market in the mid-1990's, initially as a distribution channel for non-branch based mortgage lenders. Due in part to alliances with estate agents they exercised significant control over the "first time buyer" market in particular. This market was viewed by lenders as an attractive market segment and key for customer acquisition and exit financing for development lending. At the peak of the market in 2005 mortgage intermediaries accounted for about 45% of new residential mortgage loans. Against this background, intermediaries were able to leverage their relationships with lenders pushing for better mortgage terms (and sometimes larger loans). This led to a considerable reduction in bank margins (interest and commission). Many banks sought to compensate by increasing loan volumes to maintain earnings. While these changes impacted on the mortgage market, mortgage intermediaries had only a limited and indirect impact on the banking problems which are the subject of this Report because, in the final analysis, intermediaries did not make the lending decisions.

various “unique Irish circumstances” (e.g. demographic, immigration, catch up in terms of living standards, shortage of housing) would, at worst, guarantee a “soft landing”²⁸ in the event of an economic downturn. It was furthermore assumed that low-cost wholesale funding, which was necessary to finance the rapid growth in property lending, would continue to be widely available. These optimistic assumptions, strongly held and built on relatively recent trends specifically in Ireland, later proved to be the downfall of all the covered banks.

- 2.3.5 The rest of this Chapter reviews developments related to some of the essential procedures and control functions of the covered banks. While the banks broadly ended up making fairly similar mistakes, relying on wholesale funding and lending excessively to property projects, there were otherwise large differences between them. Despite this, it appears that all covered banks remained convinced that their business models, strategies and operations were sufficient to ensure unproblematic, continued and successful growth.

2.4 Business Models and Strategies

Anglo

- 2.4.1 Anglo concentrated almost entirely on business banking. Its core strategy was to provide bespoke banking services to well-defined target markets. The main driver of business and profit growth was business lending involving the provision of commercial mortgages and asset financing (mainly property) on a secured basis. It wanted to “grow with its customers” while simultaneously diversifying its business geographically (in both the UK and the US). The bank classified itself to customers, rating agencies, funders and the authorities as a “relationship based business bank with a centralised business model operating in three core areas – Business Banking, Treasury and Wealth Management”. Customers were described as “experienced business professionals” and loans were to be “supported by secure cash flows and strong collateral”. In particular, business lending, which was classified as “secured term lending”, was presented as the Bank’s core offering and main driver of revenues and profitability.²⁹
- 2.4.2 Notwithstanding this description of itself as a broadly based business bank, in reality Anglo actually catered for a relatively limited number of customers, many of them in the property development sector. The bank felt confident that a good knowledge of its customers, asset security and personal recourse, combined with geographic diversification of its loan book, would reduce the risks inherent in its property lending model.
- 2.4.3 Retail deposit funding was less available to Anglo than the full-service banks due to its small branch network. As a consequence, Anglo put huge effort into developing retail funding using a

²⁸ A term used to describe the shift of economic growth from high to low, or potentially flat, while avoiding recession.

²⁹ The extracts in this paragraph are taken from the September 2007 Annual Report of Anglo. It also reported that the bank delivered its 22nd consecutive year of uninterrupted earnings growth with underlying profits increasing by 44% to a record €1,221m. The excellent performance was attributed by Anglo to “its disciplined and focused business model, prudent risk appetite and very limited exposure to areas affected by current credit market issues”. This annual report provided details of risk concentration by geographic location but did not provide a detailed breakdown by sector. Accordingly, there was no reference to C&P lending other than a specific comment that “the Bank does not engage in speculative development lending”.

centralised model and by generally paying higher deposit rates than the other banks. Nevertheless, this was not sufficient to fund the bank's massive lending growth and Anglo became increasingly dependent on UK retail deposits, corporate deposits and wholesale market funding.

- 2.4.4 A change in leadership at the beginning of 2005 coincided with a number of key long-time experienced executives leaving the bank. While there was no discernable change in the strategy set out above, there was a clear ambition to grow into a "big bank" specialising in non-retail lending. There also was accelerated lending growth from 2005; total loans grew by over 200%; from €23.7bn at September 2004 to €72.2bn at September 2008.
- 2.4.5 The risks of, and governance requirements for, a high-growth and relationship-based business model had been identified within Anglo in 2003 and frequently thereafter. To be successful, such a strategy requires that the increased risk is well handled. This, in turn, requires that governance, policies, operations, risk management and information systems are well developed and stringently applied throughout the bank. While Anglo's emphasis on growth and relationship banking was real, lending criteria and credit procedures in particular were not tightened but were in fact relaxed, especially from 2005 onwards, leading to an accumulation of risk. Furthermore, as detailed below, these risks were not properly recognised or managed.

INBS

- 2.4.6 INBS's business model during the Period was unique. Earlier INBS had grown modestly over a number of years as a provider of residential mortgages. The Building Societies Act 1989 (the 1989 Act), however, empowered building societies to make loans for, *inter alia*, residential housing development. Subsequently, INBS entered the development finance market where interest margins and fees were greater and consequently the business was deemed to be more profitable. The 1989 Act and subsequent amendments allowed building societies to raise wholesale funding which facilitated a much faster growth of loan assets than its deposit funding would have allowed. INBS fully embraced this empowerment that made high lending growth possible. By the end of the Period almost 50% of its funding was from wholesale sources.
- 2.4.7 There is no evidence of the Board having approved a formal business model or strategy during the Period. However, in its communications to the outside world, INBS presented a strategy which was "to develop secure profitable lending to both the residential and commercial sectors". Notwithstanding this, it was commercial property lending rather than residential mortgages that showed significant growth over the Period. By the end of the Period no less than 85% of its loan book comprised commercial property lending.
- 2.4.8 In many cases, INBS's business model involved providing 100% finance to experienced and proven property developers, enabling them to purchase sites (mainly for residential development) which were generally zoned but required planning permission. These sites were situated in the UK and on the Continent, as well as in Ireland. Security generally comprised the property asset only (i.e. without recourse to guarantees or cross security), while interest, fees and associated costs were frequently added to the loan (i.e. interest and/or fees roll-up). When

planning permission, which generally increased the value of the site, was attained it was intended that another bank would refinance the loan and INBS would be repaid. Loan contracts tended to include profit share agreements, with INBS receiving typically between 25% and 50% of the profit if and when a project was concluded successfully.

- 2.4.9 This business model was, in principle and in practice, risky because of the planning permission risks involved and because of the reliance on the refinancing of borrowers by other banks. These risks were seen by INBS as significantly mitigated by accepting, as borrowers, only developers who had a long and successful history of doing such projects. The model was in some ways closer to that of a venture-capital financier than that of typical banks. Its key risks were a decline in property values and a disturbance in the refinancing abilities of other banks.
- 2.4.10 INBS's overarching driver was demutualisation and sale. This was frequently expressed by management, the Board and INBS members and was expected to result in a cash windfall for all parties.³⁰ As the value of INBS would dictate the size of the windfall, it is noteworthy that the bank's most significant growth spurt was during the years leading up to the expected demutualisation.

Other Banks

- 2.4.11 The four other banks can be broadly divided into the two bigger full-service banks (AIB and BoI) and the two smaller institutions primarily concentrating on providing residential mortgages and other similar products (Educational Building Society (EBS)³¹ and Irish Life and Permanent (IL&P)³²).
- 2.4.12 The strategies of the two bigger banks included a desire to maintain their independence. To drive share price growth, and thereby increase their market capitalisations, it was felt that banks needed to show sufficiently strong growth in earnings and at least maintain market share. Strong market capitalisations, in turn, somewhat protected the banks from takeover by a domestic or foreign competitor. Both banks viewed Anglo as a major threat: it was growing rapidly and it was greatly admired by many market commentators and advisors both domestically and abroad.³³ Also, as illustrated in Figure 2.12 below, Anglo had a higher price-earnings ratio than the other listed Irish banks for most of the Period.

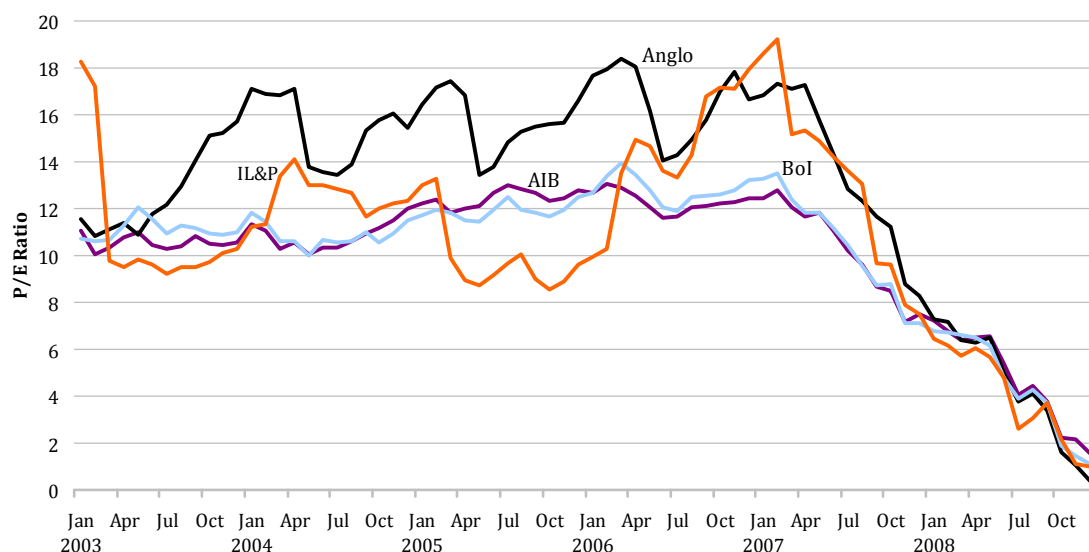
³⁰ An amendment to the Act in 2006 repealed a rule which provided that, after demutualisation, a building society could not be sold to a single entity for five years. The INBS had been lobbying for this change for many years and a trade sale would have resulted in a windfall for members and a substantial bonus for management. When the legislation was passed, the INBS did not achieve a sale straight away. This was probably because the 2007 financial results were to have yielded a higher valuation and consequently a higher sale price. However, the economic collapse meant that the planned trade sale never materialised.

³¹ In the case of EBS, the Commission focused primarily on its commercial property lending.

³² In the case of IL&P, the Commission focused only on the banking arm of the institution.

³³ For instance, as late as 2007, a well-respected external consultancy firm presented Anglo, at an AIB seminar, as an example to which AIB should aspire.

Figure 2.12: Average Monthly Price Earnings Ratios of Listed Covered Banks – 2003-2008



Source: Datastream

- 2.4.13 Accordingly, during the Period, strategies in both bigger banks evolved to allow increased exposure to the commercial property market as this was a sector that could provide for the significant loan growth required to meet earnings targets. To fund the rapid growth of assets, deposits had to be increasingly complemented by wholesale funding that had become readily available in large quantum and at attractive pricing for all eurozone banks.
- 2.4.14 Increased competition in the residential mortgage market led to falling margins and put pressure on such market shares for all banks. The smaller banks (EBS and IL&P) responded to this by pursuing increased lending volumes that aimed to both ensure retention of market share and compensate for the fall in margins. Although both banks continued to see their primary focus as providers of retail financial products, they increased their involvement in commercial property lending to varying degrees.
- 2.4.15 EBS in particular made an explicit decision to take on more risk in 2005 when it made a concerted effort to grow its property development financing book in order to offset the effect of competition on residential mortgage margins. Competition was perceived as threatening its status as an independent mutual. Although the bank imposed strict caps on the level of property development lending permitted, this did not protect it from incurring significant losses as the strategy was not well executed.
- 2.4.16 IL&P differed from the other banks in that it did not engage in speculative C&P lending and its banking business model continued to be primarily focused on providing residential mortgages (which made up 84% of its total bank loan portfolio in December 2008).

2.5 Governance and Procedures

- 2.5.1 A board is responsible for the safety and soundness of a bank, its depositors and shareholders (or members in the case of a building society). It determines the strategic direction, governance culture, risk appetite and procedures which are designed to generate a return for the owners while ensuring prudence at all times. A Chairman is responsible for the leadership and effectiveness of a board.
- 2.5.2 A CEO is appointed by a board to lead the day to day management of a bank and to ensure that the strategies, risk appetite and procedures, as set by a board, are followed. A CEO is also responsible for providing executive advice and for formulating policy proposals for consideration by a board.
- 2.5.3 Independent of a CEO, Board Sub-Committees have a direct reporting line to a board covering, *inter alia*, the following key areas: Risk and Compliance, Funding, Remuneration and Audit. As will be outlined below, in a few of the covered banks significant parts of this proper governance structure either did not exist or were, in practice, not effective. This section goes on to examine if and where the covered banks failed to meet these standards while the Chapter then goes on to examine the effectiveness of individual functions within the covered banks, such as credit and risk management.
- 2.5.4 It has been argued by some that a board in any large company must rely on information it receives from its management and the knowledge and expertise of that management. While this assumption of good and open cooperation is valid, it is, nevertheless, incumbent on a board to have sufficient understanding and awareness of the risks associated with the business for which it has oversight responsibility on behalf of shareholders and others. To ensure this oversight happens, even more so in the case of a regulated entity such as a bank, the board must ensure that sufficient checks and balances are in place and operating effectively to assist the board to meet its responsibilities. Over a protracted period, like the Period under scrutiny, the board would inevitably have sufficient time and information to understand the company's affairs and the evolution of risks to which it is subject. It would also be possible to ensure that sufficient checks and balances are in place, are working properly and are seen to be working properly. It is the board's unique responsibility to satisfy itself that the senior management, which it has appointed, ensures that the structures for such board work are in place.

Anglo

- 2.5.5 As already noted in paragraph 2.4.5 above, the risks of and governance requirements for a high-growth scenario had been well identified within Anglo in 2003 and again in both 2006 and 2008. These requirements included reinforcing the culture of risk awareness within the bank and the need for an enhanced risk management approach. However, little effective action was taken to address these requirements. By implication, the Board and management remained convinced that the challenges identified were adequately met by the systems that were in place. They appear to have mainly concentrated on business development and growth, particularly from the middle of the Period, and seem to have lacked sufficient awareness of risk.

- 2.5.6 Anglo's internal governance structure corresponded to the usual requirements. The Bank had a board sufficiently large to run the various necessary Board Sub-Committees. In 2005 the Bank changed CEO and, in addition, a number of executive Directors, who had been with the bank for many years and were experienced bankers, either retired or left the bank around this time. Anglo worked from there on with a new team of executives. In addition, the former CEO was appointed as the new Chairman of the Board, in contravention of generally accepted governance principles at the time. Thus, while the governance structure remained in place, the key people running the bank changed within a short time; this could have contributed to the changing interpretation of governance principles. As already mentioned, one change apparent was an acceleration of lending growth over the following few years.
- 2.5.7 The board members were experienced and well regarded in their own fields of speciality. However, they were not expert in the field of banking and several therefore appear to have been dependent on senior management to assess the needs for the reporting systems and procedures necessary to contain the key risks identified. Accordingly, there is little evidence that board directors at the time were active in challenging the bank's approach or its pace of lending growth. A number of Non-Executive Directors (NED's) and executives also had significant Anglo shareholdings, which indicates their confidence in the operations of Anglo and their assessment of the risks involved.
- 2.5.8 In 2007, the responsibilities of the Chief Risk Officer (CRO) were assumed by the Finance Director in addition to his other duties. At this time, Anglo's property-related exposure in Ireland, the UK and the US had grown very significantly, and the need to monitor and manage the attendant complexities and risks had grown proportionately. This decision would suggest that risk management was not appropriately prioritised within the bank.

INBS

- 2.5.9 INBS operated with a very flat organisational structure and had a relatively small number of staff responsible for the large commercial loan book. The Managing Director (MD) had been given extraordinary powers by the Board and many staff reported directly to him. In August 1997, the Board had formally delegated its powers for the practical, effective and efficient management, promotion and development of the bank to the MD. This delegation of powers was most unusual given its vague and general formulation. Indeed, it is not immediately apparent what the limits to this empowerment were.
- 2.5.10 Though INBS had an Asset and Liability Committee and an Audit Committee, it operated without a number of other standard Board Sub-Committees (Risk or Nominations Committee). Moreover, there were functional inconsistencies in the operation of the committees that were in place.³⁴ Often basic procedural requirements for the operation of these committees, such as

³⁴ For example, in relation to INBS's Credit Committee, an inspection by the Financial Regulator in 2006 identified that, for the period 8 May 2005 to 11 May 2006, the quorum of three members was only achieved for two of the twenty seven meetings and for four of the meetings only one member was present.

terms of reference, were only put in place following protracted representations from the Financial Regulator (FR).

- 2.5.11 INBS essentially appears to have attempted to manage risk through its choice of trusted borrowers and correctly identifying profitable property development projects. Therefore, its Risk or Credit functions do not appear to have been effective in any traditional sense. For instance, the Credit Committee was populated at times primarily by the lenders who should normally be challenged by such a committee. INBS also operated without a Head of Commercial Lending and a CRO for most of the Period. The functions that did exist lacked independence, as they all reported directly to the MD.
- 2.5.12 The Board had only three NEDs for most of the Period. Rotation was modest and board members had little practical banking experience. Despite this, they were responsible for assessing virtually all large commercial loan proposals; though documentation was limited few proposals were apparently ever refused. The INBS NEDs nevertheless seem to have accepted the unique method used to assess, manage and monitor risks. The frequent requests from the FR to improve governance were noted but did not, for various reasons, lead to much improvement. Great comfort appears to have been taken also by the NEDs from the past profitable activity of INBS. Past performance seems to have been taken as a sign that governance (and risk) on the whole was appropriate.
- 2.5.13 As INBS neglected to build up robust organisational structures and risk management frameworks, it is not surprising that there was no evidence of even basic analysis or reporting of, for example, internal sector limits, concentration risk and the adequacy of security. The absence of such structures resulted in low overheads leading to a remarkably low cost-income ratio over several years. By 2007 the reported cost-income ratio had declined to 10%.³⁵ Notably, this does not appear to have been seen as a cause for concern by rating agencies or other outside observers, although such a deviation from the norm could have implied shortcomings in resources, governance and control.

Other Banks

- 2.5.14 In the other banks, governance structures and procedures were largely in place. However, as explained in more detail in the following sections, the effectiveness of the procedures tended to change over time. Because lending growth, in practice, became prioritised over credit and risk management, checks and balances in the banks were weakened even though the formal structures remained.
- 2.5.15 The strategic emphasis on earnings growth and market share tended to coincide with a dominant sales culture³⁶ among senior executives in some of the banks. At the same time, credit and risk

³⁵ For the same period, EBS's cost income ratio was 56% as was Nationwide (UK)'s. In 2007, the median ratio for all UK building societies was 70% with the lowest at 40%.

³⁶ Some banks strongly stressed their commitment to provide services to their traditional customers as their needs developed over time (relationship banking). This policy of "follow the customer" can, in fact, be seen as a form of sales culture, though limited to part of the market only.

management expertise among management was not as prevalent as would have been the case a number of years before. At the CEO level, with some exceptions, the depth of hands-on lending expertise required to appreciate fully the types and scale of risk being taken on by their respective banks was modest.

2.5.16 Also, both of the bigger banks showed marked divisional structures with large property exposures being handled by the retail side of the business rather than in specialist corporate lending divisions. This was a key issue particularly in AIB where there was a rapid build up of lending in the Republic of Ireland (RoI) division through the Period. C&P lending was the major driver of RoI growth, with lending mainly to experienced property developers. AIB's divisional structure was judged by some to have made group-wide credit and management difficult, due in part to inadequacies in IT systems. In addition, large loans were not receiving the close attention and supervision necessary due to the volume of business growth. Credit procedures for large property exposures were furthermore undermined by pressures on RoI to meet growth and profitability targets. The transfer of large property related loans from the retail division to corporate banking specialists would have impacted negatively on RoI divisional profitability. As such transfers did not take place, not surprisingly, RoI came to contain major problem loans.

2.5.17 In BoI, where each division did not have its own Credit Committee, the Group Credit Committee dealt with a much greater volume of loans. This enabled it to occasionally decide that large property-related loans should be moved from one division to another where specialisation and manpower would allow for closer supervision and management. Probably for divisional profitability reasons, the migration of accounts to specialist divisions did not always take place. While this may have contributed to a higher level of loan impairment at BoI, it was not on the scale of impairment that emerged in AIB.

2.5.18 As noted above, EBS embarked on a strategy to lend into riskier parts of the property market in 2005. However, execution skills and procedures were inadequate, which led to significant impairments.

2.6 Remuneration

2.6.1 The extent to which remuneration policies and practices of banks internationally have contributed significantly to the crisis has been the subject of extensive worldwide debate, including at the highest political levels,³⁷ resulting in the publication, in a European context, of guidelines on remuneration in December 2010 by the Committee of European Banking Supervisors.

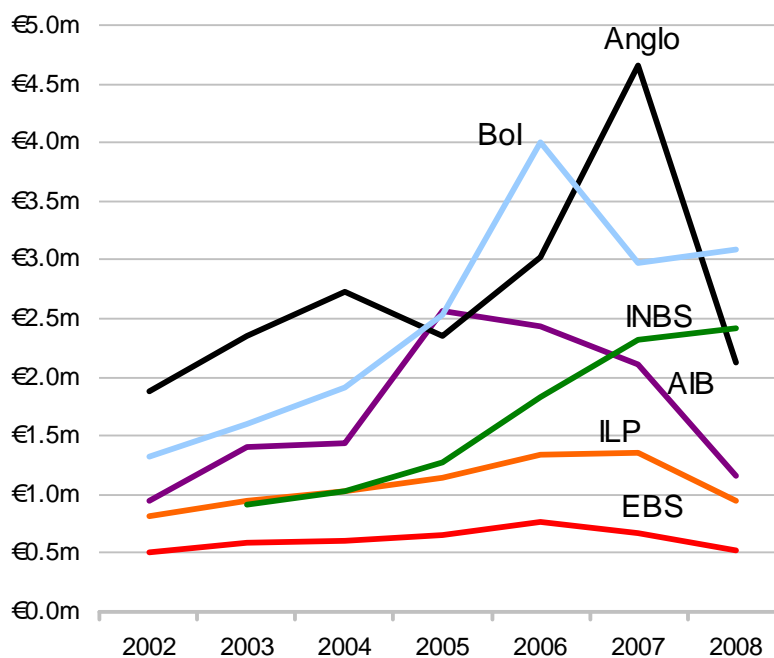
2.6.2 Remuneration models in Ireland were usually designed by specialist consultants in the field and normally benchmarked against other companies both in Ireland and in the UK, on the basis of size.

³⁷ For example, the issue was discussed by both the G7 and the G20.

2.6.3 The models, as operated by the covered banks in Ireland, lacked effective modifiers for risk. Therefore rapid loan asset growth was extensively and significantly rewarded at executive and other senior levels in most banks, and to a lesser extent among staff where profit sharing and/or share ownership schemes existed. Targets that were intended to be demanding through the pursuit of sound policies and prudent spread of risk were easily achieved through volume lending to the property sector. On the other hand, most banks also included performance factors in their models other than financial growth.

2.6.4 As illustrated by the graph and separate table in Figure 2.13 below, rewards of CEOs reached levels, at least in some cases, that must have appeared remarkable to staff and public alike. It is notable, that proportionate to size, the CEOs of Anglo and INBS received by far the highest remuneration of all the covered bank leaders. Conversely, despite AIB having one of the largest exposures to the property market, its CEO was paid the least, proportionate to size, of the covered bank leaders.

Figure 2.13 CEO Remuneration in the Covered Banks



Source: Annual Reports

Note:

1. CEO remuneration includes all reported remuneration including salary, fees, bonus, pension contributions other than shares or share options granted
2. INBS CEO Remuneration for 2002 not disclosed in annual report
3. Amounts relate to reported remuneration of officer holding period for the majority of the financial year except AIB 2005 where two CEOs' figures are combined due to mid-year hand-over
4. The 2008 (31/3/09) figure for BoI includes €1.46m for payment in lieu of notice

Figure 2.13 (continued)

'000	2002	2003	2004	2005	2006	2007	2008
Anglo	€1,885	€2,346	€2,721	€2,354	€3,015	€4,656	€2,129
INBS	(Note 3)	€10	€1,034	€1,269	€1,836	€2,313	€2,417
AIB	€40	€1,399	€1,445	€2,563	€2,436	€2,105	€1,152
BoI	€1,318	€1,594	€1,919	€2,525	€3,998	€2,972	€3,095
EBS	€13	€89	€601	€55	€760	€678	€22
IL&P	€22	€46	€1,025	€1,138	€1,335	€1,362	€42

- 2.6.5 Financial incentives were unlikely to have been the major cause of the crisis. However, given their scale, such incentives must have contributed to the rapid expansion of bank lending. Nevertheless, it was claimed by a number of bankers that management and staff were not motivated by compensation alone. Most would compete, it was claimed, as they had during the previous period of lower compensation, on the basis of natural competitiveness and professional pride.

2.7 Lending and Credit

- 2.7.1 The core principles, values and requirements governing the provision of credit are contained in a bank's credit policy document which must, as a regulatory requirement, be approved at least annually by a bank's board. The policy defines the risk appetite acceptable to the bank and appropriate for the markets in which the bank operates and the lending products which it provides. Procedures for approving and reporting exceptions to policy should also be clearly defined in the credit policy document. The purpose of such a credit policy is to set out clearly, particularly for lenders and risk officers, the bank's approach to lending and the types and levels of exposures to counterparties that the board is willing to accept.
- 2.7.2 During the Period, all of the covered banks regularly and materially deviated from their formal policies in order to facilitate rapid and significant property lending growth. In some banks, credit policies were revised to accommodate exceptions, to be followed by further exceptions to this new policy, thereby continuing the cycle. Furthermore, systems and procedures often lagged as lending activity increased.

Anglo

- 2.7.3 Anglo was not known for offering cheap loans either before or during the Period. Instead, the large financing needs of known customers would, if necessary, be provided quickly. This was particularly convenient for property developers needing to conclude deals rapidly or in competition with each other. However, as competition increased in Anglo's core lending markets, margins declined and greater risks were taken to retain customers. This is evidenced by material changes made to Credit Policy in 2005, 2006 and 2007 which relaxed key elements of lending criteria.

- 2.7.4 In Anglo, credit risk management structures were, in practice, deficient and there was ineffective overview of Group credit decisions.³⁸ Lending policies were treated as guidelines rather than strict rules; exceptions to policy were very common. In addition, the internal sector limits which did exist were not enforced. Loans were not clearly or appropriately classified by commonly used sector lending categories. This created an image of diversified business, corporate and SME lending portfolios secured on stable cash flows and solid assets.
- 2.7.5 In fact, Anglo was essentially a monoline bank focused almost exclusively on commercial property lending.³⁹ One of its strong selling points was “speed of approval” for loan applications. Additionally, the lending culture was such that when applications were problematic, the mindset was “there is a ‘yes’ in there somewhere”. Being a relationship lender, Anglo found it quite difficult to decline a loan to any of its traditional top customers. Furthermore, loans that were not supported by strong or sufficient cash flows or collateral were frequently reinforced by personal guarantees, which were either unsupported by assets free of debt, or supported by equity in other property (often highly leveraged and correlated in value) already pledged to Anglo.
- 2.7.6 Reporting processes in Anglo in relation to the management of credit risk were deficient. The quality of information being presented to the Risk and Compliance Committee and the Board was not of the highest standard. For example, exceptions to credit policy were reported as a percentage of overall loans rather than by borrower and exposure. Also, reporting of arrears and impairments, which are simple but vital measures of portfolio quality, was inadequate. This weakness in reporting processes was combined with a lack of sufficiently extensive banking experience and expertise at board level of the type which would have allowed the board to identify shortcomings in the information being provided. This meant that the Board may not have been conscious on a timely basis of the significant risks accumulating on the bank’s balance sheet or of the deterioration in credit quality.
- 2.7.7 During the Period there was limited effort to de-risk⁴⁰ the balance sheet growth. This was consistent with the policy to become a “big bank”. In 2006, Anglo made a decision to stop taking on new customers for development finance but continued to accommodate its existing customers. Nevertheless, lending continued to be strong even in 2008. Aggregate exposure to the top 20 customers (individuals and related entities) as at 31 May 2008 equated to circa 50% of the Irish loan book of €41.7bn. This information was presented to the Anglo Board in June 2008.

³⁸ Recording of Credit Committee minutes only began in 2004 at the behest of the FR. Reports on Exceptions to Credit Policy were only started in November 2005, again at the behest of the FR. The level of exceptions was running at 25%+ monthly from commencement of reports despite underwriting criteria having been relaxed in 2005, 2006 and 2007. In the first quarter of 2006, a total of 1,047 loans were approved by the Credit Committee of which 519 (49%) were exceptions to the Credit Policy.

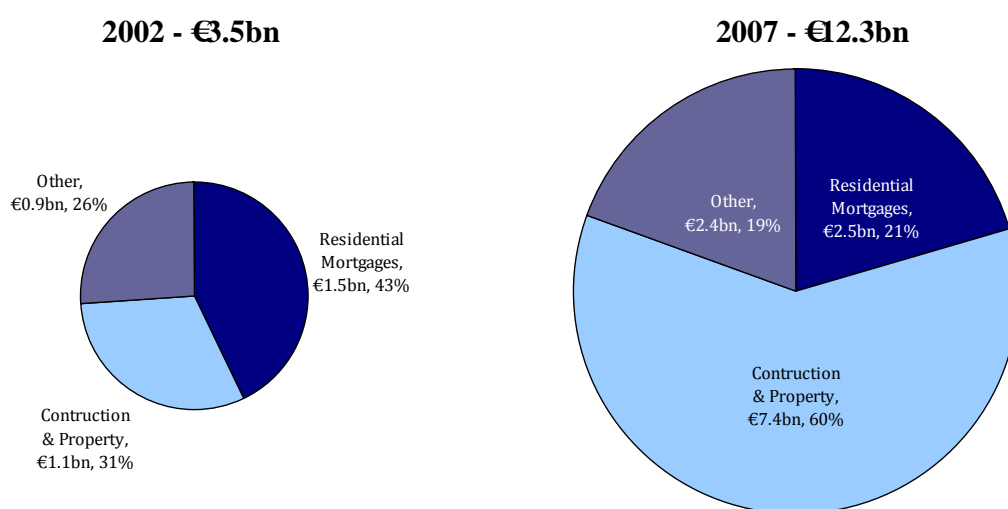
³⁹ Even from fairly broad public information, this should have been apparent to outside observers. To professionals with access to detailed bank loan portfolios, it should have been obvious.

⁴⁰ For example, the use of risk management strategies such as the syndication of larger loans to other banks would have de-risked the balance sheet.

INBS

- 2.7.8 From 2000 to 2007 INBS's commercial loan portfolio grew rapidly from €2bn to €9.8bn. Over the same period its residential mortgages grew relatively slowly, from €1.5bn to €2.5bn; falling from 43% of the portfolio to 21%. At the end of 2007, its commercial loan book comprised €4.3bn of lending in Ireland, €4.5bn in the UK and €1bn relating to mainland Europe. Its loan portfolio became very concentrated in speculative site finance with €5.1bn (52% of the commercial book) in this category at December 2007. The growth and composition of INBS's lending during the 2002 to 2007 period is illustrated in Figure 2.14 below.

Figure 2.14 INBS: Year End Loans & Advances to Customers



Source: INBS & Annual Report

- 2.7.9 INBS's credit management was unusual in many respects. Credit policies were applied very flexibly and, in addition, it had no effective, independent credit risk management function. Consequently it operated without the "checks and balances" normally considered necessary in banks. For the duration of the Period, while exposure to commercial property lending grew rapidly, there was inadequate additional expenditure or investment in infrastructure (for example IT and Management Information Systems (MIS)). Few of the additional skilled and experienced staff necessary to manage INBS's growing and more complex portfolio of loans were hired.⁴¹ Furthermore, credit risk mitigants were not applied in any meaningful way since INBS's leadership generally assumed that focusing on a limited number of traditionally good customers was in itself safe enough. Of course, this meant creating a high concentration of loans to individuals and related entities, any of which on their own posed a substantial risk to INBS's capital. At September 2008, the top 25 customers represented 51% of the INBS commercial loan book.

⁴¹ The non-Irish commercial book of €5.5bn was handled by only two managers.

2.7.10 INBS's approach to lending frequently included profit share arrangements which formed part of the loan structure, generating substantial reported profits in the 2004-2007 period as the portfolio grew and property values increased. However, the nature of INBS's lending involved extending credit at extremely high LTC or LTV ratios secured on the underlying asset. Generally there was no access or recourse to additional tangible security in the event of problems arising. As a result, INBS was particularly exposed to any downturn in property prices.

2.7.11 As a result of the extensive governance issues (as set out in Section 2.5 above), the INBS loan approval and administration process was not up to accepted banking standards, files were often badly maintained and loans were not subject to regular review or appropriately graded and classified. There was high staff turnover and recruitment, particularly at management level, appeared to be difficult as INBS's stated intention was to demutualise and be sold.

All Banks (including Anglo and INBS)

2.7.12 As all banks had effectively adopted high-growth strategies (IL&P less so), the aggregate increase in credit available could not be fully absorbed by good quality loan demand in Ireland. Banks had two options to remedy this; diversify their lending into other markets or relax lending standards. Though the covered banks did lend into new markets (particularly into the UK but also, as in the case of Anglo, into the US), substantial numbers of new loans were made in Ireland. By implication, credit standards fell.⁴² The lowering of standards manifested itself as both a reduction in minimum accepted credit criteria and (more subtly) as an increase in accepted customer and property leverage.

2.7.13 Occasionally, management and boards clearly mandated changes to credit criteria. However, in most banks, changes just steadily evolved to enable earnings growth targets to be met by increased lending. The resulting asset growth meant that internal lending limits (both sector and large exposure limits) were exceeded. Regulatory sector limits in some banks were also exceeded, both prior to and during the Period. Gradually, as such excesses became more frequent, they were viewed with less seriousness.⁴³ Essentially, there was "procedures creep" whereby exceptions to previously approved lending policies and procedures gradually became the new norm.

2.7.14 AIB's C&P loan book totalled €50.4bn as at end September 2008 of which €23.7bn related to development finance. AIB had a comprehensive Credit Policy specifically for C&P lending. However, the extent to which exceptions were accommodated indicates a very high degree of flexibility, making the policy more of a guideline. In addition, management authority to approve exceptions to the then current Group Large Exposure Policy was increased by the Board in 2006 from €250m to €750m. The rationale put forward for this increase was the growth in the

⁴² The Commission evaluated lending policies using a set of core lending principles including, *inter alia*: underwriting criteria, recourse, security, valuations, repayment capacity, internal sector limits, concentration limits, loan size limits, aggregation rules, large exposure limits and stress testing.

⁴³ The decision by the Financial Regulator, and the Central Bank before it, not to impose sanctions for these excesses (see Chapter 4) may have given inappropriate comfort to the banks at the time.

funding needs of the bank's customers on the back of the strong growth in the Irish economy. Exceptions were to be reported to the first board meeting following each such management approval.

- 2.7.15 BOI's C&P loan book totalled €38bn as at end September 2008 of which €13.1bn related to Development Finance. This smaller exposure can be explained by the bank's relative conservatism and, related to this, a more modest escalation of its exposure to the Irish property market.
- 2.7.16 In the case of EBS, specific weaknesses were identified in its commercial lending function, particularly in the area of Development Finance. There were insufficient lenders with extensive experience in property development lending and, in addition, there was poor supervision of the overall portfolio.
- 2.7.17 In some of the covered banks, the larger loan sizes and volumes, as well as greater complexity, required greater expertise, skill and resources for credit assessment and management than were usually available.
- 2.7.18 The common issues identified included: the relaxation of formal lending policies into only guidelines; a lack of operational limits on loan size or on total exposure to connected parties or sectors; the slow slide from lower-risk to higher-risk lending, from cash flow-lending to asset-backed lending and from small to large to enormous loan amounts; an increasing amount of facilities provided on an interest roll-up or interest-only basis; higher loan-to-value ratios, equity releases and increased loan complexity (particularly involving investor syndicates later in the Period). Other common features included: relaxation of borrower loan covenants; substantial increases in delegated lending approval limits which led to a reduction in board oversight; a lack of adequate collateral and repayment prospects apparently "corrected" by personal guarantees or cross-collateralisation;⁴⁴ and provision of higher-risk loans to protect a business relationship.
- 2.7.19 Lack of implementation of internal sector lending limits meant that assessments of credit applications, while understandably concentrating on the merits of the individual proposal, paid inadequate attention to the overall bank exposure to the underlying sector. Thus, as long as a proposed loan seemed profitable in itself, there was a tendency to approve it regardless of how many loans with similar risks were already on the books. This lack of an internal sector constraint is a major factor in seeking to explain the amount of property exposure in the covered banks.
- 2.7.20 Both of the bigger banks also gradually shifted their focus from lower-risk investment property loans to more speculative property construction, property development and site financing loans. The demand for Development Finance was so strong over the Period that bank and individual growth targets were easily met from this sector. Both of the bigger banks continued to lend into

⁴⁴ The taking of charges over other property assets to improve a bank's security position.

the more speculative parts of the property market well into 2008, even though demand for residential property (a major end-user) had begun to decline by the end of 2006.

- 2.7.21 There was a general reluctance by banks to reduce their risk by syndicating loans.⁴⁵ Individual banks therefore, partly unknowingly, built up significant exposures to the same high profile property developers as other banks. This meant that the larger developers' overall debts across different banks became colossal. Also, the value of the developers' personal guarantees to each bank was diminished by their concentrations in highly-correlated property assets.
- 2.7.22 A significant contributor to lending growth in all banks was the so-called "equity release" on a secured property. Equity release could take place after the assessed value⁴⁶ of a property increased in the property boom. Provided the bank agreed, the borrower could then use this uplift in value as collateral for an increase in the existing loan or for an additional loan secured on that property. This was higher risk lending than was appreciated by bank management at the time as the apparent increase in value (usually supported by an external valuation) which created the equity in the property was not necessarily sustainable.
- 2.7.23 In a growth environment, readily available liquidity and perceived/expected demand for property can artificially inflate its value and create additional equity above existing loans. When the perceived demand and liquidity disappear so does the supposed equity. Banks lent significant amounts to the Irish property market against apparent equity with the expected source of repayment being anticipated rental uplifts (in the case of property investment) or, in many cases, the refinance or sale of the asset. Hence, when liquidity became scarce and demand for property decreased, properties rapidly lost value, loan-to-value ratios increased markedly and rents did not increase, or fell. The result was larger loan losses as the equity cushions were much smaller than when the properties were originally financed.
- 2.7.24 In residential mortgage lending, credit quality decline had two distinct components. Firstly, banks increased the availability of products with a higher risk profile than traditional mortgages, such as 100% LTV mortgages, interest only mortgages and remortgages/equity release

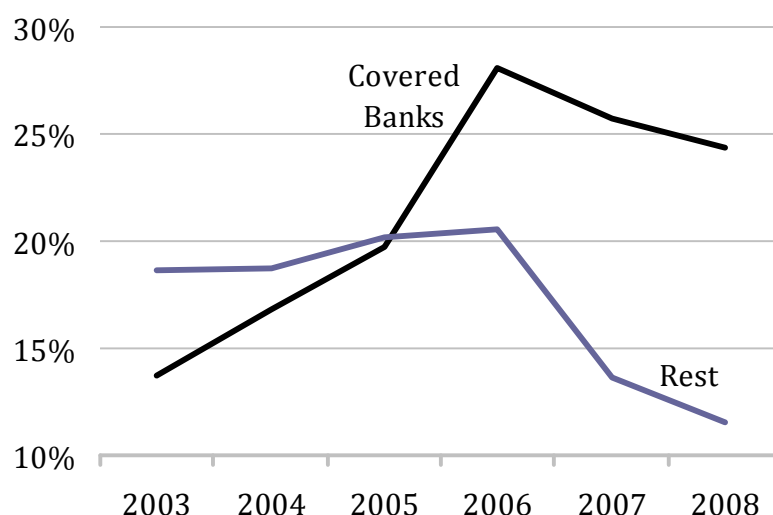
⁴⁵ The frequent syndication of loans might also have limited the size of the aggregate debts of certain property developers as participating banks would have had more visibility over their borrowers' financial liabilities to other institutions.

⁴⁶ At its simplest level, an investment property valuation divides the rental income by the required yield to produce a value. Thus a rent of €30,000 at a yield of 7% produces a value of €428,571. In a boom economy, with readily available finance, investor demand and anticipated rental growth, investors will accept lower yields, thus boosting property values. Property valuations are carried out at 'a point in time' and will use the average rents achievable for properties of a similar type and location as the benchmark. If rents are high for prime office space, then the capital value will be commensurately high whereas a fall of 25% in the benchmark will have a commensurate impact on capital values. It is for this reason that banks traditionally discounted valuations in loan assessments to around 70% of the value (or cost if lower) of prime real estate and at a higher discount to valuation for property of a specialist nature (e.g. factories). As well as an LTV covenant, the loan conditions should include a Debt Service Coverage Ratio covenant which would, at a minimum, require that the annual net operating income from the underlying property equates to 130% of the annual interest charge on the loan. A further prudent condition is to require a "cash sweep" whereby all surplus rental income is used to repay debt, thus enhancing the lender's security cover.

mortgages. These products required either less equity from the borrower or involved higher gearing due to an upward revaluation of collateral. Interest only mortgages also failed to ensure gradual repayment that would increase owner equity in the house and simultaneously reduce bank risk. A fall in property values meant that the collateral underlying the loan would be worth less than the amount of the loan and any inability to repay on behalf of the borrower would result in a loss for the bank if it sought to enforce security.

- 2.7.25 Secondly, many retail customers acquired second or more properties and there was a significant growth in the buy-to-let market (see Figure 2.15 below). Lending into the buy-to-let market is riskier than providing a loan for a person's primary residence because borrowers will naturally protect their principal residence at the expense of servicing debts on a second property. Furthermore, repayment capacity on a buy-to-let loan is almost always dependent on the rent it can achieve and, as evidenced recently, rents can suffer significant declines.

Figure 2.15 Buy to Let Lending as % of Overall Residential Mortgage Lending 2003-2008



Source: Central Bank of Ireland

- 2.7.26 Furthermore, a fundamental flaw in the product design of “tracker mortgages” was the assumption that sufficient funding would be available in the longer term at or near ECB rates. When a bank's actual cost of funds increased to well above the ECB rate in 2007, it was unable to pass these costs on to customers. While this feature was attractive from the borrowers' perspective, it posed a potential risk to interest margin for the banks. Tracker mortgages were available from four of the covered banks but were particularly a feature in the three largest residential mortgage lenders among the covered banks, where they accounted for in excess of 50% of the mortgage books as against approximately 20% in the case of EBS.
- 2.7.27 Boards and relevant observers appear to have had little appreciation of how the banks actually were run at grass-root level; at least they did not seem unduly concerned about the practices

referred to above. The inadequate attention banks generally paid to credit risk management is, in the end, evidenced by the extent and nature of their subsequent problem loans.

2.7.28 As the global financial crisis deepened, the covered banks' reported combined losses for 2009 were €19.4bn. Further losses are expected for 2010 based on the interim published combined losses of €10.3bn. These combined losses of €29.7bn exceeded the covered banks' combined after tax profits of €21.1bn reported for the 2003-2008 period.

2.7.29 Losses incurred by five of the covered banks were crystallised in the transfer of loans to NAMA and the "haircuts" are summarised in Figure 2.16 below.

Figure 2.16 Transfers by five of the Covered Banks to NAMA

Transfers to end-2010	AIB €bn	Anglo €bn	BoI €bn	EBS €bn	INBS €bn	Total €bn
Nominal Loan Value	19.6	34.0	9.3	0.8	8.5	72.3
Discount	54%	62%	42%	60%	64%	58%
Consideration	8.9	12.9	5.4	0.3	3.0	30.5
Realised Loss	10.7	21.1	3.9	0.5	5.5	41.8

Source: NAMA, Department of Finance

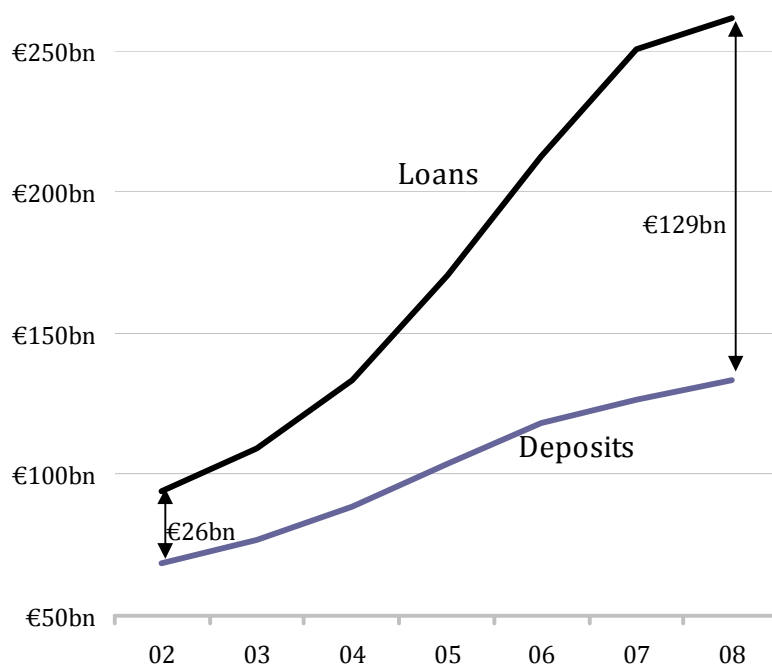
Note: Five of the six covered banks, with the exception of IL&P, applied to participate in the NAMA process.

2.8 Funding, Liquidity and Capital

2.8.1 Changes on the liabilities side of their balance sheets were broadly similar across all covered banks for the Period. Over time, traditional deposit funding proved insufficient to meet the banks' lending targets. To fund their growing asset portfolios, banks therefore began to look to the wholesale markets.⁴⁷ This was facilitated by the introduction of the Euro which provided easier and cheaper access to seemingly unlimited funds. Building Societies (INBS and EBS) could also increase their ratio of wholesale funding due to an amendment to the Building Societies legislation (see paragraph 2.4.6 above). The covered banks' growing funding gap during the Period is illustrated in Figure 2.17 below.

⁴⁷ Wholesale funding usually comprises deposits from banks, senior debt, asset covered securities, commercial paper, certificates of deposit and securitisations. It tends to be diversified across geographies, investor types and maturities.

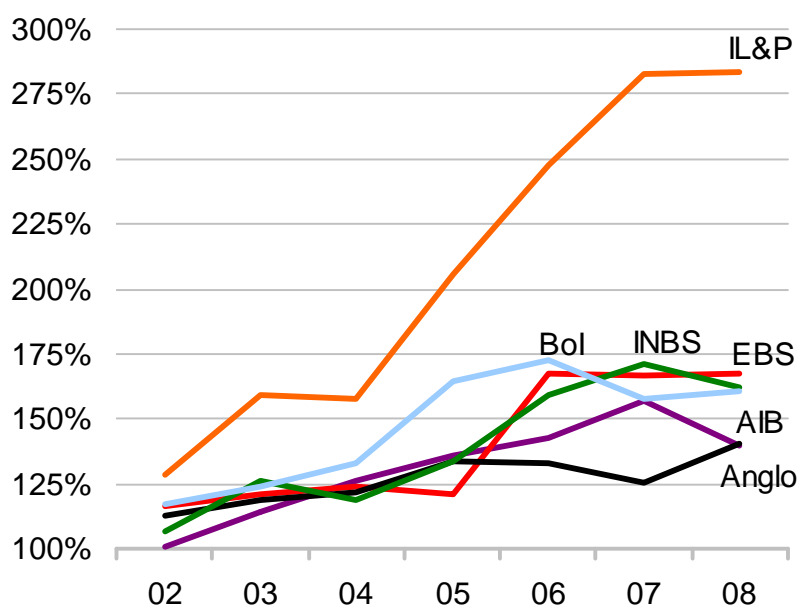
Figure 2.17 Funding Gap: Aggregate Domestic Lending and Deposits of the Covered Banks 2002-08



Source: Central Bank of Ireland

2.8.2 This change in funding structure made banks more vulnerable not only to fluctuations in international interest rates but also to changes in market sentiment and in their own perceived creditworthiness. In benign economic conditions, the wholesale market provides flexible funding in terms of maturity profile, types of structures and instruments as well as pricing. However, this funding can dry up in a very short timeframe if confidence disappears. This is captured in the old adage that “in wholesale funding there is only one depositor” (i.e. when one such depositor leaves, all follow).

Figure 2.18 **Loan to Deposit Ratios of the Covered Banks 2002-2008**



Source: Annual Reports

- 2.8.3 As illustrated by the loan to deposit ratios in Figure 2.18 above, the covered banks' relative dependencies on wholesale funding (much of it from overseas) grew to varying degrees during the Period. In particular, IL&P was very dependent on wholesale funding⁴⁸ but dependence increased for all covered banks. The bigger banks could fund a greater part of their lending through deposits gathered via their extensive branch networks. Banks commonly assumed that access to funding in the wholesale markets would continue unchecked. The Commission was repeatedly assured that, during the Period, there was little or no concern with banks' deteriorating loan/deposit ratios or the absolute amounts of wholesale funding being accessed as balance sheets expanded and leverage grew. There was a firm belief that wholesale funding was being diversified by relying on different instruments and maturity profiles or by accessing different investors or geographically different markets.
- 2.8.4 Observers, analysts and consultants invited to address bank management and boards did dutifully point out the increased funding and liquidity risks. However, there is no evidence that this made a discernible impression. This is not surprising given that many of these same invitees simultaneously stressed the need to grow rapidly without suggesting alternative funding sources. Also, comfort was drawn from the fact that "all peer banks" in Ireland and abroad had chosen the same kind of funding strategy. Furthermore, longer-term securitisations and issuance of covered bonds by some banks alleviated the short-term refinancing risks. The key inherent risk in wholesale funding, its volatility, does not seem to have been seriously appreciated.

⁴⁸ However, IL&P had the backstop of being able to use residential mortgages (which are deemed to be less risky than commercial mortgages) to access ECB funding when wholesale funding markets became less accessible.

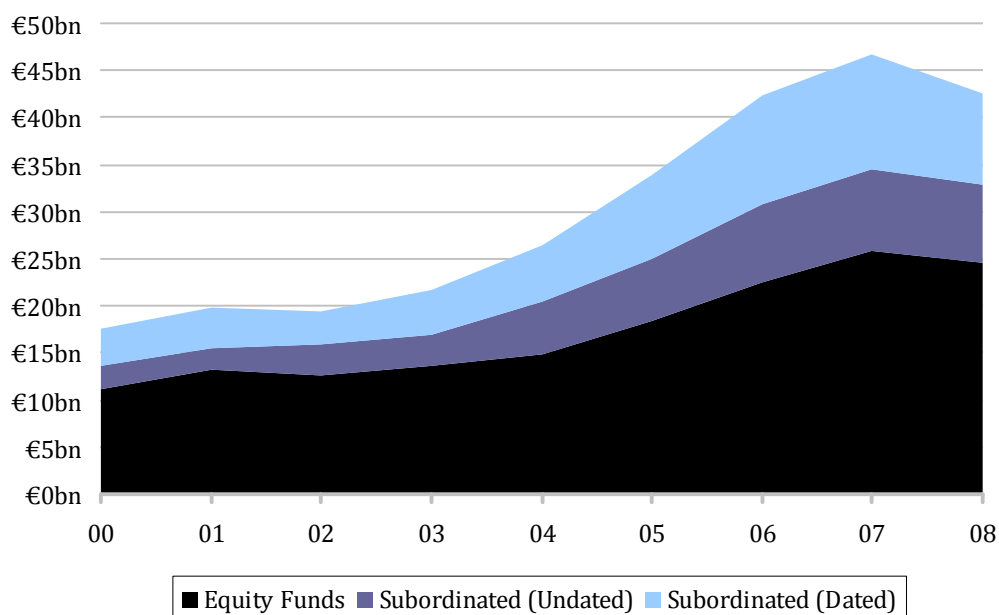
Instead it appears that liquidity risk was accumulated passively because deposits were not sufficient to grow the loan books at a rate necessary to meet earnings targets.

- 2.8.5 However, the general tightening in international credit markets around mid 2007 and into 2008 led to the curtailment of wholesale funding. This problem became more acute as 2008 progressed because of a growing negative assessment of Ireland and Irish banks' exposure to property lending in particular. Maturities shortened, credit and deposit lines for Irish banks were reduced or withdrawn and markets for note issuance grew more challenging. Inevitably, the loss of foreign funding coupled with a weakening demand for property resulted in a fall in asset values.
- 2.8.6 In banks where Treasury was a profit centre an unresolved conflict of interest arose. On the one hand, Treasury was interested in maximising its own revenues by increasing wholesale funding, particularly in shorter term maturities where interest rates are lower (but refinancing risks are higher). These funds could then be transferred to the banks lending departments (at a margin) for on-lending to customers. In some banks there was a drift towards the use of specifically short-term wholesale funding to further reduce funding costs.⁴⁹ This was not always appreciated by boards. On the other hand, Treasury should also have been concerned with minimising a bank's liquidity and refinancing risks. This issue is best illustrated by the fact that, from 2007 onwards, most if not all Treasury functions in the covered banks did try to grow customer deposits and lengthen maturities. As Treasury functions are responsible for funding banks, this conflict, in so far as it arose involving the maturity structure of banks' funding, should not have been permitted. It remains unclear, however, whether or not this conflict substantially influenced the ultimate maturity structure for those banks that were highly reliant on wholesale funding.
- 2.8.7 Turning to capital, the aggregate capital resources (including shareholder funds and subordinated liabilities) of the covered banks grew from almost €18bn in 2000 to circa €47bn at the peak in 2007. Though the covered banks continued to meet their regulatory requirements in relation to capital ratios, the composition of this capital changed materially. As Figure 2.19 below demonstrates, the proportion of shareholder equity in the covered banks' capital decreased significantly, with the balance being made up by subordinated loan capital.⁵⁰ This had the effect of further leveraging the banks' equity, and resulted in higher lending and reported EPS growth which in turn enhanced share prices throughout most of the Period. It also meant a weakening of the capital structures of the covered banks, as subordinated debt had to be refinanced at maturity and at call or margin step-up dates.

⁴⁹ It was the practice in Anglo to maintain a significant amount of surplus liquidity for sound banking reasons. A material portion of this liquidity was invested in financial instruments, such as asset backed securities, in order to earn additional income (yield pick-up). However, these investments became illiquid directly as a result of the crisis in the US sub-prime market and they subsequently became heavily impaired.

⁵⁰ Subordinated debt holders are generally paid a set percentage return or coupon on their investment and do not share in additional profits of a bank. Also, subordinated debt instruments generally did not have voting rights attached.

Figure 2.19: Covered Banks – Aggregate Capital Resources 2000-2008



Source: Annual Reports

2.8.8 A key financial reporting standard change during the Period was the required adoption by all listed EU companies of new IFRS⁵¹ accounting rules applicable, *inter alia*, to loan loss provisioning for accounting periods beginning in 2005. IFRS was adopted by all of the covered banks at that time. An objective of IFRS was to reduce subjectivity in financial statements and, in the case of banks, to have a more objective loan-loss provisioning process. Provisions could only be made where objective evidence of impairment existed at the closing balance sheet date i.e. at a historic point in time (the incurred-loss model). General provisions, which tended to produce a “smoothing” of a bank’s results from year to year, could no longer be made. It was considered that the incurred-loss model was likely to lead to more volatility in a bank’s loan-loss provisioning during changes in economic cycles.

2.8.9 These new accounting rules proved to be pro-cyclical and had important consequences for the covered banks. In the benign economic environment before 2007, the banks reduced their loan loss provisions, reported higher profits and gained additional lending capacity. The banks could no longer make more prudent through-the-cycle general provisions, or anticipate future losses in their loan books, particularly in relation to (secured) property lending in a rising property market. The higher reported profits also enabled increased dividend and remuneration distributions during the Period. All of this led to reduced provisioning buffers in the covered banks when the financial crisis emerged. Finally, the incurred-loss model also restricted the

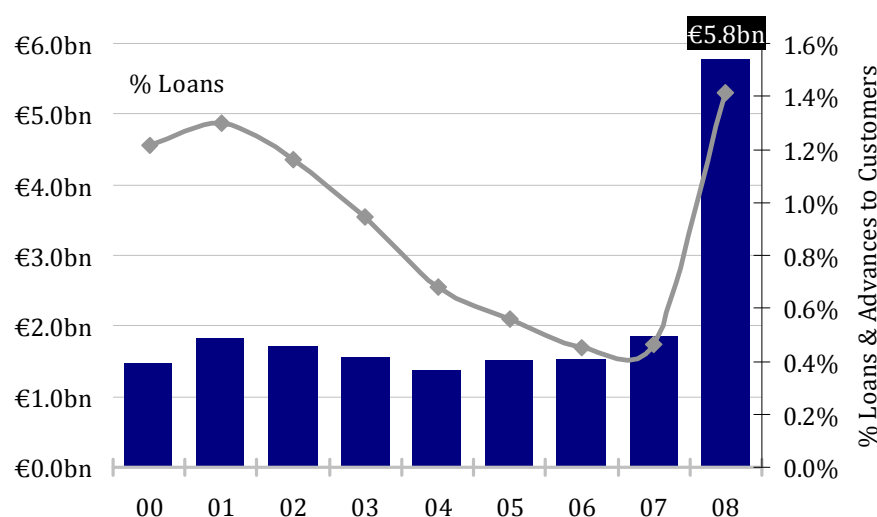
⁵¹ International Financial Reporting Standards, IFRS or IAS, and in particular IAS 39; Financial Instruments: Recognition and Measurement.

banks' ability to report early provisions for likely future loan losses as the crisis developed from 2007 onwards.

2.8.10 Figure 2.20 below demonstrates how loan loss provisioning levels fell between 2000 and 2007. The composite provisioning level for the covered banks at end 2000 was 1.2% of loans and advanced to customers. If this 1.2% provisioning level had been applied at the 2007 year end by the covered banks, aggregate provisions would have increased by approximately €3.5bn (i.e. from the €1.8bn actual to €5.3bn). As a consequence of not making this level of loan loss provisions, increased accounting profits effectively provided additional capital of up to €3.5bn⁵² to the covered banks. This, in turn, increased their capacity to lend by over €30bn.⁵³

2.8.11 In the competitive market, many property loans were made at margins of less than 1% per annum. A composite year end provisioning level at the 2000 level of 1.2% might have caused the banks to reconsider the amount of low margin property lending and might have led to more appropriate pricing for risk.

Figure 2.20: Covered Banks – Provisions for Impairment Charges on Loans 2000-2008



Source: Annual Reports

2.8.12 Following the financial crisis, there is widespread international acceptance of the limitations of the pro-cyclical IFRS incurred-loss approach to bank provisioning. Accordingly, financial

⁵² Subject to taxation and other distributions of profits which would have reduced the positive impact on capital, and subject to differences between accounting and regulatory capital.

⁵³ The average Total Capital Ratio for the covered banks was 10% at 30 September 2008 which broadly implied a multiple of 10 times capital in terms of capacity to lend.

regulators and accounting bodies are reviewing the merits of alternative expected-loss models⁵⁴ for financial reporting.

- 2.8.13 Experience from the present crisis indicates that the prudential value of financial statements can be enhanced through a bank's counter-cyclical ability to anticipate future losses in its annual loan loss provisioning. The Commission believes that relevant Irish authorities should actively engage in the international work currently in progress to improve provisioning rules. In case this work does not succeed or developments so require, authorities might, where possible, consider using available national discretion to adopt financial reporting standards which support the stability of Ireland's banking system.
- 2.8.14 In this regard, it is noteworthy that the Bank of Spain (BoS) had introduced a dynamic provisioning (DP)⁵⁵ model for Spanish banks in 2000. BoS required the Spanish banks to continue using DP after 2005 notwithstanding the EU-mandated IFRS adoption. It was open to the FR to consider adopting provision along the lines of the DP model and to require Irish auditors to accept this. Alternatively, other counter-cyclical measures such as higher capital adequacy ratios could have been imposed by the FR in the benign Irish economic conditions in 2005.

2.9 Risk Management

- 2.9.1 Management and boards in general appear not to have fully appreciated the two key risks to which their banks were exposed. The risks were increased exposures to funding-dependent development projects with future refinance risks and to volatile wholesale funding. In addition, in many institutions, governance, systems and processes were also inadequate, exposing the covered banks to significant but often unrecognised operational risks.
- 2.9.2 Inadequate and ineffective Management Information Systems (MIS) have been identified as a weakness in most banks. Sound strategy and policy formulation requires that senior management and boards are well and promptly informed about the key metrics of a bank especially in relation to risk. For this reason, MIS needs to be of a quality, depth and timeliness that ensures that these requirements are met. In many of the covered banks, it appears that MIS did not always provide timely information on the extent and quality of property-related exposures.

⁵⁴Under consideration by the accounting standards setter, the IASB, in response to perceived weaknesses in IAS 39. Under the expected-loss approach, losses can be recognised earlier by banks through building up provisions for any expected loan losses over the life of a loan.

⁵⁵ The Spanish dynamic provisioning (DP) model uses a statistical method to provide for losses considered inherent in a loan portfolio which have not yet materialised. In an economic upturn, additional buffers beyond IFRS incurred-losses provisions are built up, which can be used during a downturn.

- 2.9.3 A number of banks indicated that the introduction of Basel II⁵⁶ and other required financial industry related projects meant that a significant number of their better risk management personnel were diverted from regular risk management operations to work on the Basel project implementation. This reduced the resources available to manage day-to-day risks accumulating in loan portfolios. Management also appear to have considered Basel compliance in itself more important than its application as an active risk management tool.⁵⁷ More generally, this links in to a comment by some observers that one general factor behind the increased acceptance of risk was an over-reliance on quantitative models. These models were not just seen as aids to judgment; they were seen as delivering objectively correct estimates of risk. Therefore, the use of such models may have created an unwarranted sense of security among bank leadership, as a movement towards apparently more sophisticated systems led to neglect of the basics.
- 2.9.4 Many banks seem to have considered their property portfolios as balanced and their risks well diversified. Loan books included assets in countries outside Ireland as well as in various property market segments. Stress tests had been carried out (both internally and at the behest of the FR) with apparently severe downside risk scenarios. These showed the banks to be resilient to economic shocks based on the assumptions used. However, the more severe shocks were discounted as the banks were confident that a soft landing was likely outcome and that their loan portfolios and funding sources were sufficiently diversified.⁵⁸
- 2.9.5 Bank management and boards seem to have been totally unprepared for both of their key risks (property loan impairment and funding problems) occurring simultaneously. This must be seen partly as a direct consequence of the insufficient attention paid to the assessment and management of risk over several years. Also, the link between credit and property values may not have been fully appreciated. The now regular references to “totally unexpected external shocks” cannot be taken fully at face value. Good risk management should endeavour to identify, assess and mitigate all types of shocks experienced elsewhere, no matter how “unexpected” or unlikely at the present moment or location.

⁵⁶ Basel II is the second of the Basel Accords (first accord was in 1988) which are recommendations on banking laws and regulations. The purpose of Basel II, which was published in 2004, was to create an international standard that banking regulators can use in determining the capital that banks need to cover their financial and operational risks. Following the international banking crisis further reforms are in train in the form of Basel III.

⁵⁷ Similarly, the FR implemented Basel II with no major increase in staff resources, implicitly reprioritising ongoing supervisory work.

⁵⁸ In one of the covered banks’ internal stress test of its property loan book in 2007, the extreme (1 in 25 years) shock scenario used declines in commercial property values of 30-60%. Using LTV data at that time the extreme shock loan losses were estimated to total some €2bn over 3 years. Due to the perceived diversification within the property portfolio, the plausible shock scenario (1 in 7 years with estimated declines of 15-30%) with estimated loan losses totalling €250m over 3 years was considered the more likely event.

Anglo

- 2.9.6 The Risk function in Anglo was inadequately resourced and did not have the conviction necessary to ensure compliance with credit policy. While the Risk function had responsibility for Credit Committee meetings, the lack of adherence to good credit standards was manifest with exceptions to policy a frequent occurrence. Although the legacy IT system had shortcomings, it did hold all the relevant data. However, there is no evidence that this system was appropriately interrogated for the purpose of risk analysis by the Risk function. This may point to insufficient risk awareness both at management and board level.
- 2.9.7 These issues were particularly problematic because most Anglo Board members did not appear to have sufficient experience or specialist knowledge to fully recognise the specific risks attaching to a fast-growing monoline bank and the necessity for high quality MIS. Also, it is not clear whether all key letters from the FR, highlighting *inter alia* lending and risk management shortcomings, were disclosed to or considered by either the Risk and Compliance Committee, or the Board. The Board therefore lacked an internal, robust source of risk assessment and external feedback.

INBS

- 2.9.8 As already noted, INBS did not have a formal risk management function. In practice, this meant that there was no independent unit challenging risk appetite, checking compliance with credit policy, assessing proposals prior to lending decisions being taken, undertaking credit reviews, or monitoring risk limits. Essentially, there were no independent checks to limit or balance the risks that INBS continuously took, despite its increasing exposure to high risk land and site financing.

Other Banks

- 2.9.9 The profile, role and effectiveness of risk management varied across the other four covered banks. All had a functioning, though not always adequately resourced or mandated, risk management function.
- 2.9.10 The two bigger banks (AIB and BoI) had well staffed risk management functions that, at least in recent years, had a seat at the highest executive forum. However, the effectiveness of risk management was curtailed by poor implementation even though a number of risk mitigants had been introduced; flexibility was required and used to meet targets set down by new strategies (see Sections 2.4 and 2.5) whereas robust risk management has a tendency to dampen loan book growth. Thus, there were frequent exceptions to policy, a lack of specified risk appetite thresholds, significant deficiencies in MIS and a general unawareness or lack of concern about concentration risk. In addition, partly because of divisional structures, risk management lacked the ability to consolidate information on sector exposures.
- 2.9.11 The remaining two smaller banks differed from each other. IL&P had a very well functioning risk management system and lending was driven by strict principles and controls (exceptions to

policy were routinely notified to the Board). EBS had a system that was not adequately resourced and seems to have lacked influence within the bank.

2.10 Internal Audit

2.10.1 Internal Audit (IA) functions existed in each of the covered banks during the Period. Their purpose, authority and responsibility were in all cases defined and set out in terms of reference or by charter approved by an Audit Committee and Board of each bank. In all the covered banks, IA reported to the CEO and Audit Committee, in line with best practice. IA is generally recognised as “a third line of defence” coming after business unit control functions (first line of defence) and risk/compliance control functions (second line of defence). IA is there to provide independent assurance on the continuing effectiveness of the institution’s corporate governance and control environment. It reviews, at regular intervals, key control function processes, reports on risk and control practices, frameworks and policies, and reports its findings to the audit committee. Across the covered banks, the functions of IA were carried out with varying degrees of effectiveness and professionalism.

Anglo

2.10.2 Anglo’s IA function had been assessed by external consultants in April 2004 and was then classified as a “strong performer” but with a number of opportunities for improvement. The two most relevant areas noted for further development related to “greater clarity of the role of IA in the overall risk management framework to ensure there are no gaps in risk coverage” and “enhanced reporting on emerging risks”. The IA function was again reviewed, this time internally, in February 2007 and again in 2008 and 2009 and the findings of these reviews were positive. Prior to the commencement of the Period, Anglo had established a Risk and Compliance Committee with oversight responsibility for Credit and Treasury Risks. Accordingly, neither IA nor the Audit Committee was in a position to challenge credit decisions per se, where the main problems ultimately arose. The IA role in credit risk was limited mainly to carrying out inspections on processes such as adherence to terms and conditions of loan sanctions, which it duly did.

INBS

2.10.3 The IA function in INBS, while effective for its traditional residential mortgage type business, proved to be inadequate in the growth oriented commercial lending environment. It was lacking the requisite knowledge and skills in key areas such as IT, Treasury, and Commercial Lending and, as a result, responsibility for these areas was required to be outsourced to a large auditing firm. During the Period the FR identified a significant number of weaknesses, shortcomings and concerns in IA. The FR made numerous requests and specific recommendations for IA to be strengthened stressing, *inter alia*, that the enhancement of the IA function was particularly important given the fact that INBS had a small executive team which required the support of a strong IA function. In 2007, the FR continued to raise significant concerns about the independence and expertise of IA. This culminated in a request in May 2008 for an independent external consultant to review and report on the adequacy of IA and of the control environment within INBS. The FR subsequently required that the Audit Committee be strengthened.

Other Banks

- 2.10.4 The other banks had well developed IA functions which in each case reported to their respective Audit Committees. They operated under broadly similar terms of reference, concentrating in the main on matters relating to internal controls. However, the remit of Audit Committees (and therefore IA) tended to be somewhat constrained and limited in relation to their role in reviewing the effectiveness of risk management across the banks. This overarching weakness resulted in certain credit risk areas receiving inadequate scrutiny from an independent IA unit. In some cases, even where weaknesses were identified by IA, these findings were set aside on the basis of management representations. In this context, it is questionable whether there was sufficient action taken by management to ensure IA findings were addressed on a timely basis.

2.11 Behavioural Factors

- 2.11.1 The Commission both detected and inferred signs of widespread herding and groupthink (including “disaster myopia”) in Irish banks during the Period. A substantial number of interviewees indicated to the Commission that conforming to team values and a collegiate approach was expected. The presence of a “strong personality” acting as Chairman, CEO or Executive Director was occasionally seen as contributing to this.⁵⁹ Views of the bank as “family” or acceptance of silo strategies within the bank may have hindered critical thinking and overall risk assessment. Presentation of diverging views or initiatives were often not appreciated and only occasionally sanctioned. In particular, there was a view among bank management that “contrarian” strategies probably would have led to resistance from a number of stakeholders and, ultimately, to loss of position for both the bank and the individuals concerned. There was a general denial of the extent of accumulated risk until the very end.
- 2.11.2 As a consequence of virtually common goals and some largely ignored risks, many banks in Ireland followed quite similar profit growth strategies in engaging the domestic markets, though with different degrees of abandon. None appeared to seriously consider alternative or contrarian strategies. Comparisons with peers, but also with a number of banks in the UK and EU, and concentration on market shares were an important part of both strategy and implementation. This willingness to indirectly let other banks steer the actions of one’s own bank, regardless of traditional objective risks, appears to conform to herding behaviour. In the same manner, the reported lack of challenging discourse and analysis within banks, together with occasional mention of alleged or feared sanctions against contrarians, indicates groupthink.
- 2.11.3 During its discussions with a great number of past and present bankers from the covered banks, the Commission seldom detected major differences in how they had viewed the situation in the economy and in their bank. Occasionally discussants wished they had taken a more contrarian approach. More often, there was a view that contrarian behaviour at bank or individual level

⁵⁹ A “dominant personality” cannot, of course, generally exist and operate without the explicit or implicit consent of others. Arguments explaining developments in terms of personalities must take this into account.

would have led to sanctions, loss of independence, loss of job or loss of credibility. One reason for this assessment may well have been the long period of apparently successful banking business in the property market; it is difficult to dispute or refuse recent success.

- 2.11.4 All bank boards appear to have operated largely on a collegiate and consensual basis. In general, while NEDs were successful and respected individuals from various parts of Irish business, not many of them were banking professionals or had comparative experience. Even though discussions on management proposals and reports were robust at times, actual rejections of business models, strategies and proposals were rare. In some cases there were explicit references to both the good atmosphere of the board and the wish to avoid fractious or consistently contrarian behaviour. Thus, it appears likely that boards in practice presented at most a modest check on management activities.
- 2.11.5 The generally held belief in a soft landing outcome, which was quite common even as late as 2008, can also be seen as a consequence of groupthink. There appear to have been several instances in banks where either outside consultants or staff touched on the implications of a potential property crash or wholesale funding disturbances. The Commission could find no indication that such contributions affected strategy or policy in any material way until late in the Period; interviews tended to confirm that these scenarios were seen as too extreme for consideration. Instead, more comforting and familiar downside alternatives were considered (and generally also eventually rejected as a basis for strategy or policy).
- 2.11.6 The Commission had the opportunity to concretely evaluate herding and groupthink only in a limited number of Irish banks. However, judging from publicised losses in other banks active in the Irish market (RBS, HBOS, Den Danske), similar behaviour may well have been dominant there as well. Also, the Commission has no way of judging whether herding and groupthink in Ireland is or was more or less prevalent than in other countries. Similar modes of behaviour appear likely to have occurred also in other countries, including large ones, where financial market problems with attendant surprising laxity in banking and regulatory practices are coming to light.
- 2.11.7 It appears now, with hindsight, to be almost unbelievable that intelligent professionals in the banking sector appear not to have been aware of the size of the risks they were taking. There may, of course, have been awareness, but evidence does not support this. After all, there were a great many smart professionals and businesspeople, including those working in financial services, who bought property near the top of the market and also, as a result of personal leverage, lost large chunks of their personal fortunes in the crash.

2.12 To Sum Up - the Mechanism of Contagion

- 2.12.1 High profit growth was the primary strategic focus of the covered banks, although holding market share was also an important factor. Since the potential for high growth (in assets) and resultant profitability in Ireland were to be found primarily in the property market, bank lending became increasingly concentrated there. The associated risks appeared relevant to management and boards only to the extent that growth targets were not seriously compromised.

- 2.12.2 Thus, banks accumulated large portfolios of increasingly risky loan assets in the property development sector. This was the riskiest but also (temporarily) the easiest and quickest route to achieve profit growth. At the same time many banks also financed increased demand in the end-user part of the property market e.g. mortgages and investment loans. Credit, in turn, drove property prices higher and the value of property offered as collateral by households, investors and developers also. As long as there was confidence that prices would always increase and exit finance was available, an upward spiral of lending and property price increases was maintained.
- 2.12.3 Of course, once such confidence and related liquidity disappeared, the spiral turned in the other direction. This link seems not to have been fully or generally understood by the banks, their customers or the authorities at the time. There was little, if any, challenge or testing of the assumption of a continuously benign economic environment in the Irish banks or elsewhere. Thus there was little or no contingency planning for a “hard landing” or much less a “crash”.
- 2.12.4 It could be argued that bank management in Ireland, like many banks elsewhere in the world, had forgotten the very nature of credit. Providing credit is not a sale of bank services; it is the acquisition of a risky asset. The appropriate prudential focus of such a transaction is therefore limiting and mitigating risk (or, at the very least, understanding the real risk and pricing it accordingly) rather than expanding sales. This apparent inability, some might say unwillingness, of Irish banks to remember this basic principle of banking was a major cause of the banking crisis in Ireland. This problem was further exacerbated as many banks appear to have emphasised and valued loan sales skills above risk and credit analysis skills.
- 2.12.5 It is not necessarily surprising that banks continued to lend into the property sector considering the fact that the vast majority of academics, independent economists, observers and, indeed, the Irish Government, were strongly supportive of this expansion rather than doubtful. Meanwhile, much of the media enthusiastically supported households’ preoccupation with property ownership. Bank leadership and staff also appear to have taken comfort from the fact that neither the FR nor the Central Bank, apparently, saw any problem worthy of a policy change with either the very rapid growth of balance sheets or the related concentration of exposure to property.

Chapter 3 - External Auditors

3.1 The Issue

- 3.1.1 The Commission's Terms of Reference regarding auditors are to investigate whether they commented in their audit reports, or other communications, on the covered banks' failures; or on the business models, strategies and lending practices in the cases of Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS).
- 3.1.2 No such auditor comments⁶⁰ are contained in the unqualified or "clean" audit reports on the covered banks prior to or immediately after the Guarantee.⁶¹ The Commission's work has therefore focused on whether the auditors made any such comments in other communications. One would expect any such other communications with the banks to have taken place in a formal way in the annual audit plans, reports of audit findings, or management letters.
- 3.1.3 Given the additional regulatory reporting obligations for auditors of banks (discussed below), the Commission has also reviewed the auditors' communications with the Financial Regulator (FR), the Central Bank (CB) and the Department of Finance (DoF).

3.2 Background

- 3.2.1 The external audit has a key reassurance role at the heart of the financial reporting system in Ireland and internationally. The covered banks' audits were required by statute⁶² and the auditors received substantial fees for their work. In return, the auditors were required to report on the banks' financial statements. The general expectation was that financial statements with unqualified audit reports gave reassurance regarding the financial health of the banks.
- 3.2.2 All of the covered banks received unqualified audit reports throughout the Period. An obvious question is: why did the banks require State support in 2008 so soon after all of them had received unqualified audit reports from various auditing firms?
- 3.2.3 This question can be, and has been, posed regarding recent unqualified reports from the same and other auditing firms for banks in the UK and elsewhere⁶³ which also required government

⁶⁰ With the exception of the emphasis of matter paragraphs in Anglo's 2008 Annual Report and Accounts, discussed further in footnote 68 below. The format of statutory audit reports is prescribed in various Auditing Standards and legislation.

⁶¹ The September 2008 State guarantee in respect of certain liabilities of the covered banks.

⁶² Companies Acts 1963-2006. Annual audits were required to be carried out by registered external auditors. As regulated entities, additional reporting obligations on the banks and their auditors were imposed by other legislation including the Building Societies Acts, the Central Bank Acts, and various European Union (EU) laws and regulations. Four of the banks, BoI, AIB, Anglo and IL&P, were listed on stock exchanges and therefore had further reporting obligations. Two of the banks had also issued certain securities in the US and therefore had US reporting obligations including Form 20-F filings. Under US rules, those filings included separate external auditor reports on the financial statements and on the internal controls over financial reporting.

⁶³ The January 2011 ICAI discussion paper, Statutory Audit; What the Future Holds? accepts that confidence in the statutory audit has been shaken following the global financial crisis.

support during the financial crisis. Support from governments prevented bank collapses in Ireland and elsewhere; it also avoided the legal challenges commonly mounted by liquidators against auditors when businesses collapse soon after clean audit reports.

- 3.2.4 The covered banks' auditors had privileged positions which provided exceptional access to bank information and to bank management. The banks adopted increasingly risky business models, to varying degrees, in pursuit of earnings growth as the Period progressed. The increasing wholesale funding and property lending risks were often accommodated by growing levels of governance failings.
- 3.2.5 Given the scale of these risks and failings, it is an issue of interest whether the bank audit specialists at the different auditing firms recognised the covered banks' growing vulnerabilities. When subjected to the escalating shocks from late 2007, the scale of the banks' vulnerabilities inevitably put into question the sustainability of the banks' property lending business models.
- 3.2.6 The financial statements, which are the responsibility of the directors, were required to be published by the covered banks shortly after each financial year-end, together with the auditors' reports thereon. Interim (half-yearly) reports also had to be published by the four listed banks shortly after each half-year end.⁶⁴
- 3.2.7 During the Period, the covered banks were audited by three of the Big Four international auditing firms. The banks' auditors are member firms of the Institute of Chartered Accountants in Ireland (ICAI). The Irish Auditing & Accounting Supervisory Authority (IAASA) supervises a self-regulatory regime for ICAI and the other recognised accountancy bodies.⁶⁵
- 3.2.8 Prior to the Guarantee,⁶⁶ all of the covered banks received unqualified audit reports on their financial statements. Furthermore, those bank interim 2008 figures released prior to the Guarantee which were reviewed by the auditors, confirmed no evidence of non-compliance with accounting standards.⁶⁷
- 3.2.9 Subsequent to the Guarantee, all of the covered banks continued to receive unqualified audit reports, as did Anglo's September 2008 financial statements.⁶⁸ The Anglo auditor's earlier audit

⁶⁴ Such less detailed interim statements were reviewed (but not audited) by the auditors to enable interim profits to be considered by the FR for capital purposes.

⁶⁵ The recognised accountancy bodies including ICAI are empowered to authorise qualified members or member firms to perform statutory audits.

⁶⁶ Anglo's most recent prior year end was September 2007; BoI's was March 2008, while the other four banks' were December 2007. Anglo's September 2007 audit report was issued in November 2007. BoI's March 2008 audit report was issued in May 2008. The other four banks' December 2007 audit reports were dated in February and March 2008.

⁶⁷ The March 2008 interim figures for Anglo were released in May 2008; while IL&P' and AIB's 30 June interim figures were released in July/August 2008. The standard form independent review reports by the auditors confirmed no evidence of non-compliance with accounting standards in the interim figures.

⁶⁸ Anglo's 30 September 2008 financial statements had been approved by the Board on 2 December 2008 but, following a number of disclosures concerning governance issues the Board revised the financial statements and a

report dated 2 December 2008, had been withdrawn following major governance disclosures at that time.⁶⁹

3.3 The Statutory Audit and Going Concern

- 3.3.1 The purpose of the external audit as set out in Irish company law⁷⁰ was to enable the covered banks' auditors to express opinions to the shareholders on whether the financial statements prepared by the directors gave a "true and fair view"⁷¹ of the banks' financial results and positions for the financial periods just ended. In broad practical terms, "true and fair" means in this context compliance with applicable accounting standards and applicable laws and regulations.
- 3.3.2 The statutory audit covers historic point-in-time financial statements; i.e. statements covering the financial period just ended. A formal assessment of the future takes place when the auditor has reason to question the going concern basis used by the directors in preparing the financial statements. In practical terms, preparing the financial statements on a going concern basis meant that directors believed the covered banks had sufficient capital and liquidity for at least the twelve months after year end.
- 3.3.3 In preparing financial statements, the covered banks' directors were required to use the going concern basis, unless it was inappropriate to do so. In using the going concern basis, the banks' directors needed to satisfy themselves, as well as satisfying the auditors,⁷² that the going concern basis was appropriate.
- 3.3.4 If there are material uncertainties about going concern, broadly there are two options open to the auditor. If such uncertainties have been adequately disclosed in the financial statements, the audit report can be modified but remain unqualified. Alternatively, if the auditor concludes that the disclosures in the financial statements are not sufficient to meet the requirements of accounting standards, the auditor is required to issue a qualified audit opinion or a disclaimer of opinion.

3.4 Auditing Irish Banks

- 3.4.1 While the statutory audit report is addressed to the shareholders, in practice there were various other users of the covered banks' audited financial statements including regulators, bank

new audit opinion was required in respect of the accounts subsequently approved by the Board on 19 February 2009, post nationalisation. The new audit opinion included emphasis of matter paragraphs highlighting a range of additional disclosures in the notes to Anglo's financial statements. Emphasis of matter paragraphs are used by auditors to draw attention to matters considered of material relevance to users of financial statements while issuing unqualified opinions.

⁶⁹The ICAI regulatory board, CARB is investigating a number of matters concerning Anglo directors as well as the role and performance of the auditors in relation to these matters. This work has yet to be completed.

⁷⁰Companies Acts 1963-2006. The applicable provisions are similar to UK and other developed country law.

⁷¹Broadly equivalent to the IAS 1 "present fairly" requirement under EU law for companies whose shares are publicly traded on EU stock exchanges

⁷²Audit opinions are usually signed-off within some ninety days after the year end, meaning that the auditor's going concern judgment often extends up to fifteen months after year end.

funders, rating agencies and media. Additional statutory and other reporting requirements are imposed on Irish banks and their auditors.⁷³ The primary overall guidance for the auditors of Irish banks is provided in PN19(I),⁷⁴ including the items which bank auditors are obliged to report to the FR.

3.4.2 PN19(I) includes reference to an Administrative Provision⁷⁵ containing prudential sector lending limit guidelines for the covered banks. Four of the covered banks exceeded the property and construction⁷⁶ sector prudential limit guidelines from varying dates during the Period. These sector limit excesses were discussed within the FR and in correspondence with the relevant banks from time to time during the Period. While the FR did not enforce these prudential limits, no formal waivers were given to the relevant banks.

3.4.3 One bank auditor reported these sector limit excesses to the FR under the PN19(I) guidance. The other three non-reporting cases involved a lack of auditor awareness of the relevant limit excesses or a decision by the auditors that reporting was not required since the FR already knew about the excesses.

3.5 Audit Limitations and an “Expectations Gap”

3.5.1 In addition to commenting on the covered banks’ individual audits, the Commission has considered the views expressed in the current Irish and international audit reform debate.⁷⁷ This debate highlights a number of structural weaknesses in the statutory audit which have limited its predictive value in relation to the banking crisis in Ireland and elsewhere.

3.5.2 The statutory audit focuses on historical financial statements. Formal reviews of the covered banks’ future sustainability only occurred during going concern reviews late in the Period after the emerging liquidity squeeze began to impact the banks. However, the remedial options are limited once a bank faces such liquidity issues.

3.5.3 When assessing going concern, the auditor is faced with binary audit opinion options, which only foresee either an unqualified audit opinion or a qualified audit opinion/disclaimer of opinion. Audit qualifications/disclaimers, or even unqualified opinions with emphasis of matter

⁷³ These include provisions of the Building Societies Acts 1989-2006 for those credit institutions which were Building Societies, the Central Bank Acts, and various EU laws and regulations.

⁷⁴ Auditing Practice Note 19(I); The Audit of Banks in the Republic of Ireland issued by the auditing standards setter, the Auditing Practices Board (APB), in consultation with the FR. While practice notes summarising underlying auditing standards, legislation and regulations such as PN19(I) are persuasive rather than prescriptive, they are indicative of good practice.

⁷⁵ The Winter 1995 Central Bank Quarterly Bulletin; Licensing and Supervision Requirements and Standards for Credit Institutions. Section 8.6 of these (non-statutory) guidelines sets out prudential sector lending limits of 200% of a bank’s own funds for any one sector, and 250% for sectors subject to a common predominant risk factor.

⁷⁶ Property and construction is the bank lending categorisation covering residential/commercial land and development, property investment, and lending to contractors; but excluding residential mortgages. The limit excesses were calculated from data provided by the banks in regulatory returns to the FR.

⁷⁷ Including the ICAI January 2011 publication; Statutory Audit; What the Future Holds?, and the EU Green Paper; Audit policy: Lessons from the Crisis.

modifications, are particularly unsuitable financial reporting options for banks. By their nature, banks are highly geared and are particularly dependent on market confidence for their liquidity. A qualified audit opinion would likely mean that a bank could not continue trading, which would have an immediate adverse impact on the bank and possibly on the banking sector generally. Accordingly, any audit opinion qualifications would be of limited value in constructively addressing well developed problems such as the covered banks' excessive property lending or wholesale funding exposures late in the Period.

- 3.5.4 Pro-cyclical IFRS accounting rules⁷⁸ further limited the predictive value of the covered banks' financial statements. From 2005 the banks' profits, capital and lending capacity were enhanced by lower loan loss provisioning while the benign economic conditions continued. As the global crisis developed from mid-2007, the banks were constrained by these incurred-loss rules from making more prudent loan-loss provisions earlier, and the auditors were restricted from insisting on such earlier provisioning.⁷⁹
- 3.5.5 Many users of financial statements do not appreciate the limitations in the statutory audit. Accordingly, more is expected from the statutory audit than it is currently designed to provide. The ongoing Irish and international reform debate includes commentary on this "expectation gap".⁸⁰ A number of themes have emerged from this debate including reducing the complexity of financial statements and financial reporting, improving the information-sharing between auditors and regulators, and extending the scope of the statutory audit.
- 3.5.6 Irish stakeholders should, on the basis of recent experiences here, be active contributors to this Irish and international audit and accounting reform work. The Commission believes that this work needs to enhance the value of the statutory audit in meeting the needs of users of financial statements, particularly for systemically important sectors such as banking.

3.6 Other Communication by Bank Auditors

- 3.6.1 Given the limited constructive value of the audit report as a means of communicating a bank's problems, the Commission has considered the other options open to a bank auditor in communicating concerns to a bank's board and to a financial regulator. In this regard, it should

⁷⁸ International Financial Reporting Standards, IFRS or IAS and in particular IAS 39; Financial Instruments: Recognition and Measurement. All listed EU companies were required to adopt IFRS from 2005, at which time all of the covered banks became compliant with the incurred-loss standard. Following the financial crisis, the accounting standards setters are debating the introduction of *inter alia* the expected-loss approach. With such a change, loan losses can be anticipated by banks through building up provisions over the life of a loan for any expected future losses. In general, pro-cyclical accounting rules tend to result in higher profits in an economic upturn and higher losses in a downturn, as compared with counter-cyclical rules which could give rise to less volatile results through the use of provisioning buffers. While constrained in their audited accounts, the banks had the flexibility to include any expected losses in their Regulatory Capital Returns to the FR.

⁷⁹ A detailed review of the auditing of the banks loan loss provisions is beyond the scope of this Report. A review of the audits of the banks' loan loss provisions for certain periods is currently being carried out by CARB.

⁸⁰ "Expectation gap" in relation to audits and auditors is not a new phenomenon and is not unique to auditing. The audit expectation gap tends to be at its widest following business collapses and in times of financial crisis such as the recent global banking crisis.

be noted that, unlike in the UK, in Ireland the bank auditor has a duty to report specific matters to the FR but has no right to report other matters. Client confidentiality has been cited by auditors as a limitation to their ability to report matters to the FR which are not specifically covered by statutory or regulatory duty. However, no such limitations would arise in respect of reports to the audit client.

- 3.6.2 The Commission would have expected a bank auditor, exercising necessary professional scepticism, to have concerns where there were growing property and funding exposures, combined with material governance failings. This combination of factors should, in the Commission's opinion, have raised questions for the auditor about the sustainability of a bank's business, the extent of concern necessarily involving judgment. Of course, the point at which going concern becomes a critical issue may not be clearly known. This, in principle, makes client communications on such concerns feasible without necessarily triggering going concern issues.
- 3.6.3 Communication with a bank's board and with a financial regulator is in the Commission's view the only constructive avenue for a bank auditor to raise any such concerns. To be effective, any such concerns would need to be communicated in a very clear manner and at an early stage of the issue identified. Once identified, acute problem situations are often resolved by a financial regulator facilitating the takeover of a troubled bank by a stronger bank. There were a number of examples of this remedy being used in the US and the UK during the financial crisis, but this remedy was not used in Ireland.
- 3.6.4 The Commission has also considered the options available to a bank auditor if a board or a financial regulator does not address concerns raised. In those circumstances, the only constructive sanction open to a bank auditor is resignation. In practical terms, such resignation could not take place during an audit, as such action could lead to a loss of confidence in a bank. In practice, this means that the auditor, in order to be able to safely finish the ongoing audit, would have to address the problem before it became acute. Therefore, to have had any constructive impact in relation to the Irish banking crisis, any such resignations would need to have taken place before the crisis emerged. There were no such Irish bank auditor resignations during the Period.

3.7 General Auditor Concerns in early 2008

- 3.7.1 General auditor concerns about the impact of the developing financial crisis on the covered banks' audits emerged in January 2008. These concerns led the Big Four auditors to initiate contact as a group, via ICAI, with the FR in respect of the audits then in progress or being planned. The issues discussed included auditor-regulator communication, bank liquidity, asset valuations, provisioning, and 100% mortgages.⁸¹

⁸¹ A Press article in late January 2008 mentions FR instructions to the auditing firms to report any concerns about liquidity or solvency arising out of the 2007 year end audits. The focus on liquidity and capital adequacy was reported to be aimed at providing the FR with additional assurance about the soundness of the Irish banks given the ongoing liquidity squeeze.

3.7.2 This meeting, as well as the additional audit work carried out in respect of the 2007 audits (including going concern reviews) and the additional reporting to management and to the FR, confirm some auditor concerns at that time. Of course, by then the great majority of the covered banks' property lending and funding vulnerabilities were already embedded in their balance sheets. At this stage the options for remedial action had become limited, even if the implications of the banks' vulnerabilities had been appreciated.

3.8 Auditor Bank-Specific Communication with Authorities

3.8.1 Bank-specific auditor communication with the FR can be considered under the following broad headings; annual communication in the form of audit findings reports, management letters,⁸² or M46 letters;⁸³ as well as additional communication in respect of the 2007 and 2008 audits.⁸⁴

3.8.2 The annual audit findings reports were addressed to the covered banks' Audit Committees and copied to the FR. These reports were finalised just prior to the audit report sign-off. They provided, *inter alia*, details of the banks' business models, and their growing property and individual borrower concentrations, to varying degrees, as the Period progressed. Annual management letters covered any observed weaknesses in the banks' internal controls and other systems, auditor recommendations thereon, and management responses. These reports were again addressed to the banks' Audit Committees and were copied to the FR.

3.8.3 Annual M46 letters were issued direct to the FR and copied to the banks. These letters provided a forum for communicating regulatory issues uncovered by the auditors. As discussed above, in the majority of cases the auditors did not report regulatory sector lending limit excesses to the FR. Even if all excesses had been reported, it appears unlikely that any action would have been taken by the FR, who was already aware of and not concerned about such excesses.

3.8.4 In relation to the 2007 audits, the Commission is aware of one bank-specific meeting between an auditor and the FR. This meeting covered, *inter alia*, the additional work done in relation to going concern. Individual auditors had various bank-specific meetings with the Authorities in relation to the 2008 audits post the Guarantee. These meetings centred on continuing State support for the going concern basis used by the covered banks' directors in preparing the 2008 financial statements.

3.8.5 The Commission concludes that auditors, working within the narrow/limited mandate of the statutory audit, highlighted valuable information for the FR on the banks as the Period progressed. The banks' business models and lending practices, including those of Anglo and INBS, were to varying degrees visible from audit findings reports, management letters,⁸⁵ or M46 letters, but were without comment on their possible implications, however.

⁸² For a number of the covered banks, annual management letter issues were merged into audit findings reports late in the Period.

⁸³ M46 letters are based on ICAI guidance for auditor reporting to the FR, drawn up in consultation with the FR.

⁸⁴ Including the BoI audits in respect of the years to March 2008 and 2009.

⁸⁵ Where management letters were separately issued. For a number of the covered banks, annual management letter issues were merged into audit findings reports late in the Period.

3.8.6 In contrast with matters raised in management letters, there appears to have been no dialogue between the auditors and the FR regarding the annual audit findings reports. To varying degrees, these reports contained growing details of the banks' business models as the Period progressed. Even though there was no specific requirement for the auditors to comment on business models, such dialogue from mid-Period onwards could have highlighted important issues such as the covered banks' growing vulnerabilities.

3.9 Auditor Communication with their Clients –The Covered Banks

3.9.1 Formal auditor communication with their bank clients each year was in the form of audit plans, audit findings reports, and management letters. For the 2007 and 2008 audits,⁸⁶ additional audit work was done in respect of going concern and provisioning levels. This work included reviews of going concern forecasts prepared by the banks' directors. In the December 2007 audits, this forecasting was primarily focused on liquidity.

3.9.2 In relation to the covered banks' growing property exposure and related risks, the main forum for auditor communication was the annual audit findings report to the Audit Committee issued immediately prior to audit report sign-off. Failings in internal controls and other systems were covered in management letters.

3.9.3 The Commission concludes that auditors, again working within the narrow/limited mandate of the statutory audit, communicated many issues annually to the covered banks' boards via the Audit Committees in annual audit plans, audit findings reports or management letters. To varying degrees, the audit findings reports contained growing details of the banks' business models as the Period progressed, without commenting on their possible implications, however.

3.9.4 Specifically in relation to Anglo and INBS, the business models and lending practices adopted were identified by the auditors, to varying degrees and as the Period progressed. This information was communicated to the Audit Committees in annual audit plans, annual audit findings reports, management letters, or copied M46 letters.

3.9.5 In the absence of an express requirement for the auditors to do so, there appears to have been no challenging dialogue with the covered banks on their business models and their growing property and funding exposures. Such dialogue could have highlighted the business model risks and might have influenced the banks in relation to their growing vulnerabilities as the Period progressed.

3.9.6 The Commission finds it unfortunate, therefore, that sufficient, timely and challenging auditor dialogue was not used to influence the banks' business models and lending practices. This type of professional scepticism could have been a considerable value-added contribution by the auditors.

⁸⁶ Including the BoI audits in respect of the years to March 2008 and 2009.

Chapter 4 - The Role of the Authorities⁸⁷

4.1 Introduction

- 4.1.1 This Chapter addresses the issue of why the responsible Irish financial market authorities, i.e. the Central Bank (CB), the Financial Regulator (FR) and the Department of Finance (DoF), facilitated the covered institutions to operate in a way that eventually made substantial State support necessary. It also considers why a broad guarantee was chosen from the various alternatives available, at least in principle, at the time.
- 4.1.2 The Commission has not and could not assess the actions or inactions of particular individuals in the authorities and did not think it was appropriate or fair to do so. Firstly, the time limit set for the investigation does not allow for that level of forensic scrutiny. Secondly, the detailed documentation that would have been needed for this often simply did not exist. Thirdly, operations of individual staff or units in hierarchical systems are likely to be influenced by a number of factors not directly attributable to the individual concerned.⁸⁸ Finally, despite an organisation being led from the top, decisions tend to be taken in a complex set of personal interactions within the institution. These interactions are virtually never documented. Any reference to one of the authorities or to any board, Committee or function is therefore not intended as a reference to any specific individual.

4.2 The Policy Challenge

- 4.2.1 For several years before the banking crisis, the authorities operated under the assumption that financial markets generally were efficient and self-regulating; this was generally considered as the modern and reasonable approach both in Ireland and abroad. However, the banking system requires the oversight and, when necessary, intervention of alert, aware and empowered authorities. This is because of the economic and social importance of banking, as well as its high leverage, public depositor support and a tendency to exhibit occasional problems. In Ireland, as noted above, the relevant authorities were the FR, the CB and the DoF. The FR was charged with the micro supervision of the financial industry. The CB was charged with oversight of financial stability in the economy.⁸⁹ The DoF was responsible for advising the Government on relevant economic and fiscal policy based, *inter alia*, on the findings of the former two. This Chapter addresses the question of why the extent of the problems described earlier remained essentially undiscovered and were inadequately addressed.

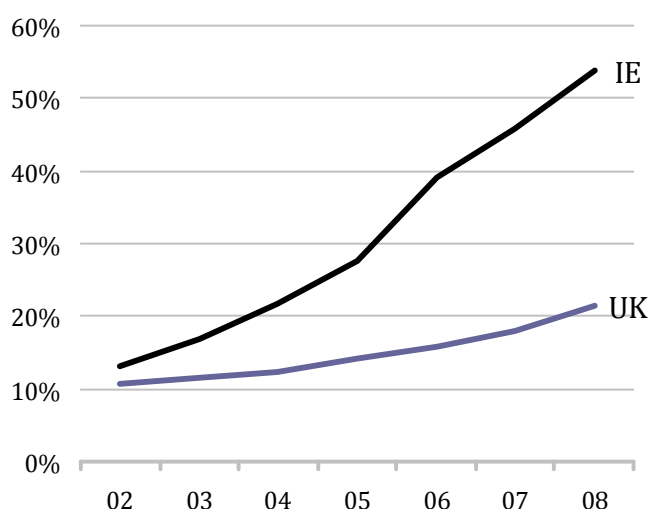
⁸⁷ The Commission, as already noted, broadly agrees with the main findings contained in the Regling & Watson and Honohan scoping reports. The Honohan Report covers in extensive detail the failings of the FR and CB. However, certain issues could not be fully covered in those scoping reports. These include the role of the DoF during the Period and events during the post-guarantee period September 30 2008 – January 15, 2009. The Commission's work has also benefited from reactions by many of participants to the findings of the scoping reports.

⁸⁸ These could include the extent to which they may be sufficiently resourced and supported.

⁸⁹ In assessing the performance of the CB and FR, it is important to bear in mind that membership of both Boards overlapped to a significant extent. For example, as at end September 2008, the breakdown of membership was as follows: CB only (5); FR only (3); and Members of both the CB & FR (7).

- 4.2.2 The core policy challenge of the authorities was to recognise early warning signs, within banks and the economy, in time to take pre-emptive action and mitigate any potential threats to financial stability. Specifying exactly when such risks should reasonably have been detected by the CB and FR is difficult. However, when confronted with the information that was available to these authorities throughout the Period, it is safe to say that vigilant authorities should have been much more concerned by the end of 2005. By this stage, not only were there numerous signals that pointed to the development of unsustainable macroeconomic and financial imbalances in the economy, but the risks being taken by the Irish banks had increased markedly as well.
- 4.2.3 By the end of 2005, on a reasonable assessment, the authorities should have been sufficiently concerned about the emergence of a property bubble to consider aggressive action to deflate it: new house prices had increased by 40% since 2002; property-related lending in relation to GDP was double that of the UK (see Figure 4.1 below) and proportionate to population, house completions were six times higher in Ireland than in the UK.⁹⁰ 12% of the Irish working population was employed in construction and construction output accounted for 20% of Ireland's GDP.

Figure 4.1: Real Estate, Renting & Other Business Lending as % of GDP



Source: Central Bank of Ireland, CSO, Bank of England & UK ONS

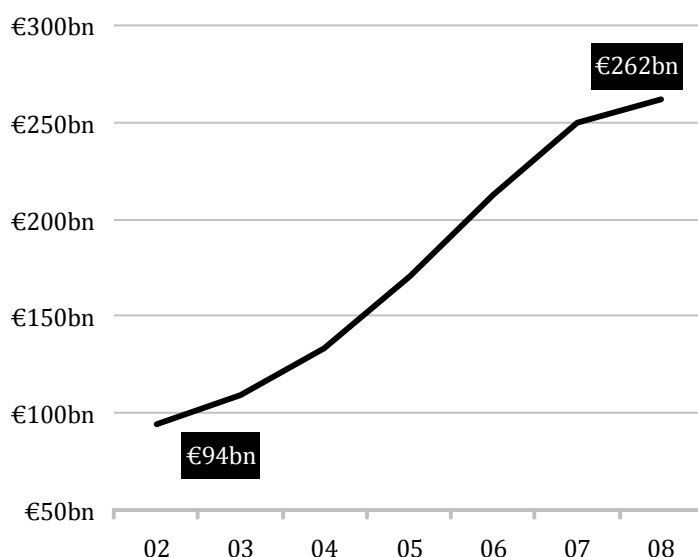
- 4.2.4 Apart from the developments within the Irish property sector, by 2006 the continued dramatic growth in domestic lending⁹¹ and the deteriorating prudential behaviour on the part of the

⁹⁰ In 2005, house completions in Ireland were some 80,000 relative to a population of 4m compared with 209,000 relative to a population of 60m in the UK (Source: UK Department for Communities and Local Government).

⁹¹ A Fitch report published in September 2006 ranked Ireland among five countries most likely to suffer a banking crisis due to excessive lending growth (although the credit rating agencies generally awarded the Irish banks strong credit ratings until the onset of the crisis). The other four countries were: Azerbaijan; Iceland; Russia; and South Africa.

banks should have given rise to serious disquiet among the authorities. In particular, the FR had full access to any banking information it required, including regular prudential returns⁹² which included detailed financial information on individual institutions. Even in the absence of in-depth analysis, by early 2006 information from the covered banks would have shown the following: aggregate domestic lending had doubled since 2002 or had grown much more than nominal GDP (see Figure 4.2 below); exposure to the wholesale markets had increased threefold in the same period (see Figure 2.11); four of the six covered institutions had exceeded the regulatory sector limits for property backed lending and there were significant lending concentrations to a small number of property developers.⁹³ A more detailed analysis of institution-specific information would have established unsound lending practices and deficient governance and risk management functions.

Figure 4.2: Covered Banks – Aggregate Domestic Lending 2002- 2008



Source: Central Bank of Ireland

4.2.5 Clearly the three key public authorities did not intervene effectively. This raises two important issues. Firstly, why were macroeconomic imbalances and unsound banking practices not

⁹² Regulated banks were required to report on their largest borrowers, growth in lending, the sector distribution of lending and how lending was funded etc. Such information was also available to the CB, either directly from its statistical returns or via the FR.

⁹³ This was evident from the banks' large exposure reports to the FR. The top twenty exposures across the domestically regulated institutions were also reported on a quarterly basis to the Board of the FR. These showed a marked increase in both the number and quantum of property development exposures over the period. For example, the aggregate borrowings of three particular property developers (who were in the top twenty in 2005) increased from €2bn in 2005, to €5.5bn by end September 2008.

acknowledged at a sufficiently early stage? Secondly, to the extent that certain issues were actually identified, why was the policy response so modest?

4.3 The Financial Regulator Pre-Crisis (2003 to mid-2007)

- 4.3.1 The FR was responsible for the micro prudential supervision of individual banks as well as other financial service providers. Where this work gave rise to concerns over financial stability, the FR was obliged to consult the Governor of the CB. The Commission found no evidence that the bulk of the problems within the banks, as outlined in Chapter 2, received the necessary attention of the FR. The FR does not appear to have appreciated the funding and lending risks accumulating in the banking system which were evident from institution-specific returns made to it by the banks.

Principles-Based Regulation

- 4.3.2 The particular version of “principles-based regulation” embraced by the FR (and supported by other stakeholders) stressed the importance of sound bank governance and internal bank processes for ensuring appropriate prudential behaviour. This policy was intellectually supported by the efficient market paradigm referred to earlier in Section 1.3 and was consistent with the Government’s “Better Regulation” policy. Thus, although the FR did engage with regulated banks⁹⁴ and supervised their activities, interactions and communications usually addressed issues of governance or structure. The FR was unwilling to engage in a process of (what was possibly perceived to be) intrusive verification to establish whether institutions were in fact behaving in a prudent manner and managing risk appropriately.⁹⁵ Instead the FR relied on management and boards to act in the best interests of their respective institutions. Given that the FR did not perform the required detailed scrutiny of lending practices it is very unlikely that it would, at any time, have formed an adequate understanding of bank exposures or the risks arising from the “procedures creep” as documented in Section 2.7.
- 4.3.3 Where risks, deficiencies or weaknesses were identified in processes and procedures, the FR did not act forcefully to ensure that these issues were addressed. This, in effect, undermined the FR’s authority as it was seen to be unwilling to take firm action, even in the face of clear breaches of “principles”. It appears that the general policy of the FR was not to risk action unless a legally watertight case could be made.⁹⁶ In any case, no administrative sanction was taken by the FR against a bank until after the introduction of the Guarantee.⁹⁷

⁹⁴ For example, it conducted regulatory inspections, annual risk reviews and met with bank representatives.

⁹⁵ It should be noted, however, that in November 2003, the FR sent a communication to all banks requesting that they review and tighten their residential mortgage lending criteria. Within 18 months, certain banks had relaxed criteria. Preparations for increasing capital requirements for some mortgages were started in the FR in the second half of 2005 and were implemented in May 2006.

⁹⁶ Even should the FR have lost a legal case, this would have been useful in clarifying the FR’s powers or in demonstrating the need for additional legislative powers to fulfil its mandate.

⁹⁷ The Administrative Sanctions procedure was a bespoke enforcement regime designed for the FR. It was introduced in 2004 and came on stream in 2005 – 17 separate sanctions were applied up to end 2008.

- 4.3.4 This inactivity had serious consequences for the banking sector. For example, in the case of INBS, the main theme of correspondence between the bank and the FR over the length of the Period was governance and internal control – business decisions were left to the institution itself with little regard to actually limiting the risk exposures that the unique structures, unsound for licensed banks, continuously were generating.⁹⁸ Despite the fact that the FR detected numerous governance and process issues in INBS throughout and, indeed, prior to the Period, it remained hesitant to take effective action even when the engagement with INBS resulted in little material change. As a result, the very significant risks inherent in INBS's business model described above, had time to develop essentially undisturbed.
- 4.3.5 In the same vein, inspection reports on Anglo during the Period (both in 2004 and 2007) correctly identified a number of the more important problems in the bank at the time. However, there is no indication that these internal reports led to either a reconsideration of supervisory practices or serious consideration of regulatory action. Had the FR rigorously enforced its recommendations to improve structures and process, it is possible that Anglo would have grown its property lending in a more prudent manner. Moreover, determined public action by the FR early in the Period could possibly have meant that other banks' prudential standards would not have deteriorated to such an extent over the Period.

Willingness and Ability to take Action

- 4.3.6 While acknowledging that the Banking Supervision Division of the FR may have been under-resourced, the Commission does not consider that this accounts sufficiently for the lack of action. As noted in Chapter 2, the essential information was readily available in the banks' regulatory returns and (publicly available) in annual reports. Also, as noted above, the serious governance and procedural problems in INBS, and to a lesser extent in Anglo, were known to the FR for years. Furthermore, there are no signs of the FR requesting increased resources.⁹⁹ What unfortunately seems to have been lacking is professional scepticism or suspicion on the part of the FR that all things might not be as well as they seemed on the surface.¹⁰⁰
- 4.3.7 It has been argued that even were the FR to have recognised the existence of a major problem it would have been difficult to intervene effectively. The Commission does not share such a

⁹⁸ This approach is captured in a letter from the FR to INBS in December 2004. It states that the FR's overall concern at that time was the significant shift in the risk profile of INBS's overall loan portfolio in a relatively short period of time. While the letter notes that it was a matter for a credit institutions' Board and management to decide upon the business activities it engages in, it was considered essential that there were appropriate policies, procedures, resources, internal controls and reporting structures in place commensurate with the risk arising from these activities which would be sufficient to effectively manage, monitor and control that risk.

⁹⁹ The Banking Supervision Division of the FR may have been under-staffed and sought additional resources. However, there is no evidence that the FR requested authorisation for substantial increase in prudential staff from the DoF which was responsible for approving the FR's budget. Nor is there evidence to suggest that the FR's very strong emphasis on consumer protection issues was at the expense of the consideration of prudential issues (in terms of either time spent, e.g., at FR meetings, or resource usage).

¹⁰⁰ This unsceptical approach seems to have widely prevailed in the FR though with a small number of exceptions at the level of the Regulatory Authority.

view, particularly since the FR had close institutional links with the CB and thus could have enlisted its support. More generally, there is no evidence in the Period that the FR brought to the attention of the DoF any requirement for significant additional powers in order to be able to address immediate prudential concerns effectively. If the will had been there, a number of possible approaches were available which, while they might not have warded off the problem entirely, could have reduced considerably the scale of what eventually emerged.

4.3.8 As regards instruments, the FR could have attached conditions to the banking licenses of certain institutions or withdrawn those licenses altogether. Indeed, even a clear threat to do so if the banks did not change their lending behaviour might have had an effect. The measures taken by the FR in 2006 to increase capital requirements (after much discussion and debate) are widely accepted to have been a move in the right direction, although it appears that there were some internal concerns raised at the time. However, these additional capital requirements remained ineffective given the very high reported profitability of property lending at the time. The Commission is not fully convinced that it would have been impossible for the FR to apply greater capital requirements for overall lending or particular classes of lending in the domestic banking system.¹⁰¹

4.3.9 Several other possible measures were available. For example, throughout the Period (and even prior to the commencement of the Period) regulatory sector credit limits were exceeded by large margins in certain institutions, with the tacit approval of the FR.¹⁰² Insistence on observing these limits in itself would, if implemented, have reduced the Irish banks' exposure to the property market by some €2bn in risk-weighted asset terms¹⁰³ (see Figure 4.3). Similarly, limits could have been placed on loan-to-deposit ratios. While these limits could not have been enforced on a statutory basis, if backed up by CB support and a strong dose of "moral suasion" (also involving, for example, discouraging high loan to value mortgages and/or calling for greater provisioning¹⁰⁴), a significant impact could have been expected.

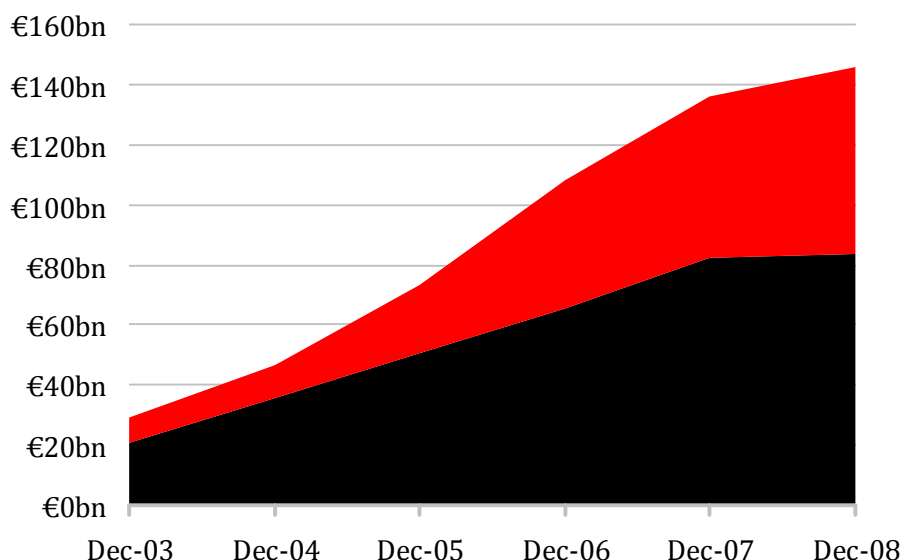
¹⁰¹ For example, INBS's total capital requirement was increased in both 2004 and 2007.

¹⁰² Non-adherence to these limits had been accepted by the CB prior to the establishment of the FR, initially for IFSC banks. As sector limits had not been applied to these banks, it was accepted on the grounds of competition that sector limits could not be applied to banks operating in the domestic market.

¹⁰³ Risk weighting a loan asset involves categorising the loan in terms of its credit risk, or risk of non-repayment. Risk weightings are then used to calculate related regulatory capital. For example, low risk assets, such as residential mortgages may attract a risk weighting of 25%. Higher risk assets (including types of speculative property lending) can attract risk weightings well in excess of 100%. Risk weighting is designed so that banks need to set aside additional capital for riskier types of lending.

¹⁰⁴ Although the pro-cyclical approach to provisioning was in line with newly developed accounting rules, a more conservative and counter-cyclical approach – similar to that applied by the Spanish regulatory authorities – may have provided an additional albeit modest cushion to absorb losses (see Section 2.8).

Figure 4.3: Aggregate Risk Weighted Lending to Construction and Real Estate Sectors by Covered Banks



Source: Central Bank of Ireland

Note: Red (top) section indicates aggregate risk weighted amount deemed in breach of guidelines

- 4.3.10 It appears that concerns about a loss of market share by Irish banks to potentially less regulated foreign competitors may have inhibited forceful action by the FR. However, fears on this score may have been overstated. It is not clear to the Commission why cooperation from relevant foreign Regulators could not have been sought to help discourage imprudent behaviour specifically in Irish financial markets.¹⁰⁵ Of course, effective regulatory action could have had indirect adverse effects on the attractiveness of the International Financial Services Centre (IFSC), despite the limited engagement of IFSC banks in domestic business.¹⁰⁶ However, if forceful action were to be targeted at banks systemically important for the domestic economy, such adverse effects could probably have been largely mitigated by clear policy statements on the motivation for such action. More importantly, while the FR's mandate included the promotion of the Irish financial sector, this was subject to the promotion of financial stability.
- 4.3.11 Prudential measures by the FR that would have had an impact on financial stability required by law the prior approval of the CB Governor (this practice was followed when the decision to raise capital requirements was taken by the FR in 2006). Because of this, initiatives were unlikely to be taken unless a consensus emerged between the CB and the FR as to the appropriate need for action. On its own, the CB appears also to have concluded that there was

¹⁰⁵ In the case of foreign competition there is no evidence to indicate that the FR contemplated enlisting the assistance of the UK FSA in attempting to address these issues, or raised them in the Committee of European Banking Supervisors (CEBS) a forum intended, *inter alia*, "to promote supervisory cooperation, including through the exchange of information" (Charter of the Committee of European Banking Supervisors).

¹⁰⁶ Of course the counter-argument could be made that a reputable regulatory regime is critical in attracting foreign investment.

no financial stability problem serious enough to warrant action at the time. While it is possible that a warning from the FR would have changed the CB's view, this is by no means certain.

- 4.3.12 Finally, the IMF Financial Sector Assessment Programme (FSAP) report on the Irish financial system in 2006 rated the performance of the FR highly. It did not call for any significant changes in its overall approach or methods. It also concluded that the Irish banking system was basically sound.¹⁰⁷ The FSAP methodology itself suffered from weaknesses, especially a concentration on process rather than substance. The positive FSAP report also served to reinforce the confidence in the soundness of the banking system being expressed by the CB/FR in their Financial Stability Report.

4.4 The Central Bank Pre-Crisis (2003 to mid-2007)

- 4.4.1 As in the case of the FR, there was a major domestic policy failure at the CB in respect of the maintenance of financial stability. Not only did the CB (with a small number of contrarians at board level) seriously underestimate the nature and extent of the risks in the Irish financial system but it was content to express only nuanced and somewhat indirect concerns on possible risks rather than study contingent worst-case scenarios. Had it done so, it might have issued stronger warnings (at least confidentially to the Government) or even taken appropriate action.

Willingness and Ability to take Action

- 4.4.2 At the outset, it is important to note that a view was expressed to the Commission that it was not the primary responsibility of the CB to evaluate possible problems in domestic financial markets emanating from the behaviour of individual institutions. CB legislation provides that while the CB was charged with overall financial stability matters, the FR was responsible for identifying and bringing to the attention of the CB any bank-specific/prudential matters of potential system-wide significance. Therefore, according to this view, the CB should not question, or be seen as questioning, the FR's activities. As the FR did not raise any such concerns with the CB, the CB could therefore not have been expected to detect existing or emerging problems. Indeed, it was even suggested that detailed enquiries by the CB regarding the basis for the FR's assessments could have been regarded as an unacceptable intrusion into the autonomous status of the FR.
- 4.4.3 Such a narrow interpretation of the CB's role is not shared by the Commission. When combined with the static¹⁰⁸ approach of the FR in assessing individual institutions, it could – and did – create a situation where financial stability problems could not be addressed or prevented. Financial stability should be the overriding objective and the CB (as well as other responsible authorities) should do whatever is reasonably necessary to maintain it.

¹⁰⁷ These views were also broadly reflected in various IMF Article IV Consultation reports during this period. It may be noted that the Independent Evaluation Office of the IMF in its report of 10.1.2011 *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07* paints a bleak picture of the ability of the organisation to detect the financial stability problems arising internationally and particularly in a number of developed countries.

¹⁰⁸ The FR had a static or backward-looking approach to assessing the financial health of institutions (i.e. whether they met certain prudential ratios at the last filing date).

- 4.4.4 An active and suspicious CB would have had concerns over the macro-economic data emerging in mid-to-late 2005. At that stage, on the basis of available data at a macro level, there were more than ample grounds for the CB to have pursued a closer and more intensive dialogue with the FR than actually occurred. The aim would have been to determine, in sufficiently good time, whether the macro-economic warning signals also indicated a pattern of unsound lending behaviour by banks.¹⁰⁹ Apart from the available funding and lending trends, there is little doubt that a closer look at bank balance sheets and lending practices by the mid-2000's could have uncovered a number of the imprudent practices and unacceptable risk exposures referred to in Chapter 2. However, this did not happen.
- 4.4.5 It is difficult to fully understand why the alarming macro-economic signs detailed in Section 4.2 were regarded with such relative calm for so long by the CB. Although its Financial Stability Reports show an awareness of such economic risks, they were not subject to further systematic analysis. The CB consistently held the view that these risks would not materialise; this was the case despite some internal questioning.

Financial Stability Reports

- 4.4.6 The CB appears to have chosen the path of addressing macro-economic risks through carefully formulated “concerns” in its Financial Stability Report (FSR).¹¹⁰ The FSR was, in theory, a cooperative effort by the CB and the FR but, in practice, it was almost entirely written by CB staff.¹¹¹ The text regularly and correctly refers to a great number of uncertainties and potential risks to stability, yet the overall conclusion of these FSRs was consistently a reassuring one; the most likely outcome was a “soft landing” for the property market, and the banking system was considered sound and well placed to deal with any potential shocks. Although the evidence in favour of this view was far from analytically compelling, it was widely accepted by banking circles and among the authorities. This message remained essentially unchanged even as funding and lending risks increased and the property market was beginning to collapse.¹¹²
- 4.4.7 As regards the health of the financial system itself, comfort was drawn in the FSRs from the benign results of stress tests. However, the models used by the banks in their bottom-up tests were not subjected to any significant evaluation by the CB at the time and they have later turned out to have been quite unsophisticated and of little value. The banks’ funding risks, which had increased sharply as their dependence on wholesale funding had risen, were not subject to serious testing. While many of the limitations of the stress test exercises were noted at various stages within the body of FSRs, this did not prevent fairly benign overall conclusions from being drawn.

¹⁰⁹ If so, it would also have been an opportunity to suggest that banks seek additional capital.

¹¹⁰ Many of the shortcomings described below, in the case of Irish FSRs, as noted by many commentators, were also present in FSRs for other industrialised countries.

¹¹¹ The reassignment of FR staff from this process is particularly regrettable given their familiarity with individual institutions and relevant issues of a regulatory nature.

¹¹² See Honohan (2010) paragraph 6.3 for sample extracts of FSR conclusions over the period 2004-2007.

- 4.4.8 The Commission has also noted evidence of a tendency to ensure that the FSRs should not convey a negative message even when some internal contrarian information, analysis or view argued for a less benign tone.¹¹³ There are clear indications that little attention was paid to such material or that it was only included after toning down in redrafting. This approach risked creating an internal intellectual climate that discouraged less senior staff from offering their best professional assessments. It also encouraged staff to focus their research work in areas with less relevance for financial stability but where publication would not be subject to such pressures. While it is one thing to tone down external messages, the Commission has difficulty in understanding the apparent lack of interest in fostering critical debate within the confidential confines of the CB on stability issues. There are signs that, reinforced by the relatively hierarchical structure of the CB, a climate of self-censorship had become prevalent in CB policy work.
- 4.4.9 The Commission accepts the view that it may not be in the best interests of financial stability to publish alarmist views in the FSRs. Given the traditionally fine-tuned nature of CB statements, any sudden or major change in the degree of stated optimism could, in principle, be interpreted by markets as a sign of a looming problem. On the other hand, if official publications are seen as not addressing relevant concerns, there is also the risk of reducing public credibility. Nevertheless, if the CB had had greater concerns there was nothing preventing them from confidentially voicing these concerns to the Government while keeping its public messages benign. However, the Commission has found no evidence that this was done.

Insufficient Contingency Work

- 4.4.10 The Commission notes that the CB did not choose to confidentially study worst-case contingency scenarios. The CB could have commissioned its staff to assess both what the macroeconomic consequences would be if major identified risks were realised and what could be done to avoid a worst-case situation. Such scenarios could have made use of international as well as domestic information, thus providing some estimate of the extent of the economic risks. While it is impossible to assess how such a study might have affected the judgments of the CB, such an exercise would have been useful in many indirect ways. More information and analysis would have been available; staff would have become sensitive to stability issues; the FR might have been inspired to look more closely at the banks; and the CB would have been better prepared when the financial crisis deepened in 2008.
- 4.4.11 Although action taken by any authority that dampened down the rapid economic growth would have been seen as “spoiling the party”, an independent and effective CB must be willing to take unpopular actions. Even in the unavoidable presence of uncertainty, such actions are essential in order to avoid far greater future costs that might (and, in Ireland’s case, did) lie ahead. Of course, a CB must first take the steps necessary to ensure that it has an accurate

¹¹³ For example, an internal study estimating that house prices were overvalued by up to 39% in 2007 was not published in that year’s FSR.

picture of the financial market. Failure to perform either of these tasks is, in the Commission's view, difficult to reconcile with the responsibilities of an independent CB.

4.5 The Department of Finance Pre-Crisis (2003 to mid-2007)

- 4.5.1 The Commission's Terms of Reference require it to examine the relevance of any advices or directions given by the DoF to the CB and the FR in relation to their supervisory role. In seeking to address this area, the Commission felt it necessary to examine the broader policy advice of the DoF over the Period in order to establish: (i) whether the DoF had concerns about growing macroeconomic imbalances and downside risks to the economy; (ii) whether such concerns were seen in terms of a threat to financial stability; (iii) how active and insistent the DoF generally was in its advice to Government, and (iv) what impact the DoF staff may have had on financial developments through its interaction with the CB and the FR.¹¹⁴

*Advice on Economic Policy*¹¹⁵

- 4.5.2 The DoF was generally conscious of the need to rein in both general government expenditure and tax reliefs that favoured the property market. For example, a 2004 brief prepared for the new Minister for Finance urged restraint in terms of growth in expenditure and tax reliefs and emphasised the need for base-broadening taxation measures. It also stated that competitiveness should be maintained by controlling the domestic cost base and identified the need for capacity to respond to economic shocks.¹¹⁶ However, the brief was silent in relation to credit growth.
- 4.5.3 The ability of the DoF and the Minister for Finance to convince Government of the need to restrain expenditure growth was somewhat blunted by the fact that during 2003-2007 tax revenues were consistently higher than forecast, leading to a larger budget surplus than projected. As maintaining budgetary surpluses was seen as less important once public debt had reached relatively low levels,¹¹⁷ the Minister for Finance was under considerable pressure to allow relatively high rates of expenditure to meet social and other priorities. Thus, current expenditure growth exceeded that of nominal GDP growth in all years since 2000, increasing particularly rapidly from 2005 onwards.

¹¹⁴ The Department is responsible for advising Government on economic and budgetary policy as well as the appropriate framework for financial services legislation. A further objective was the 'promotion of financial stability', which the DoF had determined to consist primarily of implementing legislative proposals. It appears that the Department saw its main role as helping to resolve an emerging financial stability problem rather than as assessing and pre-empting threats to stability.

¹¹⁵ The 2010 report of an Independent Review Panel, "Strengthening the Capacity of the Department of Finance" gives more details on the economic policy advice which the Department provided to the Minister and Government. The Review Panel was appointed by the Minister for Finance to assess the DoF's performance over the past 10 years and, based on the lessons drawn from that assessment, to make recommendations for the future development, structure and resourcing of the Department.

¹¹⁶ Some of the potential shocks it saw to the economy in 2004 were an increase in oil prices, an appreciation of the euro and the "impact on the economy of a fall in the number of houses being built from the current high level to a more sustainable level in the medium term".

¹¹⁷ The general government debt/GDP ratio had fallen from just under 120 % in 1987 to 27.5 % in 2005 and to 25 % by 2007.

- 4.5.4 Despite the significant political pressures operating in the opposite direction, the advice on restraining expenditure should have been more vigorously articulated than actually was the case. Greater emphasis should have been put on the cyclically adjusted budget balance, given the fact that the composition of total revenue had changed significantly with a sharp increase in the share of cyclical taxes,¹¹⁸ many of which were directly related to the credit-induced housing boom. At the same time, tax reliefs relating to property distorted resource allocation and undoubtedly contributed to overheating in the property market.
- 4.5.5 Both scoping reports document the extent of taxation incentives aimed at boosting the construction sector. Different classes of construction investment attracted sizeable tax subsidies (capital allowances and other tax reliefs) that extended over long periods. In addition to lowering the rate of stamp duties on several occasions, arrangements existed whereby stamp duty could be legitimately reduced or avoided entirely. Mortgage interest was deductible for tax purposes while capital gains for owner-occupiers on the sale of primary residences were not taxed. No domestic property tax (nor a possible alternative, a tax on imputed rental income) existed. As each of the above incentives artificially and unsustainably boosted the demand for property, a major review of these incentives was undertaken in 2005.¹¹⁹ Although the majority of the review recommendations were contained in the 2006 Finance Bill, they were subject to transitional arrangements so as to avoid any sudden shock to the construction sector.
- 4.5.6 While the DoF identified various risks to the economy and to its budgetary forecasts, no single comprehensive analysis integrating all of these risks (including risks emanating from the financial sector) and assessing their implications for the economy into the medium-term was carried out. Had this been done annually, it might have led to an increased awareness in the DoF of the need to take policy actions to counteract some of the factors contributing to these risks.

Advice on Economic and Financial Stability

- 4.5.7 Internally, senior management in the DoF was updated regularly on housing developments (the main focus being on macroeconomic implications of a fall in housing output) and credit growth. Concerns with respect to credit growth date back to 2004 and subsequent updates noted credit growth was unsustainable, fast approaching the highest in the euro area, and driven by property market expansion. It was further noted that the construction sector's increasing share of credit made it vulnerable to a property downturn and that developments in house prices, relative to incomes and yields, could indicate that they were out of kilter with fundamentals. However, referring to the CB's 2005 Financial Stability Report, it was concluded in a briefing to the Minister that "all evidence is that systemic risk ... to the financial system from a downturn in the property market is relatively limited". While concern was also expressed at official level about the impact on GDP and the budget balance of a fall in

¹¹⁸ Including corporation tax, stamp duty, capital gains tax and VAT.

¹¹⁹ The review was commissioned by the Minister for Finance on foot of advice from the DoF to phase out some schemes and close certain loopholes; separate reviews were conducted by Indecon Consultants and Goodbody Consultants.

housing output towards a medium-term sustainable level, such a fall was viewed as a necessary adjustment in the housing market.^{120, 121}

- 4.5.8 The Economic and Social Research Institute's (ESRI) Quarterly Economic Commentaries (QEC) and Medium-Term Reviews (MTRs) frequently examined the interaction between the construction sector and the real economy and briefings were provided to the Minister based on their findings. In briefing for the Minister on the 2005-2010 MTR, the Minister was informed that the continued rise in house prices posed a serious threat. The briefing for the Minister on the ESRI Spring 2007 QEC referred to the QEC's speculation regarding a housing bubble but advised that a soft landing was the most likely outcome. The Spring 2007 QEC also noted that if the astonishing growth in net foreign borrowing by Irish credit institutions since 2003 had been used to fund the ongoing boom in the housing market, the situation was not sustainable. This particular point does not appear to have been followed up by the DoF or brought to the attention of the Minister. Following the widely referenced article by Professor Morgan Kelly in the Summer 2007 QEC predicting a real house price fall, speaking notes prepared for the Minister concluded that house price increases in Ireland had been based on fundamental demographic and economic factors.
- 4.5.9 Following a communication from the Department of the Environment, Heritage and Local Government to the DoF in 2005, regarding the implication of 100% LTV mortgages on house price inflation and household indebtedness, DoF, after consulting with the FR, responded that while borrowers and lenders should exercise caution, it did not see any particular need to take action. However, in 2006, the DoF supported the increase proposed by the FR in the risk weighting for high LTV mortgages.
- 4.5.10 There is no evidence that the DoF was particularly concerned with prudential matters or in assessing any possible financial stability concerns relating to either individual institutions or the financial system collectively.¹²² The annual Financial Stability Reports of the CB were brought to the attention of the Minister via briefings on the reports' main conclusions and via draft speaking points for his possible use. This material, however, essentially reflected the content of the reports themselves and did not contain any critical analysis.

Interaction with the Financial Regulator

- 4.5.11 As regards financial regulation, the DoF saw its primary role as providing the necessary legislative framework for the financial services sector. Also, the Minister for Finance approved the FR's annual budget. The Department's approach in dealing with the FR was based on the principle that the FR was independent of the DoF in respect of operational matters, a principle very much in line with international practice. The DoF did, however, have close contact with

¹²⁰ According to a note of May 2005, a fall of 10,000 units in new house construction would reduce GDP by 0.5-1% and worsen the budget balance by 0.5% of GDP.

¹²¹ There is evidence also of less sanguine outlooks in the DoF; however, it appears that such views unfortunately were not widely shared and they were not reflected in official views to the Minister.

¹²² An exception arose in the case of Credit Unions, where the DoF was actively engaged, at the request of FR, with potential risks to stability.

the FR regarding the transposition into Irish law of various EU directives relating to the financial sector and regarding the implementation of the Government's broader "better regulation" agenda. While the FR's strategic plans were submitted to the DoF for comment and approval prior to their finalisation, comments or suggestions were in areas other than the exercise of its prudential supervisory functions.

- 4.5.12 One particular issue that deserves attention is the failure of the FR to require financial institutions to provide Directors' compliance statements.¹²³ This was a discretionary measure available to the FR from 2004 pursuant to an amendment to the Central Bank Acts. Given the FR's approach of relying on the boards and senior management of regulated institutions to act prudently, the ability to require a compliance statement would have been an extremely useful tool in increasing the accountability of management and boards for the assurances they may have given.
- 4.5.13 When the FR began to consider the issuance of a guidance paper on the proposed introduction of Directors' compliance statements in 2006, there were complaints from industry representatives. They argued that the planned legislation was inconsistent with the views of the Company Law Review Group and a decision was taken by the FR not to proceed with the matter at that stage. The Honohan Report (p. 50) noted that this decision was taken following a request from the DoF "not to proceed with the consultation process on the implementation of this requirement without engaging in further discussions with the Department". Following subsequent informal discussions, as well as written communications with the DoF, the FR decided to review the provision as part of the overall project to consolidate and modernise financial services legislation.¹²⁴
- 4.5.14 When informed of this decision in early 2007, the DoF reminded the FR that the relevant power remained in the legislation and that the FR could always seek a compliance statement where circumstances warranted. Thus, the Commission could find no record that the DoF gave explicit instructions to the FR not to proceed with implementation of this provision.¹²⁵

¹²³ The statement would confirm whether the regulated services provider had complied with its 'relevant obligations' during a specified period. In addition, external auditors would have been required to report on these compliance statements.

¹²⁴ In communicating publicly the decision not to proceed with the consultation process the FR (in 2007) noted that the most significant comments received during the informal consultation process were: "(i) The legislation is impaired by the absence of a materiality threshold and the extent of the confirmation required. The current wording requires the regulated entity to specify whether it has complied with its relevant obligation as opposed to confirming that they have in place appropriate 'arrangements or structures' to secure material compliance; (ii) The Company Law Review Group (CLRG) recommendation on Section 45 of the Companies (Auditing and Accounting) Act 2003 are not reflected in CBFSAI legislation; (iii) The Compliance Statement provision is not principles based and therefore inconsistent with the FR's approach; and (iv) This requirement would have a negative effect on Ireland's competitiveness. The FR considered that these remarks "called into question the practical application of the legislation".

¹²⁵ There remains, however, the impression that the DoF discouraged the FR from implementing this requirement.

Interaction with the Central Bank

- 4.5.15 As regards formal communications between the CB and the DoF in the pre-crisis Period, these appear to have been largely confined to routine matters. In particular, substantive discussions do not appear to have taken place directly between the DoF and the CB on the content of the various Financial Stability Reports, either before or after their publication. Before the Reports were finalised, the Governor regularly met with the Minister. However, no officials were present and there appear to be no records of the discussions in either departmental or CB files.¹²⁶
- 4.5.16 That being said, the Secretary General of the DoF was *ex officio* a member of the CB Board throughout the period. Legally, the Secretary General was subject to the same confidentiality restrictions applicable to all CB board members; he was thus prohibited from disclosing any written or oral material obtained via the Board to others, including other DoF staff. However, it was generally believed that the views of the Secretary General reflected (or at least were consistent with) those of the DoF. From this perspective it would have been reasonable to conclude that if the DoF had major concerns on, for example, financial stability matters, these would have surfaced in the deliberations of the CB Board, including during the discussions of the joint Board Meeting (of the CB Board and the FR) that took place prior to finalisation of the joint Financial Stability Reports.
- 4.5.17 An important communication to the Minister was the annual CB pre-budget “Governor’s letter” which was discussed by the Board before being issued. Throughout 2003-2008, the main concerns expressed in it related to the need to address the loss in competitiveness; it advised prudent wage policies and the avoidance of increases in taxes which would lead to an increase in inflation. The letter recommended a neutral budgetary stance; budgetary policy did not appear to the CB to be overly procyclical and this was reflected in the absence of strong warnings to change the stance of budgetary policy. Regarding housing, the letter’s main concern was the increasingly large proportion of output devoted to construction and the potential risk this posed in the event of a housing downturn. However, it did not provide any indication as to the likelihood of such a downturn nor mention possible associated threats to financial stability. The 2005 and 2006 letters drew attention to the rapid increase in credit which was being channelled into the housing sector.

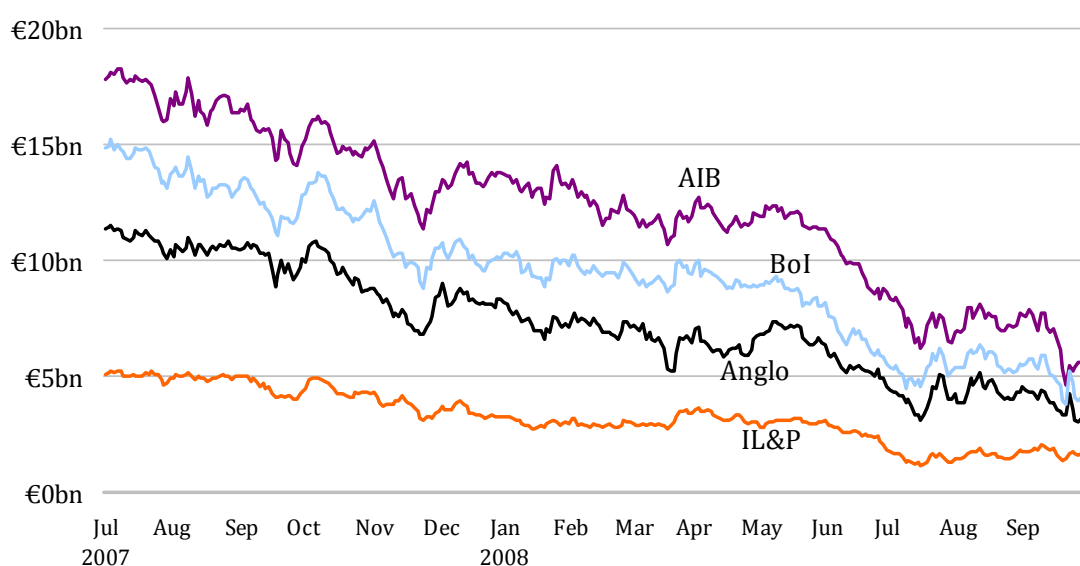
4.6 Crisis Management, Mid-2007 to September 2008

- 4.6.1 Chapter 8 of the Honohan Report describes in some detail the domestic and international background in the period leading up to the guarantee decision of September 29, 2008. The discussion which follows deals in turn with: (i) the main elements of the preparatory work undertaken by the authorities from mid-2007 onwards; (ii) the guarantee decision itself; and (iii) events during the period October 2008 – January 15, 2009.

¹²⁶ While the Governor reported to the Board of the Central Bank that he had met with the Minister, the Board minutes do not record any information as to what had transpired at the meetings.

4.6.2 The authorities began to explore contingency arrangements from mid-2007 onwards (in the wake of the Northern Rock crisis in the UK – Figure 4.4 below shows how the value of the four listed covered institutions collapsed from mid-2007 onwards). The focus of these efforts, described in more detail below, was essentially to address problems that could arise from a drying up of liquidity.¹²⁷ Some preparatory work was undertaken, examining hypothetical scenarios for banks facing serious financial difficulties. The consistent view of the FR and the CB was that, apart from liquidity concerns, there were no major underlying problems facing any individual institution nor was there any threat to the system as a whole.¹²⁸

Figure 4.4: Market Capitalisation of Listed Covered Banks mid- 2007-Sep-2008



Source: Irish Stock Exchange

4.6.3 Important initiatives taken during this period included the establishment, in line with EU guidance, of the Domestic Standing Group (DSG), which involved, for the first time, a specific structure for ongoing cooperation between the DoF, the CB and the FR. The National Treasury Management Agency (NTMA)¹²⁹ also attended several DSG meetings. In addition, especially

¹²⁷ This included the introduction by the FR of new liquidity requirements.

¹²⁸ There is no evidence of a clear understanding at senior management levels of the potential negative impact of a liquidity crisis on the banks' ability to continue to fund their property exposures. As already noted in Section 2.8, without continued funding, borrowers would fail. Given the scale of the banks property lending, such customer insolvency would quickly threaten the solvency of highly geared banks in the absence of external support.

¹²⁹ The NTMA, the body responsible for the management of State funds, reacted to the onset of the credit crisis like most market participants by withdrawing much of their deposits from private institutions and placing them with central banks. Over the following year or so, the unwillingness of the NTMA to deposit funds in Irish banks gave rise to significant interaction between it and the DoF. From early 2008, the NTMA sought a direction from the Minister

from mid-2008 onwards, many other meetings and informal interactions occurred between these institutions.¹³⁰ A liquidity monitoring group was set up within the CB which led to a more systematic evaluation of potential problems the banks might face. In parallel, arrangements were made to ensure that banks had available the maximum eligible collateral to access refinancing by the ECB and that the mechanisms to allow possible emergency lending assistance (ELA) from the CB were in place. Finally, some “crisis management” exercises were held (one involving an EU-wide exercise) using the “Black Book”¹³¹ crisis management guide as background. However, in the actual crisis no use was made of the Black Book procedures.

- 4.6.4 In early 2008, CB staff concerned with financial stability matters produced a draft document which outlined, in fairly general terms, the options available if an individual institution were to encounter difficulties (the possibility of a systemic crisis was not considered). Information on Anglo was provided as a backdrop to the discussion, although the quantitative implications for Anglo of alternative approaches were not explored. The paper, which did not contain any specific recommendations, was discussed with senior CB management. However, it is not clear to what extent the paper was followed up or if any specific recommendations ensued.
- 4.6.5 The DoF prepared a scoping paper on financial stability issues in early 2008. It examined three cases: (i) an institution that is illiquid but solvent; (ii) an institution that is insolvent or is approaching insolvency; and (iii) a scenario in which it is unclear whether the institution is illiquid or insolvent. A number of possible solutions were identified for each of these scenarios. The paper discussed the circumstances under which ELA could be available to an insolvent institution (i.e. only after a State Guarantee had been provided), as well as nationalisation; it concluded that both a guarantee and nationalisation would require new legislation. An internal departmental presentation in February 2008 indicated that “as a matter of public policy, to protect the interests of taxpayers any requirement to provide an open-end/legally binding State guarantee which would expose the Exchequer to the risk of very significant costs [is] not regarded as part of the toolkit for successful crisis management and resolution”. However, in a later presentation in April 2008, while this view was repeated, it was also noted that “there are circumstances where such guarantees may be unavoidable to maintain confidence in the overall financial system”.
- 4.6.6 One specific issue highlighted during this period concerned the possibility of introducing a special resolution regime for banks.¹³² Existing company law provisions were unsuitable for dealing with financial institutions in difficulties. Following preparation of a background paper

for Finance to roll over deposits with Irish institutions in each instance where a deposit matured. The direction was sought on the basis that it was not commercially justifiable to make such deposits in the climate as it was.

¹³⁰ For instance, in May/June 2008 the Minister of Finance met on two occasions with senior management of the NTMA to discuss financial stability issues and the role the NTMA could play.

¹³¹ The Black Book was the CB crisis management manual including guidance on subjects such as emergency liquidity assistance, legal requirements and more logistical issues.

¹³² A special resolution regime, which is in place, for example, in the US (it was introduced in the UK in 2009), allows the authorities to intervene in a troubled, although not necessarily as yet insolvent institution; it can thus, among other things, offer a broader menu of options for resolving financial claims vis-à-vis differing classes of creditors.

in June, the possibility of implementing such legislation was discussed within the Domestic Standing Group. It was concluded that the legislation would be complex and would take considerable time to prepare (also, supplementary legislative changes in other areas might be required). It was also thought that it might encounter legal difficulties, given the relatively high degree of protection afforded to property rights under the Irish constitution. In addition, there appears to have been some concern that any leakage to the effect that such legislation was being drafted could have had a serious destabilising effect on markets. For these reasons, it was decided not to pursue the initiative further.

- 4.6.7 While recognising that special resolution regimes were not in place in most industrial countries prior to the crisis, in the Commission's view, this outcome was nonetheless unfortunate. Special resolution regime legislation markedly increases the range and flexibility of policy options available. Had such legislation been prepared on a confidential basis by September 2008, it is possible that at least some of the obstacles referred to above could have begun to be addressed, and legislation might have been available at a considerably earlier stage.¹³³ However, the existence of a resolution regime in itself would not necessarily have been a panacea to avoid high fiscal costs to the State in the absence of burden sharing with creditors.
- 4.6.8 One important initiative was, however, pursued vigorously in the pre-crisis period, namely, the preparation (on a highly confidential basis) of draft contingency legislation that would (i) enable nationalisation of a financial institution;¹³⁴ and (ii) provide for the issuance of a guarantee by the Government.¹³⁵ It appears that the driving force behind this initiative included the Northern Rock crisis and the difficulties the UK authorities had without a proper legal basis. Apart from this there might have been a general desire to have more "tool kits in the armoury".
- 4.6.9 Finally, during much of 2008, the authorities were concerned with the impact on Anglo of the overhang in Anglo shares related to Contracts-for-Difference (CFD) and the potential risks posed by a large sell-off of those shares. As a minimum, dealing with this matter was an unfortunate distraction at an important time for the authorities generally and the FR in particular. At its worst, it may have led to confusion and differing interpretations as to what was driving the collapse in the Anglo share price – short sellers attempting to profit from the CFD-related overhang in shares or a more general expression of negative sentiment regarding the bank's prospects.¹³⁶

¹³³ The authorities published draft legislation on this issue on 28 February 2011.

¹³⁴ It remains unclear to the Commission why the same concerns on leakage that were present for preparing the special resolution legislation were not seen as overriding in the case of the nationalisation legislation.

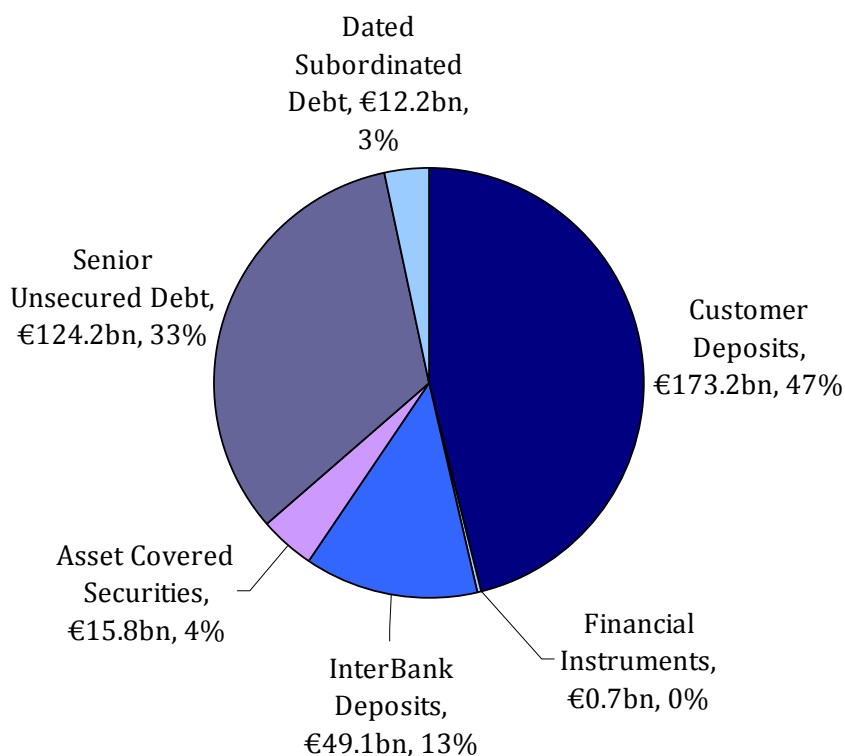
¹³⁵ On September 18 and September 25, respectively, the Minister for Finance held meetings involving senior staff from the CB, the FR and the NTMA. While the brief summary notes of these meetings do not allow one to describe with any precision the views expressed by individual participants, issues concerning liquidity pressures, a possible guarantee and various intervention possibilities for dealing with Anglo were discussed.

¹³⁶ This view on the impact of the CFD-issue on crisis preparedness should not be read as having any implications for the regulatory or legal issues possibly related to the transactions and their financing. On such issues the Commission has no view to offer, as already indicated.

4.7 The Guarantee Decision of September 29, 2008

- 4.7.1 On the night of September 29, 2008, the Irish Government took the decision to guarantee the deposits and most liabilities of all the Irish owned banks. The gross amount of liabilities guaranteed amounted to €375bn, well over twice GNP (the breakdown of the liabilities guaranteed are set out on an aggregate basis at Figure 4.5 below). This section reviews the background to the Guarantee and, in light of this, the appropriateness of the decision taken.
- 4.7.2 In reviewing this topic the Commission's task is complicated by the general lack of written records as to what transpired during the official discussions. While, as noted earlier, there is some documentation available on various broad approaches that were examined in general terms in the course of 2008, the Commission is not aware of any official record of specific alternative options or policy preferences presented to the Government on September 29 by the three main authorities involved (the CB, the FR and the DoF). From interviews with participants it appears that options presented to the DoF on September 28 by Merrill Lynch formed a basis for the discussions. The absence of a "paper trail" is perhaps understandable to the extent that it relates to the meetings surrounding September 29 itself (given the pressure of events and the *ad hoc* nature of much of the interactions), but is nonetheless regrettable, since it seriously complicates allocating specific responsibility with respect to a major policy decision with far-reaching financial consequences for Ireland.

Figure 4.5 Covered Banks – Liabilities Guaranteed by the State as at 30-Sep-2008



Source: Dept. of Finance

- 4.7.3 More importantly, the lack of a paper trail makes it difficult to assess how clear, general and sufficient was the understanding among participants of the risks to the banks' balance sheets and the potential impact of their realisation on the wider Irish economy prior to, and on, September 29. As late as September 29 itself (and indeed for quite some time afterwards), the position of the CB and the FR seems to have been that Irish banks all remained solvent in the sense that they had to date met all prudential ratios, and that there was therefore little immediate cause for concern. The possibility that they might experience catastrophic losses in asset values into the future does not appear to have been given serious consideration even from a contingency policy point of view. Unfortunately, this meant that in considering how to address the emerging immediate liquidity problems, the authorities did not give serious enough thought to such a longer-term eventuality. To this extent, decisions on September 29 directly reflect some of the failures mentioned previously in this Chapter.
- 4.7.4 In any event, by the evening of September 29, there was the immediate prospect that at least one Irish bank was facing likely default on its maturing obligations the following morning. There was no euro-wide framework in sight for dealing with emerging difficulties and clear indications had been given to the Irish authorities that it was their responsibility to address the problem. The Government had earlier concluded that it could not permit any Irish bank to fail (which the Commission understands was also the advice from the ECB), given the potentially very serious adverse effects on confidence in the banking system in Ireland and elsewhere. There was a fear that a default could set off a generalised "run on the [Irish] banks".¹³⁷
- 4.7.5 The Government and its several advisors now had to chart a crisis management policy, in principle balancing short-term and long-term risks. The main short-term risk was that measures to be announced by morning would not be sufficient, clear or credible enough to renew flagging market confidence in the Irish banking system. The long-term risk was that losses in the banks would prove much worse than foreseen and, simultaneously, have direct and severe consequences for government finances. This long-term risk, unfortunately, was not appropriately assessed because of issues earlier discussed. However, it is and was known that negative sentiment in the markets regarding Irish banks was influenced by their significant property exposure and the consequent risk of bad debts.

Limits and possible delays

- 4.7.6 Had there been sufficient appreciation of the long-term risk, the alternatives to initially limit, as much as feasible, the potential future liabilities of the State might have appeared more attractive than they apparently did at the time.. Ways to do this that were considered included limiting the number of covered banks, limiting the duration of the Guarantee and/or limiting the instruments guaranteed only to the most liquid ones (deposits and interbank liabilities). The banks most exposed to property could have been subject to immediate and very intrusive

¹³⁷ In the case of Anglo, this view was held, not because of a belief that Anglo per se was an institution essential for the Irish banking system, but because of the broader financial and reputational implications of a failure by Anglo. See Honohan (2010) for a more extensive discussion of various concepts of "systemic importance".

scrutiny by consultants with specific expertise in restructuring financial entities. Several of these alternatives appear to have been presented and seriously discussed, but eventually discarded at the meeting. Instead, encouraged by the CB and the FR, who supported the assessments of the major banks, the attention of Ministers became concentrated on how to avoid the short term risk of insufficient market funding in the morning.

- 4.7.7 Alternative funding sources were constrained so that the options facing the Government had become even more limited. The provision of funding through ELA on a major, possibly open-ended, scale was considered inappropriate as it would have exposed the CB and indirectly the State to an immediate and very large financial liability. The use of a possible domestic “fighting fund” (Secured Lending Scheme) - likely to involve a major contribution from the NTMA/ National Pensions Reserve Fund (NPRF) - was also discarded, again because of the associated immediate financial implications. Employing a special bank resolution regime was not legally available for reasons described earlier.
- 4.7.8 The policy decision not to use such alternative funding seems to have been based on judgment rather than on an externally imposed limitation. Had the authorities or the Government wished to avoid immediately providing a broad guarantee, some of these funding options were available though, perhaps, not easily. Buying time, even until following week-end, would not have been an idle exercise. It would have allowed the authorities the opportunity to assess more extensively the advantages and disadvantages of the alternative approaches available. The issue of urgently scrutinising and possibly nationalising certain banks could have been considered, including the option of splitting off their bad assets into variously managed non-bank vehicles (for which funding would have had to be found). There would perhaps have been some scope for discussing and streamlining policy alternatives more intensively with euro area partners. In the best case scenario, there could have been sufficient time to allow for the emergence of an initial common EU approach to the crisis. High priority could even have been given to urgently pursuing legislation covering a special resolution regime, thereby expanding the options available for addressing the fallout from a potentially insolvent financial institution.
- 4.7.9 Without doubt, attempting to buy time would also have had its own very serious risks, including that market confidence would not have returned sufficiently quickly or might even have further declined. Anything but a maximum State commitment could expose the Government to the risk of having to announce additional financial undertakings within a short space of time. A possible sequence of government decisions deemed to be inadequate could easily have reduced market confidence even further. This risk could have been reduced by, for instance, confidential contacts with rating agencies or major lenders,¹³⁸ but could not have been eliminated. Nevertheless, given the substantial contingent fiscal liability involved in a binding broad guarantee and particularly given market views of banks’ property exposures and their risks, it could have been worthwhile to explore the alternatives in more depth.

¹³⁸ The message would broadly have been that they would have to be content with a political guarantee; the government was on top of the situation and would initiate serious internal measures to ensure bank solvency.

Securing Tomorrow: The Broad Guarantee

- 4.7.10 All the possible policy alternatives were at this time fraught with risk and the time for decisions was very short. Increasingly, the main issue at hand was seen as ensuring market financing for the banks at the beginning of the next day; making sure that “Ireland was open for business” in the morning. There is no evidence that the CB or the FR had substantial concerns regarding an emerging solvency risk among the banks. By inference, the Commission must therefore conclude that little credibility was given to perceptions in the market of exposures and risks in Irish banks. The risk that the Guarantee would be called was apparently also judged to be small. The overriding goal was simply to make the Guarantee as effective as possible in the shortest of terms. Of course this also implied that there was no reason for any apparently solvent bank to be nationalised and risk undermining the credibility of the other banks.
- 4.7.11 Given these key elements, advices and constraints, the Commission understands that, in order to address the looming crisis at hand that night, the preferred solution of the Government was a broad guarantee. It represented, on balance, the “least bad” option to address the immediate problem. At the same time a broad guarantee was clear, decisive and uncomplicated and expressed unequivocally to the markets that the Government had confidence in and stood ready to fully support the banking system. To the markets, however, it also signalled that lenders would be indemnified to the extent provided by the Guarantee if the large property risks of Irish banks materialised, as some expected.¹³⁹ Initially the Guarantee was a success.
- 4.7.12 That being said, in the Commission’s view there is no question but that the Authorities should have had a much better idea of the underlying situation of the banks for some considerable time prior to September 29. This would have been a precondition for any crisis management approach based on the real underlying situation. On this basis, a much more systematic and rigorous assessment of the alternative measures suitable for the Irish situation could have been undertaken, possibly several years before. In particular, banks with impaired assets would probably have been required to raise additional capital prior to any guarantee on their liabilities. However, given the uncertain and unstable environment prevailing at the time, the emphasis on the need to avoid bank closures as well as the increasing amount of property losses, it is difficult to conclude with any certainty that this would have appreciably reduced the ultimate burden to the State of saving the Irish banking system. An assessment of this would require a discussion on, for instance, whether the Government could have designed a strategy to raise economic growth sufficiently in order, *inter alia*, to help cushion weakening property prices and/or to mobilise private sector capital for the banks.

¹³⁹ The continuing decline in share price of Irish banks indicated that there had been doubts about their value in the markets for some time. Furthermore, it is reported that some analysts and consultants expected a general worsening of property markets in several countries; in this regard, the exposures of Irish banks to that market were well known.

The Nationalisation Issue

- 4.7.13 Considerable debate has emerged on the separate question of whether any institution, principally but not limited to Anglo, should have been nationalised on September 29 even if it had been decided not to close it immediately. As already mentioned, it is not obvious how an apparently solvent institution without any evident need for additional capital could have been subject to nationalisation.¹⁴⁰ For a nationalisation to have efficiently addressed underlying banking problems, the Commission assumes that it would at least have been aimed at correcting the governance and procedural problems in Anglo and INBS (mentioned in Chapter 2) and making it easier to assess how these might have affected asset quality. Nationalisation could therefore have been the early start of subsequent efforts to handle impaired assets in a way that would have minimised State costs and funding problems.
- 4.7.14 It is not entirely clear to what extent various participants in the discussions on September 29 may have favoured or opposed nationalisation. It is known that at least one of the two major banks supported nationalisation, arguing that a deteriorating reputation of Anglo (their major competitor), via contagion, was contributing to liquidity pressures throughout the Irish financial system. It appears also that there was some support in the DoF for this alternative. There may also have been, in the minds of some, underlying concerns regarding the fundamental viability of the Anglo business model; however, as in the case of all the banks, assurances continued to be provided by the FR that Anglo was solvent at that time and possible solvency concerns in the future were not given sufficient consideration. Because of this, acquisition of Anglo at market share prices would still have been fairly expensive. Practical and logistical concerns regarding the timing (mid-week) of a possible nationalisation move were also noted.
- 4.7.15 Would nationalisation of Anglo have been an alternative to the Guarantee rather complementary to it? To the extent that nationalisation implies that the State takes on all the liabilities of the bank, the two outcomes would have been essentially the same in relation to the bank concerned. However, nationalisation confers ownership rights on the State, allowing it to control the activities of the nationalised entity, changing management and minimising the risk of imprudent lending or fraud as well as requiring the State to immediately decide what to do with the bank. If nationalisation were not to substantially change the behaviour of bank management, it would have had no material benefit. If nationalisation were to have been interpreted by the markets as involving a greater likelihood that the State would end up imposing losses on certain creditors, the acute liquidity problem of Irish banks would perhaps not have been successfully addressed. In this context, the preparations regarding a possible nationalisation (including a draft press release) did not address the question of the degree of protection to be afforded to creditors.

¹⁴⁰ One way would have been to require a (substantially) higher minimum solvency ratio by the next morning, for instance. How this would have affected market sentiment on that day is unclear.

- 4.7.16 In the event, after what appears to have been a short discussion at the outset of the evening, interest in the issue waned and eventually it was decided not to proceed further with consideration of the option of nationalising Anglo.
- 4.7.17 The possibility of nationalising INBS was also raised, although the bank had been experiencing a lessening of the acute liquidity pressures felt earlier in the month. The FR's view was that whatever difficulties INBS was experiencing could be better handled by leaving the current management in place, at least for the time being.¹⁴¹ As in the case of Anglo, the nationalisation option was not taken further.
- 4.7.18 The question arises as to whether the delay of three months (until January 2009) in nationalising Anglo (and INBS) had any practical impact. It is difficult to judge how and to what extent lending and other financial policies under alternative ownership and management would have differed. Additional costs could have arisen to the extent that during this three months period financial irregularities were to have taken place under the previous management. However, the Commission, in conducting its work in line with its Terms of Reference, did not become aware that such events had occurred.

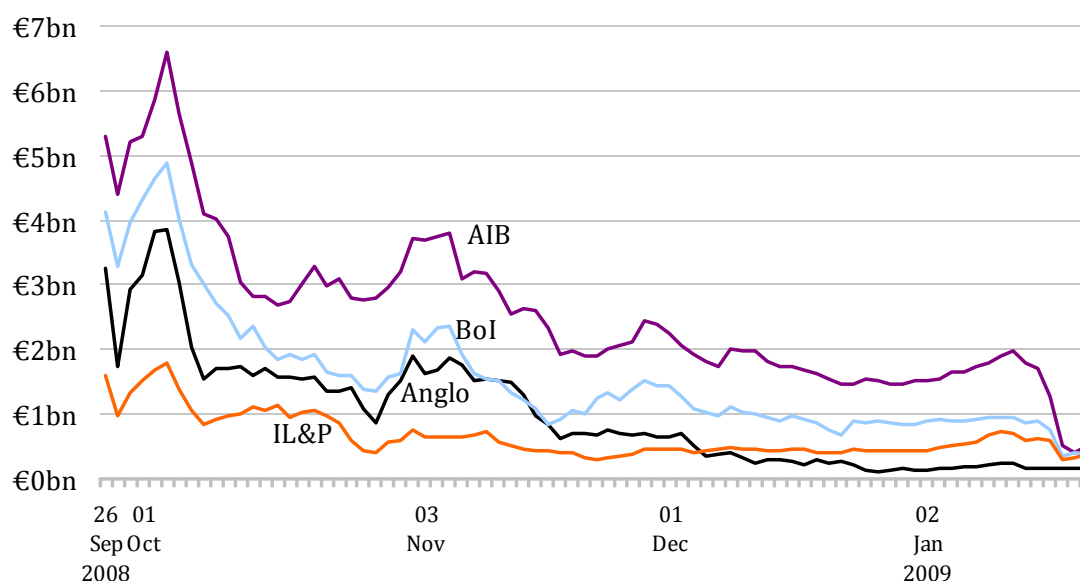
4.8 Post - Guarantee: October 2008 to January 15, 2009

- 4.8.1 Following the announcement of the Guarantee, the focus shifted to the necessary implementation measures. Issues addressed included the treatment of foreign subsidiaries, the conditions to be placed on banks' executive remuneration and the fees to be paid for the guarantee by the banks. There were also extensive discussions with the European Commission on state aid and competition-related concerns, as well as the rationale for including subordinated debt under the umbrella of the Guarantee.
- 4.8.2 The Guarantee proved initially to be effective as there was a major inflow of funds to the financial system as a whole. However, Anglo was unable to recover the vast amounts of deposits lost in the run up to the Guarantee. Moreover, the market capitalisations of the covered institutions continued on their downward trajectory (see Figure 4.6 below). In the face of these concerns a more thorough investigation began to be undertaken, along two interrelated tracks: (i) an analysis by PricewaterhouseCoopers (PwC) of selected exposures of the covered institutions at 30 September 2008¹⁴²; and, in light of this, (ii) an analysis (by Merrill Lynch) of possible recapitalisation requirements.

¹⁴¹ Given the known and serious governance problems within INBS, this view is open to question. The idea may have been to minimise any additional change so as to help encourage a return of market confidence. Another explanation could be that there was little confidence that outside management could cope with the potential problems in the bank sufficiently rapidly.

¹⁴² This included the top 20 borrower exposures, the top 20 land and development exposures, financial assets in excess of €20m and the top 10 exposures to financial institutions.

Figure 4.6: Market Capitalisations of Listed Covered Banks end Sep-2008-Jan-2009



Source: Irish Stock Exchange

4.8.3 Crisis management was now firmly in the hands of the DoF and the NTMA. Partly reflecting growing unease with the “clean bill of health” assessment emanating from the FR, the DoF and the NTMA encouraged the FR to contract an outside advisor to examine the institutions’ financial position in more detail. As noted above, PwC was appointed and the work expanded and intensified from late September onward.¹⁴³ This work would gradually provide the authorities with up-to-date financial information on the banks and, for the DoF and the NTMA, presented a clearer picture of their extensive exposure to property lending (particularly to fund land banks and development) and the high concentration of such lending among a small number of borrowers.¹⁴⁴ PwC reported that, on the basis of the information presented to them by management, all of the institutions were solvent as of end-September 2008. For illustrative purposes, PwC also applied two high-level stress scenarios. Under the first scenario, all covered institutions demonstrated the capacity to absorb an increased level of loan impairments provided the recognition of these could be managed over a 3+ year period. A higher stress case brought two covered institutions below the (then) 4% Core Tier 1 limit. However, the PwC

¹⁴³ Part of Phase I of the work had commenced prior to the guarantee decision.

¹⁴⁴ Some of this information would have been provided previously to the FR. However, parts of the underlying detail were not available in a consolidated form and would have involved a time lag. PwC’s initial work showed that as of September 30, 2008, the six covered banks had lent a combined €159bn to the property and construction sector and a further €149bn in residential mortgages – adding up to 72% of all lending by the covered banks. A combined exposure to land and development of some €63bn was identified, of which €30bn was to land. €20bn of this land did not have planning permission. The top 25 borrowers had combined borrowings from the covered banks of €25bn, with additional approved facilities of up to €5bn.

reports highlighted a number of significant risk factors on large property-related lending positions.

- 4.8.4 The outcome of the initial PwC assessment was generally viewed by the Authorities as reasonably benign. In early November a joint letter was sent by the CB and the FR to the Minister for Finance which included assurances as to the solvency of the covered institutions on the date of the Guarantee as well as their future solvency through to 2011. It also noted that, while banks generally were forecasting an improvement in capital positions (using management stress tests), their conclusions were subject to several key assumptions which were open to question. These assumptions related to profit sustainability, the scale and timing of impairments, non payment of dividends and no growth in overall lending. However, the letter notes that under stress test ‘Scenario 1’ conducted by PwC, while capital levels came close to the regulatory minimum, they remained above the critical level. Nevertheless, the letter concludes by recommending a strengthening of capital positions (probably involving the State) to ensure that institutions were in a “stronger position to support the needs of the economy and satisfy market demands for higher capital ratios”.
- 4.8.5 This letter provided assurances to Government that although some losses were likely, the problem remained one of liquidity rather than solvency, while the need for the increased capital was ascribed to market expectations. The DoF, in briefing the Minister, did not diverge from this view but added that the perceived weaknesses of Irish banks could threaten their ability to fund themselves.
- 4.8.6 Against this background, work intensified on recapitalisation options with the extensive input of Merrill Lynch. On November 28, the Minister announced that, on the basis of a report that analysed the loan books of the major financial institutions, their capital levels would remain within regulatory requirements in the period through to 2011 even under certain stress scenarios. However, in certain circumstances it would be appropriate for the State “to consider supplementing private investment with State participation”. Following a negative market reaction to the release of Anglo’s end year results, on December 14 the Government announced a recapitalisation programme of up to €10bn.¹⁴⁵ However, the positive impact of this decision was undermined by the emergence of the “loans to Directors” issue at Anglo which led to the resignations on December 18 and 19 of the Chairman and CEO of Anglo respectively. On December 21, announcements were made regarding the capital injection of €1.5bn into Anglo and €2bn each into both Bank of Ireland (BoI) and Allied Irish Bank (AIB).
- 4.8.7 Despite these announcements of capital injections, the erosion of market confidence and associated haemorrhaging of funds continued and a number of rating downgrades were

¹⁴⁵ This was preceded by discussions between the Minister and the heads of each of the major institutions. In the case of Anglo, the Minister outlined three options: (i) the provision of detailed evidence within one week by Anglo management that they themselves could raise the funds required from private investors; (ii) government injection of capital to achieve 75 % of voting rights ; this would involve changes in the board and management; and (iii) nationalisation. At around this time a financial and legal due diligence exercise was undertaken by the DoF on Anglo; it appears that nothing additional of significance was identified by this exercise.

imminent. The Government was also in possession of additional information, not yet in the public domain, which further questioned governance practices at the bank (these related to the so called Maple 10 affair and Anglo's back-to-back transaction with IL&P). Furthermore, Merrill Lynch had written to the Minister for Finance early in December recommending that he should "strongly consider" taking Anglo into State ownership. The Government now decided to dispense with its plans to recapitalise Anglo and announced the full nationalisation of the bank on January 15, 2009.

- 4.8.8 Notwithstanding the benign view generally taken by the Authorities of the PwC initial assessment it has been argued – correctly, in the Commission's view – that the nature, scale and concentration of the exposures now listed should have aroused more heightened and widespread concerns that institutions were likely to face solvency difficulties. The stark information on cross exposures as well as the size of risky property-related lending, funded via wholesale markets, should finally have highlighted the interdependency of certain institutions and amplified the risk of contagion.¹⁴⁶ Arising from the stress tests, the associated projected loan loss rates were higher than those forecast by most market analysts at the time.¹⁴⁷ Consequently, faced with data on the scale of property-based lending, particularly in the speculative land and development areas, little comfort should have been drawn.¹⁴⁸ These deliberations were also taking place against a background of a continued erosion of confidence in Irish banks as share prices continued to fall and the liquidity position of Anglo, despite the Guarantee, continued to weaken.¹⁴⁹
- 4.8.9 Moreover, it was clear that an unprecedented global credit squeeze had now taken hold. Such a tightening of liquidity would, as already noted in mid-2008 by some market observers worried about the property exposure of Irish banks, threaten the sustainability of property developers, dependent on finance to complete their developments and on exit finance in the form of new residential mortgages. With the solvency of many of their customers under threat, banks themselves could soon become insolvent.
- 4.8.10 A faster appreciation of the reality - and the associated looming costs - underlying the above elements would have allowed the authorities to take earlier, more decisive and more credible

¹⁴⁶ Apart from reviewing certain large 'trophy' land acquisitions disclosed over the previous three years, the PwC remit did not extend to capture the possible additional indebtedness of borrowers to non-Irish banks – an element which would have strained their capacity to repay the six Irish covered institutions. More generally, banks appeared to have little reliable information regarding borrowers' other exposures. The Regling and Watson report suggested that a credit registry ("centrale des risques") along the lines of some other EU countries could be a useful tool to address this issue.

¹⁴⁷ While the most "extreme" scenario, if realised, would threaten adherence to regulatory capital requirements in certain institutions by 2011, this involved only an annual loan impairment rate of 15% on development land without planning permission (the riskiest asset class).

¹⁴⁸ Indeed as early as December 2008 the further work of PwC to examine existing and prospective property valuations (the first time this work had been undertaken on an independent basis) began to indicate that the stress scenarios assessed in the previous two months were now expected to be base case scenarios.

¹⁴⁹ Only four months later, in March 2009, Anglo, following an internal assessment, identified a need for an additional €4bn in capital to avoid breaching regulatory ratios.

action. From this point of view it could have been useful to use specialists in restructuring to assess the financial position of the covered banks. The solvency position of Irish institutions could then have been strengthened with significant capital increases well before the renewed onset of the liquidity problems, and non-systemic insolvent institutions could in a “normal” way have had their doors closed earlier and been wound down over time.

- 4.8.11 The nationalisation of Anglo,¹⁵⁰ some three months after the introduction of the Guarantee, thus occurred finally only after a series of announcements by the authorities outlining alternative plans which in the end had to be abandoned. This did little to build market confidence in Irish banks or in government policy and forecasts. Combined with the emergence of governance scandals at Anglo it created a sense that the authorities did not understand the extent of the problems and that further issues could emerge. Given the broad guarantee, doubts about sovereign creditworthiness and thus the credibility of the Guarantee began to crop up. This may have contributed to the continued erosion in the liquidity position of banks in the period that followed, despite the existence of the Government Guarantee.

4.9 Behavioural Factors

- 4.9.1 This Chapter has sought to describe the particular shortcomings – deficiencies in approach, lack of analytical rigour, a misplaced sense of optimism – that contributed to an overall failure by individual institutions within the authorities to diagnose the problem correctly and take effective remedial action. But these do not quite explain fully the collective failure by all the key domestic “official” institutions - the DoF, the FR and the CB - to react as they should have. Early action by even one of these official institutions could have had a major impact in averting the disaster that eventually unfolded.
- 4.9.2 The international environment of trust in self-regulated financial markets (Section 4.2) no doubt had a major impact on the thinking and policy of Irish authorities. There was a globally widespread basic assumption that financial market problems by their very nature were temporary.
- 4.9.3 Based on its interactions with a wide range of individuals at different levels across the above institutions, the Commission is of the view that there also was pressure for “group think” within the institutions and, possibly, between them as well. This feature mirrors similar tendencies that were judged to have been at work in banks (Chapter 2). Thus, within and among authorities, only alternatives within a relatively narrow range tended to be considered and thinking “outside the box” was not encouraged or was even implicitly discouraged. Such a

¹⁵⁰ The rationale for the decision was clearly set out in an internal DoF memo of around this time. The positives of nationalisation included: (i) mitigating the risks of a downgrade (the rating would transfer to the sovereign); (ii), minimising deposit outflows; (iii) introducing market certainty; and (iv) allowing for orderly work out of the loan book and direct Ministerial control to deal with governance issues. (However, in the case of (ii) the nationalisation of Anglo in reality appears to have triggered a flight of deposits from all covered institutions that was greater than that experienced in the run-up to the guarantee). Negatives identified in the memorandum included the perception of a confused approach to Anglo, contagion risk vis-à-vis other banks, the fact that liquidity support would still be required and a possible negative impact on asset realisation values.

tendency, while facilitating the emergence of an institutional consensus and adherence to official policy, clearly was not conducive to a serious examination of what may well be considered low probability, but extremely high cost outcomes.¹⁵¹ Challenging consensus thinking, as a few individuals continued to do, is often essential to help recognise the need for preventative action and to prepare for handling otherwise unforeseen consequences.

- 4.9.4 Across institutions, this hierarchical/conformist style of policy making may have contributed, for example, to the unquestioning consensus that emerged at senior levels regarding a likely “soft landing” in the property market. While this was judged to be the most probable outcome, the absence of substantial analytical work by the CB – even on an internal, confidential basis – to consider the implications of an alternative, much less favourable outcome, is striking. A similar point relates to stress tests for the banks undertaken by the CB. The general absence of official position papers enunciating clear options and recommendations as the crisis worsened in 2008 may be another symptom of a conformist style of policy making. Officials may have been cautious to express specific views, stemming from a desire to await the preferences of Government on the general direction it wished to take. In the case of the DoF a more complex issue arises, namely, the extent to which civil servants should be expected to express their views to Ministers regardless of government programs or political priorities.
- 4.9.5 It appears that the tendency to “groupthink” may have been supported by the inattention or lack of support accorded by senior management to contrarian views provided by their subordinates. Within institutions, instances of contrarian thinking tended not to be encouraged and contrarian papers went unrecognised, especially when an overall policy conclusion appeared to have already been decided upon. In some cases, a preference for generalists, as opposed to individuals with greater technical expertise in specific problem areas, may have played a role.¹⁵²

¹⁵¹ In the case of the banks, as opposed to official policy making, the recourse to groupthink is more easily explained by market pressures and more traditional models of “herding” behaviour.

¹⁵² In the case of the FR’s Banking Supervision Department, difficulty was experienced in attracting and recruiting specialist personnel with the necessary skills. However, as earlier indicated this would not necessarily have corrected the real problem that was a lack of sufficient professional scepticism.

Chapter 5 – Findings & Final Considerations

5.1 Findings – General

- 5.1.1 The Report concentrates, as its Terms of Reference require, on explaining the reasons specifically for the Irish banking crisis. However, it is useful to keep in mind that this crisis cannot be seen in isolation from what was happening elsewhere. It appears, at least on the face of it, that many of the problems and failings in Irish banks and public institutions were quite similar to those in other countries.
- 5.1.2 For instance, Irish banks compared their policies and achievements with peer groups containing well regarded banks in the UK and the EU. Risk management systems and remuneration practices were often adopted from abroad. Judging from results, similar problems, as in Ireland, arose in implementing them in a manner consistent with prudent credit policies. The relatively greater losses seen in Ireland may thus be seen as a consequence of somewhat greater abandon in accessing wholesale funding and in lending to domestic property than in other countries. Thus, there is a difference in degree rather than in concept.
- 5.1.3 Similarly, central banks and regulators abroad generally were almost as unsuspecting of growing financial fragility as their Irish counterparts. The method of regulation or the number of available macroeconomists does not generally seem to have made a great deal of difference. The same seems true of auditors, rating agencies, analysts and investors, most of whom remained calm and optimistic until the crisis actually broke. Internal investigations in the IMF also indicate a widespread lack of understanding and clear communication of the accumulating risks by that organisation. There were incentives to conform with prevailing views, even in cases where proper analysis would have identified growing risk.
- 5.1.4 The fact that Ireland was not special does not, of course, account for or diminish the failures in the performance of the people in private and public positions responsible for financial stability and prudent banking. It does, however, put the many undoubted failings found by the Commission into perspective. Regardless, it indicates that the problems experienced in Ireland in the 2000's have a wider relevance, as do any suggestions on how to prevent similar things from easily happening again.

5.2 Findings - Banks

Business Models & Strategies

- 5.2.1 Responding to increased competition and pressure for increased earnings, banks set aggressive targets for profit growth. In many cases, this drive for growth really implied a partial change in business model and strategy without the corresponding necessary strengthening of governance, procedures and practices. This was accepted partly because future economic developments were trusted to remain benign in Ireland as they already had been for several years. Comfort was also taken from peer bank practices and the lack of concern among authorities, market

participants and observers. The particular characteristics of the property and funding markets were not taken into account.

- 5.2.2 In practice, Anglo Irish Bank (Anglo) was a monoline bank providing rapid but not cheap financing to a number of long standing customers mainly in the commercial property market; sales and customer retention were important drivers of activity. Irish Nationwide Building Society's (INBS) business model was unique and different to those of any of the other covered banks as it was concentrated primarily on speculative site finance, which proved initially to be very profitable in a rising property market. The model was risky, however, and risk mitigation primarily involved selecting trusted and previously successful customers. The business models of the other covered banks were more diversified, but during the Period most of them escalated their financing of commercial property in order to achieve profit growth. While IL&P remained concentrated on mortgage lending, it was increasingly funded by the wholesale markets.

Governance & Procedures

- 5.2.3 The primary problem with governance in the majority of the covered banks was not that it was lacking or poorly structured but that, over time, it changed as controls gradually weakened to allow increased growth. In some cases, management information systems were weak and did not give managers and the board meaningful or complete information. In particular, inadequate consolidation and categorisation of lending sometimes resulted in an incomplete picture of total or type of property exposures. In some of the bigger banks, the embedded internal divisional structures made group oversight difficult. The INBS model was atypical; the Society lacked a number of formal functions usually considered necessary in banks and, in addition, documentation was substandard.
- 5.2.4 On boards, there appears to often have existed a collegiate and consensual style with little serious challenge or debate. Among Non-Executive Directors (NED), it appears that the banking knowledge and expertise necessary to assess the lending and funding risks inherent in bank business models was insufficient. They were therefore formally independent but, in practice, highly reliant on the knowledge, openness and ability of bank management. In particular many NEDs, but also a number of senior management, seem to have believed that the existence of formal policies, structures and procedures were, on their own, sufficient for the prudent management of the business. As they came to rely more on sophisticated models, partly in consequence of the introduction of Basle II, many of the basics were neglected. It appears that senior management and boards did not appreciate how general growth targets affected operations lower down in the organisation.
- 5.2.5 In Anglo, some board members had significant shareholdings in the bank which indicates that they had particularly full trust in the operations and growth goals of the bank.

Remuneration

- 5.2.6 Financial incentives, while not the major cause of the crisis, likely contributed to the rapid expansion of bank lending since the incentives did not sufficiently stress modifiers for risk.

There are, however, also other important motivating factors which must be taken into account when assessing the behaviour of individuals.

Lending & Credit

- 5.2.7 Lending growth was substantial in all covered banks and was largely concentrated in the property sector. In order to facilitate growth and make banks more competitive, credit and lending policies gradually became more relaxed and were frequently ignored or bypassed with exceptions to policy becoming commonplace. Furthermore, sector limits and individual exposure limits, where they existed, were regularly exceeded.
- 5.2.8 Real estate valuations in a rising property market created a “confirmation bias” and frequently went unchallenged in the credit functions. The practice of equity release reduced the collateral buffers held by the banks and increased their risks accordingly.

Funding, Liquidity & Capital

- 5.2.9 On joining the Eurozone, Irish banks gained increased access to wholesale funding at a relatively low cost. As retail and corporate deposits were not sufficient to fund lending growth, wholesale funding enabled the banks to respond to competition and to grow balance sheets and earnings at a pace that banks believed would protect their independence and market share.
- 5.2.10 Treasury operations, charged with the balanced and prudent funding of asset growth, were also profit centres. This involved an inherent conflict as the use of cheaper short term funding frequently increased Treasury’s profitability at the expense of longer term funding stability
- 5.2.11 There were significant increases in the loan-to-deposit ratios and in wholesale funding-to-total funding ratios. Furthermore, risks associated with wholesale funding were not fully recognised or understood in many cases. Banks consistently assumed that the uninterrupted and unlimited access to wholesale funding, at a low or reasonable cost, would remain. They also believed that the option of securitising eligible portions of their portfolio would always be possible.

Risk Management

- 5.2.12 Risk management structures proved largely ineffective in prudently managing and controlling rapid growth. As effective structures would have made high volume targets difficult to achieve, banks allowed their effectiveness to erode over time. There was also insufficient understanding or acknowledgement of the risks associated with the adopted business strategies or the sector concentrations. With easy access to funding, there was little effort by or incentive for the banks to diversify their property risks through measures such as syndications or loan sell-down. Furthermore, there was a general belief among bankers and others in political, media and academic circles (including some very influential commentators) that there would be, at worst, a soft landing.

Regulation as seen by Banks

- 5.2.13 Banks, clearly somewhat in agreement with the Financial Regulator (FR) itself, believed that they were in a better position than the FR to judge and decide upon what was most prudent in their own operations. This belief was underpinned by the fact that regulation was “light touch” and seemed to stress consumer issues rather than prudential issues. There was almost an element of the FR being “fobbed off” by banks that had particularly full confidence in the quality and sophistication of their models and systems. Subject to this, the FR and its communications were normally, however, accorded proper formal respect.
- 5.2.14 There were numerous instances of non-compliance with respect to banking regulations and guidelines which went unsanctioned by the FR. In some cases (Anglo and INBS), where the FR did raise concerns, they sometimes led to little real change and there was little follow through by the FR. Bank management drew undeserved comfort from the acquiescence of the FR in relation to this non-compliance.
- 5.2.15 There existed a loop of excessive reliance between the various authorities on the one hand and between accounting standards, internal risk structures, credit grading systems and board sub-committees on the other. This systemic failure resulted in the dangers inherent in the business models remaining undetected until it was much too late.

5.3 Findings - Authorities

- 5.3.1 The speed and severity of the crisis was exacerbated by world-wide economic events. The main reason, however, was the unhindered expansion of the property bubble financed by the banks using wholesale market funding. government policies and pronouncements tended to support this expansion. The attendant risks went undetected or were at least seriously misjudged by the authorities whose actions and warnings were modest and insufficient.
- 5.3.2 The Irish authorities had the data required to arouse suspicion about trends in the property and financial markets. The relaxed attitude of the authorities was therefore the result of either a failure to understand the data or not being able to evaluate and analyse the implications correctly. Both macroeconomic and banking data could, particularly when combined, have provided the authorities with an understanding of what was going on. The Financial Stability Reports (FSR) provided information on individual perceived risks but, in the Commission’s view, the data should have raised greater suspicions by end-2005 or, at the latest, by 2006.

The Financial Regulator

- 5.3.3 Provided the appropriate structures and processes were in place, the FR’s approach was to trust bank leadership to make proper and prudent decisions. However, even when problems were identified and remarked upon, the FR did not subsequently ensure that sufficient corrective action was taken. Thus, even insightful and critical investigation reports tended to have little impact on banking practices. Furthermore, readily available information on, for instance, sector or borrower concentrations was not sufficiently critically analysed by the FR. Even if it were accepted that the FR was significantly under-resourced throughout the Period, this would not explain why available information was not acted upon.

- 5.3.4 It seems remarkable that the FR in practice accepted the severe governance problems in INBS. Allowing this bank to continue operations without major reforms or sanctions must, on the part of the FR, have reflected either a reluctance to pursue legal action or a profound trust in bank management and the board. Similarly, the rapid and concentrated lending growth in Anglo, and later in other banks, did not lead to regulatory action, with reliance being placed on management assurances that all was basically well. The FR continued to accept these assurances, even after the Guarantee decision in late 2008.
- 5.3.5 The Commission is aware of the view that the FR did not have sufficient powers to intervene. This view is not persuasive given that the FR could have acted in concert with the Central Bank (CB) and, ideally though perhaps unrealistically, with Government support. The real problem was not lack of powers but lack of scepticism and the appetite to prosecute challenges.

The Central Bank

- 5.3.6 The CB chose to rely on the FR appropriately handling individual bank stability issues, much as the FR in turn chose to trust bank leadership. By implication, unless there were problems in the individual banks, there could not be major stability issues in the system as a whole. The Financial Stability Report (FSR) was constrained to present benign conclusions with a number of almost routine warnings voiced in the text itself. Simultaneously, macro-economic data signalling the emergence of the two key risks – growing dependence on foreign funding and the concentration of bank lending in the property sector – did not appear to have caused acute concern.
- 5.3.7 At least at policy level, the CB seems not to have sufficiently appreciated the possibility that, while each bank was following a strategy that made sense, in the aggregate, when followed by all banks, this strategy could have serious consequences for overall financial stability. This was a classic macroeconomic fallacy that must have been recognised in the CB and it remains unclear why it was not appreciated at senior levels there. However, there are signs that a hierarchical culture, with elements of self-censorship at various levels, developed in the CB. Of course, this eventually made it even harder to address the increasing instabilities in the financial market.
- 5.3.8 The Commission is aware of but disagrees with the view that the CB would not have been entitled to intervene to address stability issues concerning individual banks. If the CB management had identified or given sufficient weight to macro-economic vulnerabilities, it could and should have initiated discussions with the FR to ensure a deeper analysis of individual banks' regulatory returns. However, as neither institution suspected any significant problems this does not appear to have been done.

The Department of Finance

- 5.3.9 The Department of Finance (DoF) did not, despite its mandate, see itself as concretely involved in financial stability issues; it also did not have the requisite professional staff for this. There were regular formal contacts with the FR (via the approval process for its budget) and

somewhat more frequently with the CB, both in practice responsible for operational stability assessments. The DoF saw itself as preparing legislation to be implemented by the other authorities, but appears to have avoided addressing other financial market issues unless brought to the table by the FR or the CB (for instance, Credit Union issues during the Period). This apparently was due to their legally independent status. The Commission could find no evidence that the DoF formally tried to influence the FR in its work. The DoF also did not make any efforts to strengthen its own financial market expertise despite crisis management exercises in the EU having shown a need for it among finance ministries.

- 5.3.10 Had the DoF taken a greater interest in financial market issues early on, preparations for dealing with the financial crisis would have been more comprehensive. It is well documented that the DoF consistently, though not forcefully enough, supported a less expansive fiscal policy, particularly regarding property market incentives. It also appears that worries about the developing financial situation were expressed internally from time to time by some DoF staff. However, nothing came of this as the CB and FR were seen as responsible for financial stability.

The Guarantee Decision

- 5.3.11 From mid-2007 onwards, cooperation improved between the key institutions involved and some important preparatory crisis management work was undertaken. However, the view that the only relevant problem was a threat to the liquidity position of the banks remained unchallenged throughout. There appears to have been no fears and, at most, a modest discussion on possible underlying acute solvency problems. This is true of the banks themselves as well as of the authorities.
- 5.3.12 The discussions for alternative measures before and on September 29, 2008, were conducted on the basis of very deficient information. The authorities were apparently convinced that bank solvency issues were not pressing or significant, as were the banks themselves, and that it therefore would be possible to resolve the acute liquidity issue. Furthermore, the liquidity problems appear to have been seen as temporary only and related mainly to international developments. If more relevant information on and analysis of the underlying position of some of the banks had been available, discussions and policy recommendations may have been very different.
- 5.3.13 Given the information provided, the Commission understands the Government's decision to provide a broad guarantee for the banks; if no major solvency problems were expected the Guarantee would not have to be called upon. However, given the size of the amounts involved as well as the domestic and global uncertainties, it could have been useful to access available temporary funding to gain time to examine more thoroughly the advantages and disadvantages of alternative approaches. These could have included limiting the scope and duration of the Guarantee. However, there were concerns that the market would not have acted positively to such a delay at the time.

- 5.3.14 The lack of information on bank exposures among the Authorities over time had profound implications for the decision actually taken. Had better information on exposures and thus the risk of future impairments already been readily available in earlier years, government advisors could have suggested, even much before September 2008, that such banks with reasonably foreseeable problems should be taken into public administration immediately and gradually closed or restructured. Management could have been changed to eliminate further lending and risk-taking. Banks could, alternatively, have been required to raise additional capital from the markets while it could be accessed markets still were open for this. However, authorities continued to believe that banks did not have excessive property exposure and even outside evaluators only gradually came to a different view. As it turned out, no bank restructuring was contemplated until several months after the Guarantee when plans announced by the Government on a piecemeal basis had proved to be insufficient, thus reducing the credibility of the Irish authorities.
- 5.3.15 Crisis management in Ireland, therefore, was rendered less than fully effective by long-standing insufficient appreciation of bank exposures on the part of all the authorities. Decision-makers and their various advisors, in autumn 2008, still mainly shared the common view that the banks were, and would remain, solvent.

5.4 Why Did It All Come Together?

- 5.4.1 It has been argued in this Report that during the Period the paradigm of efficient financial markets was widely accepted, particularly among developed nations. Believers in a naïve version of this paradigm would tend to assume that developments in the financial markets, almost by definition, could not be seriously flawed from a systemic point of view. Furthermore, they would also tend to assume that regulation of the financial markets would reduce innovation and efficiency without improving stability; less and lighter regulation was therefore better. Since there was widespread international belief in this paradigm, the international nature of the financial crisis, as well as the general unpreparedness of banks and authorities, is easier to understand.
- 5.4.2 To the extent that this paradigm, in its naïve version, had become widely trusted among Irish financial professionals in private and public institutions, such an assumption may have been made both across institutions and within institutions (strengthened through groupthink). These assumptions in turn would have led, in the absence of strong and specific proof, to a belief that virtually any market feature or development was benign almost by definition, whether in the property market, the financial market or, indeed, in any individual bank. In effect, if it was financed by somebody, it must almost by definition be sound.
- 5.4.3 However, it is the belief of the Commission that stronger, irrational forces were also present. The widespread consensus as well as the confidence, until the very last moment in late 2008, that everything would end relatively well points to the existence of a national speculative mania in Ireland during the Period, centred on the sale and acquisition of property. Warning signs were ignored as continuing economic stability was confidently assumed. Traditional values and practices were seen as less relevant in the new financial order. When the mania

ended, participants had difficulty in accepting blame for their own part in it since everything had seemed so normal and acceptable at the time.

- 5.4.4 Given this background, it is easier to understand why developing and clearly visible problems in the Irish banks and markets could remain ignored by so many. It also helps explain why banks so readily crowded into speculative property lending, which appeared to be a certain road to success (herding on the mania). It makes it easier also to understand why the authorities, despite being provided with information on increasing fragilities in the banking system, could remain complacent for so long. Finally, it goes some way towards explaining why the crisis, despite being the culmination of a number of clearly unsustainable developments, was so totally and generally unexpected almost up to the very last minute.
- 5.4.5 The general acceptance of the paradigm of efficient markets also throws light on why most international institutions, foreign analysts, rating agencies, lenders, authorities and commentators were as relaxed about Irish developments as people in Ireland themselves. It is argued that the long period of benign conditions in Ireland played a substantial role in convincing observers that developments were stable. Furthermore, if large numbers of people also believed in the naïve interpretation of the efficient financial markets paradigm, very few developments in the financial markets would appear unsound or imprudent to them anymore.
- 5.4.6 It may seem remarkable that people in Ireland (and elsewhere) with extensive experience in regulating and operating in financial markets may have accepted such fairly extreme assumptions for their daily work. It has been argued that various bandwagon effects (see Section 1.6 above) may have played an important role in this, as may the fact that international supervisory and banking peers abroad also accepted these assumptions at least to some degree.
- 5.4.7 Ireland's systemic banking crisis would have been impossible without a widespread suspension of prudence and care by those responsible for bank management as well as by those charged with ensuring responsible financial conduct.¹⁵³ Investors and other borrowers as well as bank executive management have an interest in doing deals with each other for profit and for glory; what went missing was prudence in ensuring that such deals were soundly based. Bank boards and public authorities, whose role it is to make it difficult for the dealmakers to go overboard, continued with their traditional work. However, their authority and, unfortunately, their vigilance as watchdogs were in decline. The stability of markets was becoming more dependent on bank management and their risk management systems.
- 5.4.8 The majority of bank executive management, despite their apparent superior technical knowledge of the business, chose to follow the new but unsustainable banking model. Lending

¹⁵³ It is particularly difficult to understand why the FR apparently drew no conclusions from the quarterly reports it got from each Irish bank on its largest borrowers. These reports were provided to the Board of the FR and the CB and, when consolidated, clearly revealed the extent to which credit in Ireland was heavily concentrated on a small number of borrowers active in the property development market.

was seen (and rewarded) as selling a loan or service rather than as acquiring a risky asset.¹⁵⁴ Banks' management and boards embraced a lending sales culture at the expense of prudence and risk management. This view then spread down through the ranks, partly through the effects of volume targets and bonus systems and partly through indoctrination, causing the massive run-up in risky assets.

- 5.4.9 The external watchdogs generally remained inactive as management's new banking model was introduced and implemented. There was no strong external reaction when management prudence eroded within the Irish banking system, as evidenced by the very rapid growth in lending and wholesale funding. The Commission has not found any clear and documented cause for the simultaneous lack of action by various watchdog authorities; it can therefore offer only the partly hypothetical behavioural factors described earlier in this section.

5.5 Specific Irish Features

- 5.5.1 The Commission proposes that the crisis points towards some interesting features of how Irish society appears to have functioned during the period 2003 – 2009. It is considered that these features may be specific only to Ireland and, if present, they would further help explain why there was little recognition and even less prevention of the property mania in Ireland.
- 5.5.2 Firstly, there seems to have been little suspicion or doubt among Irish decision-makers that the path being followed was the correct one. A great number of persons in very responsible management and watchdog positions insisted that, until the end, they had no idea that a serious and acute problem with lending and funding exposures in the banking system even existed. In the stated absence of this knowledge, little was done to prevent the crisis. This is true of politicians (whether in government or opposition), central bankers, regulators, department officials and bank board members as well as influential analysts in the media, academia and financial enterprises.
- 5.5.3 The Commission has been widely assured by bank management, non-executive board members and others that the problems in banks' loan books came as a complete surprise. There is regret, incredulity and guilt among them at the lending and funding policies pursued and the lack, at the time, of any recognition of what was happening. The credibility of their assertions is increased by the fact that a number of them personally suffered substantial losses in the crisis, easily avoidable if advance warnings had been available and recognised.
- 5.5.4 This suggests to the Commission that, in the absence of a liquidity crisis at this time, things would have continued much as before in Ireland, at least for a time. The property market would have continued to expand, though at a slowing pace, and banks' portfolios of property loans would have continued to grow. Therefore, banks would have had time to become even more dependent on market funding and even more exposed to the effect of any doubt regarding the value of their assets. At some point, financial markets would have realised the risks on the Irish

¹⁵⁴ If the extreme assumption was that markets tended towards stability by themselves, riskiness was less of a concern than before. Further, asset growth would ensure, on average, stable profits growth. As a direct consequence, credit and risk management would lose much of their relevance – mistakenly, as it turned out.

banks' balance sheets. While a soft landing always would have remained a possibility in principle, overall international experience with the bursting of property bubbles, the general lack of foresight as well as the scale of the exposures seems to argue against it.

- 5.5.5 Secondly, there was a conspicuous lack of timely critical debate and analysis by bank analysts within institutions and among the public at large. The complacent views of Government, other authorities, banks and their customers appear to have been very well aligned with each other. Public policy and discourse seems to have almost unanimously accepted and encouraged views and practices that later proved disastrous. Examples are not difficult to find; for instance, the pervasive assumption of continued growth, the failure to see growing indebtedness as a serious policy problem, the “soft landing” scenario and, finally, an unwillingness to recognise the existence of long-standing problems in some banks.¹⁵⁵ When alarms were finally sounded, they were too late for meaningful action; the problem loans were already on the banks' books and were largely illiquid.
- 5.5.6 The very limited number of warning voices was largely ignored. Attempts by banking insiders during the Period to send cautionary signals to market participants about escalating property values were dismissed as ill-informed and wrong.¹⁵⁶ Doubters (the few that identified themselves as such to the Commission) in the main grew unsure over the years when nothing seemed to go wrong. It also appears that some stayed silent in part to avoid possible sanctions. The Commission suspects, on the basis of discussions held with a wide number of people, that there may have been a strong belief in Ireland that contrarians, non-team players, fractious observers and whistleblowers would be informally (though sometimes even publicly) sanctioned or ignored, regardless of the quality of their analysis or their place in organisations.
- 5.5.7 Thirdly, many institutions in the broader financial sector seem to have operated in silos. There appears to have been little appetite or opportunity for looking at “the bigger picture” since, as related earlier, each part of that picture was “owned” by different authorities or, within the banks, by specific departments. While clear divisions of responsibility are important, in Ireland such divisions appear to have reduced also the desire or (legalistically argued) the ability to cooperate effectively.
- 5.5.8 For organisational silos to work well there must either be strong and frank communication between their leaders or, alternatively, little interdependence between them. It is unclear which one of these, if any, was believed to operate. One possible consequence of this “silo think” was that the DoF, discouraged from interfering in the work of the independent FR and CB, remained seriously underweight in professional financial expertise and engagement. The Commission considers it likely that the lack of overall analysis and responsibility in so many Irish public institutions may have allowed a number of warning signs to remain undetected.

¹⁵⁵ Indeed, supervisors, analysts and rating agencies must have assumed that bank activities ultimately were benign since clearly visible governance, credit concentration and funding concentration issues were not treated as problems to be addressed. Some were of the view that simply publishing the facts was sufficient; of course, this is also simply a way of transferring the responsibility for any critical assessment on to others.

¹⁵⁶ Ed Micheau, “*Bank Boss: No Property Bubble*”, Sunday Business Post, 2 April 2006.

Indeed, overlapping interest is not necessarily a bad thing as long as responsibilities remain clearly differentiated.

- 5.5.9 Fourthly, adhering to either formal or traditional, often voluntary, constraints and limits on banking and finance, does not seem to have been greatly valued in Ireland during the Period. The wide acceptance of the new financial paradigm may have amplified any such tendency as it applies to the banking sector. The consequences for financial stability are, in any case, severe in the longer term.
- 5.5.10 Regulations, rules, procedures, constraints and sanctions exist primarily to prevent management and staff from going overboard during good times. The better and longer the good times are, the more important it is that these safeguards exist and are adhered to. If they do not exist, or are ignored, exposures can grow dramatically as confidence grows and risk is underestimated. The risk of systemic disturbances therefore increases greatly if political leaders and public institutions do not insist on these safeguards being consistently and efficiently followed. Therefore, any greater than average lack of willingness in Ireland to follow rules and constraints is likely to make for a more fragile financial system than elsewhere in the long run.
- 5.5.11 The Commission considers that it cannot have remained a secret from banking and audit professionals that time-honoured prudential limits and procedures were gradually falling into disuse, particularly in some banks. Examples and indications of serious governance and prudential problems were clearly available to professional observers, including the FR. Increases in credit concentration, loan size and volumes, as well as changes in funding structures, were not concealed. They could also have been inferred from macro-economic data. Information about ongoing and accelerating property speculation was common in everyday Irish life.
- 5.5.12 The Commission accepts that the new, widespread paradigm, as well as the mania in the Irish property market, could create strong pressures for conformity in all the institutions discussed in this Report. However, while this could explain such behaviour, it does not provide an excuse for those who conformed. Only a naïve and opportunistic interpretation of the paradigm, together with a lack of either relevant experience, training or historical knowledge, could possibly have argued for a major dismantling of the traditional prudential safeguards. History is replete with examples of what happens when bankers, authorities and others come to believe that “this time it’s different”.¹⁵⁷
- 5.5.13 The Commission therefore has reluctantly come to the conclusion that at least some of the financial market professionals at the time must have entertained private, undisclosed doubts on the sustainability of banks’ lending and funding policies. However, for various reasons “the dance had to go on”. Similarly, it seems likely that the public and private watchdogs remained

¹⁵⁷ For those arguing that the crisis in Ireland or elsewhere was unique and impossible to foresee, see Carmen Reinhart & Kenneth Rogoff; *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

less active than required, not only because they did not know, but also because it was not publicly acceptable, legally necessary or prudent to act at the time.

- 5.5.14 During much of the Period, Ireland was still seen as a success story that provided a large number of its inhabitants with self-esteem as well as rising incomes, wealth and welfare. Anybody seriously interfering with this process would expect to be publicly castigated as causing the very distress, loss and crisis that they would have been trying to prevent. Instead, by allowing the party and deal-making to continue, management, investors and public and private watchdogs participated in its positive but temporary gifts.
- 5.5.15 That said, the Commission is not suggesting that financial professionals in Ireland consciously decided to let banks get into trouble. As indicated earlier, it is much more likely that professional suspicions were explained away or suppressed, in light of the new financial dogma and a long period of good times, in order not to appear fractious, unprofessional or alarmist among colleagues, superiors and others who were believed to possess equal or even superior knowledge.

5.6 Lessons to be Learned from the Irish Experience

- 5.6.1 As already noted above (Section 1.4), emergence of a systemic banking crisis requires that a number of important safeguards all become ineffective simultaneously. The likelihood of this is not large, since some part of society and the banking sector is likely to remain vigilant even if other parts do not. However, as has been seen in a number of countries and regions before, at times the unlikely occurs.
- 5.6.2 The Commission has, having extensively examined the most relevant available documentation as well as interviewed very many people involved in the run-up to the crisis, explained the crisis essentially as a consequence of applying a naïve version of the efficient market paradigm, supported by groupthink and herding. This helped create and strengthen a mania in the Irish property market. Professionals and non-professionals alike became convinced, and convinced each other, that financial markets were stable by themselves, despite historical evidence to the contrary. The implications of this conviction seemed to be in the immediate interest of the overwhelming part of Irish society. The resulting activity was something that, later on, seemed quite unsustainable, puzzling and contrary to prudential requirements and common sense.
- 5.6.3 The development of excess indebtedness and property market overheating appears to have been fairly common in many countries in recent years and decades. This Report contains a short indication of how a groupthink and herding mechanism could support a theory of recurring financial cycles.¹⁵⁸ The Commission has detected signs of such a mechanism both within Irish banks and within Irish public authorities during the run-up to the crisis. This mechanism may have been particularly strong because of the widespread existence of a belief in self-regulating, efficient markets.

¹⁵⁸ See Section 2.6 where the argument is made in the context of the Minsky cycle.

- 5.6.4 If this hypothesis is accepted, an important implication emerges. Because the real reason for the crisis is the spread of an ultimately irrational point of view, regulations and watchdog institutions cannot be counted on to be efficient preventers of a systemic crisis. As has been seen in Ireland and other countries, central bankers and regulators embraced much the same paradigm as the market participants and adapted their policies to their convictions.¹⁵⁹ The result, as shown by the crisis itself, was that no effective brake on risk-taking existed for years. It does not appear wholly unfair to propose that this is what may happen also in the future if and when another new financial or banking paradigm appears. Many of the very reforms that recently have been undertaken, at short notice, to shore up the functioning of the present financial system could turn out, once again, to be ineffective.
- 5.6.5 Permanently improving financial stability therefore should perhaps, instead, be done in ways that do not necessarily demand the unfailing attention, prescience or vigilance of ministries, central banks or regulators. Arguably, the most important goal of such a system should be to directly reduce the likelihood of serious disturbances to the real economy. A number of suggestions have been made to primarily address this problem. They seem to have been made mostly by policy makers and practitioners;¹⁶⁰ academic economists have often remained unconvinced by at least the more radical of these suggestions.
- 5.6.6 The prevalence of problem banks that are large in relation to both the economy and the sovereign (too big to fail and too big to save) suggests that measures limiting the size and growth of banks and the banking system in relation to the economy could be useful. One alternative, not widely supported due to its arbitrary nature, would be to directly set a limit on the absolute size of a bank's balance sheet. Other alternatives, briefly discussed below, are indirect and would operate by raising the cost of expanding the (properly risk-weighted) balance sheet. Such alternatives include: a high and progressive minimum capital requirement (set nationally); limiting implicit government subsidies to certain bank activity clusters only; and raising the potential default costs for investors in banks. These alternatives can, of course, be combined.
- 5.6.7 Radically increasing the capital requirements of banks would reduce their vulnerability to both funding and solvency shocks.¹⁶¹ Since banks would need much more capital to operate, the resulting buffer of private capital would be larger in case of a default. Capital requirements could also be made progressive in relation to the size of the balance sheet. Since different countries would be able to support different-sized banks, such reform would have to be nationally determined. Competitiveness would be affected, creating pressure for an internationally agreed formula. As indicated by the discussions around Basel III, the issues of definition and of interaction with other prudential constraints are always significant. Problems

¹⁵⁹ As apparently did the IMF as related in Biagio Bossone: *At the shrink's bed: The IMF, the global crisis and the Independent Evaluation Office report*, VoxEu.org, 11 February 2011.

¹⁶⁰ For instance Paul Volcker, previously Governor of the Federal Reserve Bank, and Mervyn King, Governor of the Bank of England.

¹⁶¹ For instance, Martin Hellwig: *Capital Regulation after the Crisis: Business as Usual?*, Working Paper 2010/31, The Max Planck Institute for Research on Collective Goods.

of acceptance are likely to arise particularly in large countries able to support large (potentially problem) banks.

- 5.6.8 Banks are routinely provided with a number of indirect government subsidies. These include, *inter alia*: entry-limiting licensing requirements; monopoly on gathering retail deposits; access to central bank facilities; and the possibility of government assistance. Because such subsidies are designed to make the system more stable it would not be useful to eliminate them. What may prove feasible, however, is to delimit types of allowed funding and lending activities in a way that makes government assistance dependent on the type of banking license provided.¹⁶² This would limit the part of the banking system explicitly supported by the sovereign and increase ex ante the responsibility of private investors for the rest of the system. Such a separation would need some way of, additionally, severely limiting both ownership and funding links between different types of license holders. Competition issues would create pressure for international agreement on how various activities are defined and which may or may not be publicly assisted. Similar, though not identical, effects could be achieved through sufficiently divergent capital requirements for various asset classes. Nevertheless, if license groups are appropriately defined, much of the functionality of the present system could remain.
- 5.6.9 Accepting special restructuring regimes for financial enterprises would make it possible to address bad loans before the enterprise is insolvent. Introducing mandatory, collective action clauses for bank and sovereign bonds would reduce the supply of unsustainably cheap bank funding, as well as weaken any implicit demand on and credibility of sovereigns to protect bondholders. Both these features may be introduced more generally already as a result of the present crisis.
- 5.6.10 The costs to the economy of such reforms are undeniable; higher cost of credit (though mitigated by lower risk premia) and concentration of the banking business of large international enterprises to a smaller number of major international banks being the two most obvious. However, given the losses suffered through systemic banking crises over recent decades, this might be an acceptable price to pay for less systemic fragility and attendant resource misallocations. There is no free lunch and increased financial stability will always have costs. In the end, of course, the extent to which the present crisis causes a rethink on the basic model for maintaining a stable financial system will remain a very political decision with a major impact on important and influential financial institutions.

¹⁶² An example is provided in E. Avgouleas: *The Reform of the 'Too-Big-To-Fail' Bank: A New Regulatory Model for the Institutional Separation of 'Casino' from 'Utility' Banking*, School of Law, University of Manchester, Draft of 14 February 2010.

GLOSSARY

Term	Definition
The Act	Commissions of Investigation Act, 2004
The Authorities	The Financial Regulator, the Central Bank and the Department of Finance
Big Four International Auditing Firms	Ernst & Young, Deloitte, KPMG, PricewaterhouseCoopers
Covered Institutions	<p>An institution covered pursuant to the Credit Institutions (Financial Support) Scheme 2008 (S.I. No. 411 of 2008). At the date of the publication of the Report, these are:</p> <ol style="list-style-type: none"> 1. Allied Irish Banks, p.l.c. and its subsidiaries AIB Mortgage Bank, AIB Bank (CI) Limited, AIB Group (UK) p.l.c. and Allied Irish Banks North America Inc.; 2. Anglo Irish Bank Corporation p.l.c. and its subsidiary Anglo Irish Bank Corporation (International) p.l.c.; 3. The Governor and Company of the Bank of Ireland and its subsidiaries Bank of Ireland Mortgage Bank, ICS Building Society and Bank of Ireland (I.O.M.) Limited; 4. EBS Building Society and its subsidiary EBS Mortgage Finance; 5. Irish Life and Permanent p.l.c. and its subsidiary Irish Permanent (IOM) Limited; 6. Irish Nationwide Building Society and its subsidiary Irish Nationwide (I.O.M.) Limited; and 7. Postbank Ireland Limited.
Disaster Myopia	A tendency over time to underestimate the probability of low frequency shocks (i.e. “low probability / high impact risks”).
Expectation Gap	Gap between the needs of readers (particularly in situations like the recent global financial crisis) and what is delivered by the statutory audit.
Groupthink	A psychological process that reduces the likelihood of critical views being expressed or heard within institutions, due to a desire for unanimity which overrides the motivation to realistically evaluate alternative courses of action.

Herding	The willingness of investors and banks to simultaneously invest in, lend to and own the same type of assets, accompanied by insufficient information gathering and processing.
Hard Landing	A term used to describe when an economy goes directly from a period of expansion to a recession.
Soft Landing	A term used to describe the shift of economic growth from high to low, or potentially flat, while avoiding recession.
Leverage	The degree to which an investor or business is utilising borrowed money/debt to finance assets. An institution with significantly more debt than equity is considered to be highly leveraged.
Light-Touch/ Principles-Based Regulation	A non-intrusive approach to regulating financial institutions, based on the “efficient market” hypothesis
Narrow Banks	Institutions that are licensed to conduct only a limited part of basic banking business, including payments (may only have been used once)
Paper Wealth	Wealth as measured by monetary value (which may fluctuate), reflected in the price of assets at a particular time.
The Period	1 January 2003 to 15 January 2009
Securitisation	The process by which pools of individual receivables (for ex. loan assets) are packaged and distributed, via a special purpose vehicle, to investors/purchasers in the form of securities. Collateral for the securities are often the receivables themselves.
Silo Think	Acting within a narrow legal or organisational mandate with little or no concern for overall needs or developments.
True and Fair View	Compliance with applicable accounting standards and applicable laws/regulations.

Graph References

Reference Used	Usage
Annual Reports Sources	Figures used are as at 31 December of that year Except for Anglo: 30 September and Bank of Ireland: 31 March of following year
Construction & Property	Construction plus Real Estate, Renting and Other Business per the Central Bank quarterly sectoral returns
Speculative C&P	Categories F1SPEC and K11SPC of the Central Bank quarterly sectoral returns
Other C&P	Construction plus Real Estate Lending per the Central Bank quarterly sectoral returns less Speculative C&P above
Residential Mortgages	Residential Mortgages include securitised amounts

Appendix 1 – The Commission of Investigation Act, 2004



Number 23 of 2004

COMMISSIONS OF INVESTIGATION ACT 2004

ARRANGEMENT OF SECTIONS

PART 1

PRELIMINARY MATTERS

Section

1. Short title.
2. Interpretation.

PART 2

ESTABLISHMENT, MEMBERSHIP AND INDEPENDENCE OF COMMISSIONS

3. Establishment of commissions.
4. How terms of reference are to be set.
5. Content of terms of reference and accompanying statement.
6. Amendment of terms of reference and accompanying statement.
7. Membership.
8. Advice and assistance.
9. Independence.

PART 3

INVESTIGATIONS AND RELATED MATTERS

10. Conduct of investigations.
11. In general evidence to be given in private.
12. Duty to disclose substance of evidence to other witnesses, etc., and to give them a chance to comment.

Section

34. Draft reports to be sent to certain persons.
35. Amendment of draft reports for reasons relating to failure to observe fair procedures.
36. Amendment of draft reports to preserve confidentiality of sensitive commercial information.
37. Confidentiality of draft reports.
38. Publication of final and interim reports.
39. Restriction of Data Protection Act 1988.
40. Restriction of Freedom of Information Acts 1997 to 2003.
41. Availability of records for inspection by public under National Archives Act 1986.

PART 6

MISCELLANEOUS MATTERS

42. Privilege of members and persons appointed under *section 8*.
 43. Dissolution of commissions.
 44. If a tribunal of inquiry is established.
 45. Commissions' evidence and documents to be available to tribunals.
 46. Protection of identifying information by tribunals.
 47. Proceedings in the High Court.
 48. Offences by bodies corporate.
 49. Prosecutions.
 50. Penalties for offences.
 51. Expenses.
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[No. 23.]

*Commissions of Investigation
Act 2004.*

[2004.]

ACTS REFERRED TO

Data Protection Act 1988	1988, No. 25
Freedom of Information Acts 1997 to 2003	
National Archives Act 1986	1986, No. 11
Petty Sessions (Ireland) Act 1851	14 & 15 Vict., c. 50
Tribunals of Inquiry (Evidence) Acts 1921 to 2004	



Number 23 of 2004

COMMISSIONS OF INVESTIGATIONS ACT 2004

AN ACT TO PROVIDE FOR THE ESTABLISHMENT OF COMMISSIONS FROM TIME TO TIME TO INVESTIGATE INTO AND REPORT ON MATTERS CONSIDERED TO BE OF SIGNIFICANT PUBLIC CONCERN, TO PROVIDE FOR THE POWERS OF SUCH COMMISSIONS AND TO MAKE PROVISION FOR RELATED MATTERS.

[18th July 2004]

BE IT ENACTED BY THE OIREACHTAS AS FOLLOWS:

PART 1

PRELIMINARY MATTERS

1.—This Act may be cited as the Commissions of Investigation Act 2004. Short title.

2.—(1) In this Act, except where the context otherwise requires— Interpretation.

“authorised person” has the meaning given by *section 26*;

“chairperson”, in relation to a commission, means the person appointed under *section 7(5)* as the chairperson of the commission;

“commission” means a commission of investigation established under this Act;

“Court” means the High Court;

“document” includes any book, record or other written or printed material in any form, including any information stored, maintained or preserved by means of any mechanical or electronic device, whether or not stored, maintained or preserved in a legible form;

“evidence” includes any expression, orally, in writing or otherwise, of an opinion, belief or intention;

“investigation” means an investigation conducted by a commission in accordance with its terms of reference under this Act;

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Act 2004.

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“legal costs” means fees, disbursements, charges and expenses included in a bill of costs in respect of a barrister or solicitor;

“legal representative” means a barrister or solicitor;

“premises” includes any building, dwelling, temporary construction, vehicle, ship or aircraft;

“specified Minister”, in relation to a commission, means the Minister specified under *section 3(3)(b)* in the order establishing the commission;

“tribunal” means a tribunal to which the Tribunals of Inquiry (Evidence) Acts 1921 to 2004 apply.

(2) For the purposes of this Act, a document in the power of a body corporate or an unincorporated body of any kind is considered, in the absence of evidence to the contrary, to be also in the power of any individual who, because of his or her functions or position within the body corporate or the unincorporated body, as the case may be, can reasonably be expected to have control over the document.

(3) In this Act—

- (a) a reference to a section is to a section of this Act, unless it is indicated that reference to some other enactment is intended,
- (b) a reference to a subsection or paragraph is to the subsection or paragraph of the provision in which the reference occurs, unless it is indicated that reference to some other provision is intended, and
- (c) a reference to any other enactment is to that enactment as amended by or under any other enactment, including this Act, unless the context otherwise requires.

PART 2

ESTABLISHMENT, MEMBERSHIP AND INDEPENDENCE OF COMMISSIONS

Establishment of
commissions.

3.—(1) Following a proposal made by a Minister with the approval of the Minister for Finance, the Government may, by order, establish a commission to—

- (a) investigate any matter considered by the Government to be of significant public concern, and
- (b) make any reports required under this Act in relation to its investigation.

(2) An order may be made under this section only if—

- (a) a draft of the proposed order and a statement of the reasons for establishing the commission have been laid before the Houses of the Oireachtas, and
- (b) a resolution approving the draft has been passed by each House.

(3) The order establishing a commission shall specify—

- (a) the matter that is considered by the Government to be of significant public concern and that is to be investigated by the commission, and
- (b) the Minister responsible for overseeing administrative matters relating to the establishment of the commission, for receiving its reports and for performing any other functions given to him or her under this Act.

(4) A commission may be established under this section even if the matter considered by the Government to be of significant public concern arose before the passing of this Act.

4.—(1) The order establishing a commission may authorise the specified Minister to set the commission's terms of reference.

(2) If the order establishing a commission does not authorise the specified Minister to set its terms of reference, they may be set by the Government.

(3) Before setting a commission's terms of reference, the specified Minister or the Government, as the case may be, may consult with any persons.

5.—(1) A commission's terms of reference shall, as appropriate and to the extent possible, specify the events, activities, circumstances, systems, practices or procedures to be investigated, including—

Content of terms of reference and accompanying statement.

- (a) the dates on which or the periods during which the events occurred, the activities were undertaken, the circumstances arose or the systems, practices or procedures were in operation,
- (b) the location or area within the State where the events occurred, the activities were undertaken, the circumstances arose or the systems, practices or procedures were in operation, and
- (c) the persons to whom or which those events, activities or circumstances relate or whose activities, systems, practices or procedures are to be investigated.

with a view to ensuring that the scope of the investigation into any matter referred to the commission is described precisely.

(2) The specified Minister shall ensure—

- (a) that an accompanying statement is prepared containing—
- (i) an estimate of the costs (including legal costs) to be incurred by the commission in conducting the investigation and preparing its reports, and
 - (ii) a time frame for the submission of the commission's final report to the specified Minister, and
- (b) that, as soon as possible after the terms of reference are set, they are published with the statement in *Iris Oifigiúil* and in such newspapers or other publications as the Minister considers appropriate.

[No. 23.] *Commissions of Investigation* [2004.]
Act 2004.

Pt.2

Amendment of
terms of reference
and accompanying
statement.

6.—(1) The power to set a commission's terms of reference includes the power to amend, at any time before the submission of the commission's final report, those terms with the consent or at the request of the commission for the purpose of clarifying, limiting or extending the scope of its investigation.

(2) A commission may not consent to or request an amendment of its terms of reference if satisfied that the proposed amendment would prejudice the legal rights of any person who has co-operated with or provided information to the commission in the investigation.

(3) No consent or request is required for the amendment of a commission's terms of reference under *section 44(2)*.

(4) The requirements of *section 5(1)* apply with any necessary modifications to the amendment of a commission's terms of reference as it applies to the setting of those terms.

(5) The specified Minister shall ensure that the statement accompanying a commission's terms of reference is revised if, as a consequence of an amendment of those terms under this section or *section 44(2)*, either or both of the following contents of the statement are no longer appropriate:

(a) the estimate of the costs (including legal costs) to be incurred by the commission in conducting the investigation and preparing its reports;

(b) the time frame for the submission of the commission's final report.

(6) Even though a commission's terms of reference are not amended, the specified Minister may, at the commission's request, revise the time frame for the submission of its final report to the extent consistent with the objective of having the investigation conducted and the report submitted as expeditiously as a proper consideration of the matter referred to the commission permits.

(7) The specified Minister shall ensure that, as soon as possible after a commission's terms of reference are amended or the accompanying statement is revised or both of those things are done, the amended terms, the revised statement or both, as the case may be, are published in—

(a) *Iris Oifigiúil*, and

(b) each newspaper or other publication in which the original terms were published under *section 5(2)(b)*.

Membership.

7.—(1) A commission may consist of one or more than one member.

(2) Each member of a commission is to be appointed as follows:

(a) by the specified Minister, if authorised to do so by the order establishing the commission;

(b) by the Government, in any other case.

(3) Appointments may be made to a commission at any time, including during the course of its investigation.

(4) Before appointing a person to be a member of a commission, the appointing authority (the specified Minister or the Government) shall be satisfied that, having regard to the subject matter of the investigation, the person has the appropriate experience, qualifications, training or expertise. Pt.2 S.7

(5) Where more than one member is appointed to a commission, the appointing authority shall designate one of the members as the chairperson.

(6) If a commission consists of more than one member—

(a) a decision of a majority of its members on any matter is the commission's decision, and

(b) in the case of an equal division among the members as to a decision to be made, the chairperson's decision on the matter is the commission's decision.

(7) If the chairperson is for any reason unable to continue to act as chairperson, the appointing authority may designate another member of the commission as chairperson.

(8) An appointment under *subsection (3)* or a designation under *subsection (7)* made during the course of an investigation by a commission does not affect decisions made or actions taken by the commission before the appointment or designation.

(9) A member of a commission who is unable to act as a member, whether temporarily or for the remainder of the investigation, is while unable to act deemed not to be a member of the commission.

(10) A commission may act or continue to act despite one or more than one vacancy among its members if satisfied that the legal rights of any person affected by its investigation would not be unduly prejudiced by doing so.

8.—(1) The chairperson of a commission or, if the commission consists of only one member, the sole member may, with the approval of the specified Minister given with the consent of the Minister for Finance— Advice and assistance.

(a) appoint persons with relevant qualifications and experience (including barristers and solicitors) to advise or assist the commission in relation to any matter within its terms of reference, and

(b) determine the terms and conditions of their appointment.

(2) The specified Minister may direct that a competitive tendering process be used in selecting persons with relevant qualifications and experience (including barristers and solicitors) for appointment under *subsection (1)*.

(3) The specified Minister may prepare guidelines that are to be followed if a direction is given to use a competitive tendering process.

(4) Before directing that a competitive tendering process be used, the specified Minister shall consult with the chairperson of the commission concerned or, if the commission consists of only one member, with the sole member.

PT.2 S.8

(5) In considering whether to direct that a competitive tendering process be used, the specified Minister may have regard to—

- (a) the subject matter of investigation,
- (b) the time frame for the submission of the commission's final report to the specified Minister,
- (c) the qualifications and experience required for appointment,
- (d) the functions to be performed by the persons,
- (e) the likely costs of the performance of those functions, and
- (f) any other relevant factor.

(6) Subject to *subsection (8)*, the chairperson of a commission or, if the commission consists of only one member, the sole member may specify the functions to be performed by persons appointed under this section.

(7) The functions specified under *subsection* (6) may include—

- (a) interviewing persons for the purpose of assessing the relevance or evidential value of information or documents they wish to provide to the commission,
- (b) interviewing persons as to the evidence they propose to give to the commission,
- (c) recording, in writing or otherwise, statements given and answers made by persons while being interviewed,
- (d) reporting to the commission on the results of those interviews,
- (e) requesting persons to provide the commission with written statements concerning any matter relevant for the purposes of the investigation and examining statements provided in response to the requests, and
- (f) providing the commission with any other advice or assistance required in relation to the investigation or the preparation of its reports.

(8) A person appointed under this section may not administer oaths or take affirmations, but, if authorised by the commission to do so, may request a person interviewed as described in *subsection* (7) by him or her to sign a record of a statement made or answer given by that person during the interview.

(9) When requesting that a record of a statement or answer be signed under *subsection (8)*, a person appointed under this section shall inform the person to whom the request is made of the commission's powers—

- (a) under *section 16(1)(h)* to give a direction in relation to the statement or answer, and
- (b) under *section 17* to direct payment of costs for failure to comply with a direction under *section 16(1)(h)*.

9.—A commission shall be independent in the performance of its functions.

Pt.2
Independence.

PART 3

INVESTIGATIONS AND RELATED MATTERS

10.—(1) A commission may, subject to this Act and the commission's rules and procedures, conduct its investigation in the manner that it considers appropriate in the circumstances of the case.

Conduct of
investigations.

(2) In conducting an investigation, a commission shall, to the greatest possible extent consistent with its duties under this Act—

(a) seek the voluntary co-operation of persons whose evidence is desired by the commission in relation to any matter within its terms of reference, and

(b) facilitate such co-operation.

(3) *Subsection (2)* is not to be taken to limit in any way the powers given by *sections 16, 17 and 28* to a commission or a member of a commission.

(4) A commission shall conduct its investigation as expeditiously as a proper consideration of the matter referred to the commission permits.

11.—(1) A commission shall conduct its investigation in private unless—

In general evidence
to be given in
private.

(a) a witness requests that all or part of his or her evidence be heard in public and the commission grants the request, or

(b) the commission is satisfied that it is desirable in the interests of both the investigation and fair procedures to hear all or part of the evidence of a witness in public.

(2) Where the evidence of a witness is heard in private—

(a) the commission may give directions as to the persons who may be present while the evidence is heard,

(b) legal representatives of persons other than the witness may be present only if the commission—

(i) is satisfied that their presence would be in keeping with the purposes of the investigation and would be in the interests of fair procedures, and

(ii) directs that they be allowed to be present,

(c) the witness may be cross examined by or on behalf of any person only if the commission so directs, and

(d) any member of the commission or a person who has been appointed under *section 8* and is authorised by the commission to do so may, orally or by written interrogatories, examine the witness on his or her evidence.

[No. 23.] *Commissions of Investigation* [2004.]
Act 2004.

Pt.3 S.11

(3) A person (including a member of the commission) shall not disclose or publish any evidence given or the contents of any document produced by a witness while giving evidence in private, except—

- (a) as directed by a court,
- (b) to the extent necessary for the purposes of *section 12*,
- (c) to the extent otherwise necessary in the interests of fair procedures and then only with the written consent of the chairperson or, if the commission consists of only one member, the sole member, or
- (d) to a tribunal in accordance with *section 45*.

(4) *Subsection (3)* is not to be taken to prohibit the publication in a report under this Act of any facts established by a commission on the basis of evidence received in private.

(5) A person who contravenes *subsection (3)* is guilty of an offence.

Duty to disclose substance of evidence to other witnesses, etc., and to give them a chance to comment.

12.—(1) Subject to *subsection (2)*, a commission shall disclose to a person—

- (a) who is directed to attend as a witness before the commission,
- (b) who attends voluntarily to give evidence to the commission, or
- (c) about whom evidence is given to the commission,

the substance of any evidence in its possession that, in its opinion, the person should be aware of for the purposes of the evidence that person may give or has given to the commission.

(2) *Subsection (1)* does not require the disclosure of the source of any evidence given or document produced by a witness while giving evidence in private under *section 11*, unless the commission considers that, in view of the purposes of the investigation or in the interests of fair procedures, the source should be disclosed.

(3) A commission shall give a person to whom it discloses the substance of evidence under *subsection (1)* an opportunity to comment by written or oral submissions on the evidence.

Duty to inform witnesses of commissions' powers and to advise them of their own rights and obligations.

13.—(1) Before a person gives evidence to a commission, whether voluntarily or on being directed by it to do so, the commission shall give the person a written statement—

- (a) specifying the commission's powers under *sections 16, 17 and 28*, and
- (b) indicating that, if the person does not voluntarily co-operate with the commission or withdraws co-operation, the commission will exercise any of those powers as it considers necessary.

(2) If no legal representative is present to advise a witness, the commission shall advise the witness of his or her legal rights and obligations while giving evidence on oath or affirmation. Pt.3 S.13

(3) The duties imposed on a commission under this section may be performed by any member of the commission or by any person appointed under *section 8* and authorised by the commission to perform those duties.

14.—(1) Subject to *subsection (4)*, a commission may receive evidence given— Form and manner in which evidence may be given.

(a) orally before the commission,

(b) by affidavit, or

(c) as otherwise directed by the commission or allowed by its rules and procedures, including by means of a live video link, a video recording, a sound recording or any other mode of transmission.

(2) A witness who attends before a commission to give evidence may be required to give evidence on oath or affirmation.

(3) Any member of a commission may administer any oaths or take any affirmations necessary for the purposes of an investigation.

(4) A witness who gives evidence otherwise than by attending in person before the commission or by means of a live video link shall provide the commission with a sworn statement in a form acceptable to it indicating that—

(a) the evidence was given by him or her,

(b) the evidence was given voluntarily, and

(c) to the best of his or her knowledge, the content is true and accurate.

(5) A commission that has received evidence from a witness who is required to provide a sworn statement under *subsection (4)* or who is the subject of a direction under *section 16(1)(h)* may request additional information from the witness relating to that evidence.

(6) Subject to *subsection (8)*, a witness shall, within the period specified in the request, comply with a request made to him or her under *subsection (5)*.

(7) The requirements of *subsection (4)* relating to the provision of a sworn statement apply also to any evidence given in response to a request under *subsection (5)*.

(8) A witness who claims to be entitled under any rule of law or enactment to refuse to disclose information requested under *subsection (5)* shall, for the purposes of *section 21* and within the period specified in the request, provide the commission with a written statement specifying the grounds for the claim, including the privilege or the duty of confidentiality relied on.

[No. 23.] *Commissions of Investigation* [2004.]
Act 2004.

Pt.3

Powers to establish
rules and
procedures relating
to evidence and
submissions.

15.—(1) A commission may, having regard to *sections 11 to 14* and in particular the need to observe fair procedures, establish or adopt rules and procedures for—

- (a) receiving and recording evidence, and
- (b) receiving submissions.

(2) The rules and procedures of a commission may, among other things, specify—

- (a) the form in which and the means by which evidence or submissions may be received by it, and
- (b) the conditions subject to which evidence or submissions may be received by it by means of a live video link, a video recording, a sound recording or any other mode of transmission.

(3) Where a commission consists of more than one member, its rules and procedures may, among other things, provide that evidence may be given before a single member or before more than one but fewer than all the members.

(4) Evidence given under a provision of a commission's rules and procedures authorised by *subsection (3)* is considered to have been given to all the members of the commission.

(5) A commission shall make copies of its rules and procedures available to persons likely to be affected by them.

Powers relating to
witnesses and
documents.

16.—(1) For the purposes of an investigation, a commission may do any or all of the following:

- (a) direct in writing any person to attend before the commission on a date and at a place and time specified in the direction and there to give evidence and to produce any document that is in the person's possession or power and is specified in the direction;
- (b) direct a witness to answer questions that it believes to be relevant to a matter under investigation;
- (c) examine a witness on oath or affirmation or by use of a statutory declaration or written interrogatories;
- (d) examine or cross examine any witness to the extent the commission thinks proper in order to elicit information relevant to a matter under investigation;
- (e) direct a witness to produce to the commission any document that is in his or her possession or power and is specified in the direction;
- (f) direct in writing any person to—
 - (i) provide the commission with a list, verified by affidavit, disclosing all documents in the person's possession or power relating to a matter under investigation, and

(ii) specify in the affidavit any of the listed documents that the person objects to producing to the commission and the basis for the objection; Pr.3 S.16

(g) direct in writing any person to send to the commission any document that is in the person's possession or power and is specified in the direction;

(h) direct a person who made a statement or answered a question while being interviewed by a person appointed under *section 8* to provide the commission with a sworn statement in a form acceptable to it confirming, if such is the case—

(i) that the statement was made or the answer given by him or her voluntarily, and

(ii) that to the best of his or her knowledge the content is true and accurate;

(i) give any other directions that appear to the commission to be reasonable.

(2) The powers of a commission under *subsection (1)* may be exercised by any member authorised in accordance with *section 15(3)* by the commission's rules and procedures to receive evidence on its behalf, and for that purpose a reference in *subsection (1), (3), (6), (8) or (9)* of this section to "a commission" or "the commission" is to be read as a reference to the authorised member.

(3) A person who attends, whether voluntarily or otherwise, before a commission is entitled to be paid by the specified Minister such amount in respect of the expenses of his or her attendance as is determined in accordance with guidelines prepared by that Minister with the consent of the Minister for Finance and after consulting with the commission.

(4) The rules of court relating to the discovery of documents in proceedings in the Court apply with any necessary modifications in relation to the disclosure of documents under *subsection (1)(f)*.

(5) Where a statement made or an answer given to a person appointed under *section 8* is confirmed in accordance with a direction under *subsection (1)(h)* of this section, the statement or answer is considered to have been received as evidence by the commission.

(6) Where a person does not comply with a direction given by a commission under this section, the Court may, on application by the chairperson or, if the commission consists of only one member, by the sole member—

(a) order the person to comply with the direction, and

(b) make any other order the Court considers necessary and just to enable the direction to have full effect.

(7) If a person against whom an order is made under *subsection (6)(a)* fails to comply with the direction specified in the order, the Court may deal with the matter as if it were a contempt of the Court.

(8) A person who, without reasonable excuse, fails to comply with a direction under *subsection (1)(a)* to attend before a commission is guilty of an offence.

[No. 23.] *Commissions of Investigation* [2004.]
Act 2004.

PT.3 S.16

(9) The failure of a person to comply with a direction under *subsection (1)(a)*—

(a) may be punished as a contempt even though it could be punished as an offence, and

(b) may be punished as an offence even though it could be punished as a contempt,

but the person is not liable to be punished twice.

(10) In *subsection (3)* “expenses” does not include any legal costs.

Power to direct
certain persons to
pay costs.

17.—(1) If as a result of a person—

(a) failing, without reasonable excuse, to comply with a direction under *section 16*,

(b) failing, without reasonable excuse, to comply with a request under *section 14(5)* or *21(5)*, or

(c) otherwise obstructing an investigation,

a commission incurs costs that it would not otherwise have incurred, it may, in writing, direct the person to pay to the Minister for Finance those costs, including legal costs as taxed by a Taxing Master of the Court and costs arising from any delay in completing the investigation.

(2) If any person who attends before or gives evidence to a commission is adversely affected as a result of an act or omission described in any paragraph of *subsection (1)*, the commission may—

(a) on its own initiative, or

(b) at the request of the person adversely affected,

direct the person whose act or omission had that result to pay to the person adversely affected all or part of any costs (including legal costs as taxed by a Taxing Master of the Court) that he or she incurred as a result of the act or omission.

(3) A direction of a commission to pay costs under *subsection (1)* or (2) does not take effect until it is confirmed by the Court on application by the chairperson of the commission or, if a commission consists of only one member, by the sole member.

(4) On application under *subsection (3)* for an order confirming a direction of the commission to pay costs to the Minister for Finance or another person, the Court may—

(a) make an order confirming the direction with or without modification, or

(b) refuse to make such an order.

(5) Subject to *subsection (3)*, any sum payable pursuant to a direction under this section may be recovered as a simple contract debt in any court of competent jurisdiction.

(6) A person may be directed to pay costs under this section even though the act or omission that resulted in the direction is punishable

as contempt or as an offence against a provision of this Act, and the direction does not prevent the person being punished for contempt or the bringing of proceedings in respect of the offence. Pt.3 S.17

18.—Any person who, while giving evidence pursuant to this Act, makes a statement material in the investigation concerned that the person knows to be false or does not believe to be true is guilty of an offence. Offence of making false statement.

19.—(1) None of the following is admissible as evidence against a person in any criminal or other proceedings, except proceedings in relation to an offence against *section 18*: Evidence given to commissions not admissible in certain proceedings.

- (a) a statement or admission made by the person to a commission or to a person appointed under *section 8*;
- (b) a document given or sent to a commission pursuant to a direction or request of the commission to the person;
- (c) a document specified in an affidavit of documents made by the person and given to a commission pursuant to a direction or request of the commission.

(2) *Subsection (1)* is not to be taken to limit in any way the application of *section 45(3)* to evidence received by a commission and made available to a tribunal under *section 45(1)*.

20.—A person who gives evidence to a commission or who produces or sends documents to a commission as directed by the commission— Privileges and immunities of witnesses.

- (a) has the same immunities and privileges in respect of that evidence or those documents, and
- (b) is, in addition to the penalties provided by this Act, subject to the same liabilities,

as a witness in proceedings in the Court.

21.—(1) Subject to *subsection (4)*, nothing in this Act compels— Determinations on privilege.

- (a) the disclosure by any person of any information that the person would be entitled under any rule of law or enactment to refuse to disclose on the grounds of any privilege or any duty of confidentiality, or
- (b) the production of any document in the person's possession or power containing such information.

(2) Where a person claims to be entitled under any rule of law or enactment to refuse, on the grounds of any privilege or any duty of confidentiality—

- (a) to disclose any information required in the course of an investigation by a commission (including information required in response to a request made under *section 14(5)* or to a question put under *section 16* and information in a statement or answer that is the subject to a direction under *section 16(1)(h)*), or

PT.3 S.21

(b) to produce any document in the person's possession or power that the person is directed under this Act to produce,

the commission may, subject to *subsection (4)* of this section, determine whether the privilege or the duty of confidentiality applies to that information or document.

(3) Where the commission determines that the privilege or the duty of confidentiality relied on by a person as grounds for refusing to disclose information referred to in *subsection (2)(a)* does not apply to the information, the person shall disclose that information to the commission unless the determination is overturned under *section 22*.

(4) A determination may only be made under *subsection (2)(b)* in relation to a document if the commission has—

(a) examined the document, and

(b) considered a written statement provided by the person concerned specifying the grounds for the claim, including the privilege or duty of confidentiality relied on.

(5) For the purposes of *subsection (4)*, the person concerned shall, at the commission's request—

(a) submit the document to the commission within the period specified in the request, and

(b) unless exempted under *subsection (6)*, provide the commission, within that period, with the written statement referred to in *subsection (4)(b)*.

(6) A person who has already provided the commission with an affidavit under *section 16(1)(f)* specifying the basis for objecting to the production of a document need not provide a written statement under *subsection (5)(b)* of this section concerning the same document.

(7) If a person does not, within the specified period, comply with a request of a commission to submit a document for a determination under this section or to provide a written statement under *subsection (5)(b)*—

(a) the chairperson of the commission or, if the commission consists of only one member, the sole member may apply to the Court for an order directing the person to comply with the request, and

(b) on the hearing of the application, the Court may make or refuse to make the order.

(8) Where the commission determines that the privilege or the duty of confidentiality relied on as grounds for refusing to produce a document applies to any of the information in the document, the document is not considered to be evidence received by the commission, except to the extent authorised under *subsection (10)*.

(9) Where the commission determines that the privilege or duty of confidentiality relied on as grounds for refusing to produce a document applies to any of the information in the document, the commission may cause to be prepared a summary version of the document that excludes that information, but only if—

(a) the document so allows, and Pt.3 S.21

(b) in the commission's opinion, it is in the interests of both the investigation and fair procedures to do so.

(10) Where a commission causes a summary version of a document to be prepared in accordance with this section, the summary version forms part of the evidence received by the commission.

(11) Where the commission determines that the privilege or the duty of confidentiality relied on as grounds for refusing to produce a document does not apply to any of the information in the document, the document is considered for the purposes of this Act to have been received as evidence by the commission unless the determination is overturned under *section 22*.

22.—(1) A person whose refusal to disclose information or to produce a document is the subject of a determination by a commission under *section 21(2)* may appeal to the Court against that determination. Right of appeal to High Court against determinations on privilege.

(2) The appeal must be brought within 14 days after the person concerned was notified by the commission of the determination.

(3) On the hearing of the appeal, the Court may make any order or give any direction it thinks fit, including an order—

(a) confirming the determination under appeal, or

(b) modifying or overturning that determination.

23.—(1) With the consent of the Minister for Finance and after consulting with the commission concerned, the specified Minister shall prepare general guidelines concerning the payment by the specified Minister to witnesses of legal costs necessarily incurred by them in connection with an investigation. Guidelines concerning recovery of legal costs necessarily incurred by witnesses.

(2) For the purposes of this section and *section 24*, legal costs are necessarily incurred by a witness in connection with an investigation by a commission if—

(a) the good name or conduct of the witness is called into question by any evidence received by the commission, or

(b) other personal or property rights of the witness are at risk of being jeopardized as a result of any evidence received by the commission.

(3) The guidelines may—

(a) restrict the types of legal services or fees for which payment may be made, and

(b) otherwise limit (including by specifying maximum amounts) the extent to which legal costs may be paid.

(4) Before evidence is given to a commission, the commission shall give the witness a copy of the guidelines prepared by the specified Minister.

Pt.3

Request for
recovery of legal
costs necessarily
incurred and certain
other expenses.

24.—(1) Where a witness requests a commission to direct that all or part of the legal costs necessarily incurred by the witness in connection with its investigation be paid by the specified Minister, the commission may—

(a) if satisfied as to the matters specified in *subsection (2)* of this section and that the payment comes within the guidelines prepared under *section 23*, direct that such amount of those costs as it considers reasonable be paid to the witness, or

(b) if not so satisfied, refuse to give such direction.

(2) Before a direction is given under *subsection (1)*, the commission is to be satisfied that—

(a) the legal costs were necessarily incurred, and

(b) the level and amount of those costs are reasonable.

(3) For the purpose of satisfying itself as to the matters specified in *subsection (2)*, the commission shall consider all relevant factors, including—

(a) the nature, complexity and extent of the evidence given to the commission by the witness,

(b) the nature, complexity and volume of any documents or list of documents provided by the witness to the commission,

(c) whether evidence given by or relating to the witness was given in private or in public,

(d) whether the witness was cross examined by or on behalf of other persons,

(e) whether there has been any improper failure by the witness to co-operate with the commission in its investigation and, if so, the degree of failure, and

(f) any potential consequences for the witness arising from the publication of the commission's report.

(4) After considering all relevant factors, the commission may direct that a witness be paid less than the maximum amount provided for in the guidelines prepared under *section 23* in respect of any legal costs necessarily incurred by the witness.

(5) If a witness who has incurred heavy expenses (other than legal costs) because of—

(a) the nature, volume or location of the documents produced by the witness,

(b) the location outside the State from which the witness travelled to attend before the commission, or

(c) any other factor not within the control of the witness,

requests payment of all or part of those expenses, the commission may, on being satisfied that they were necessary in the circumstances, direct that such amount of the expenses as it considers reasonable be paid by the specified Minister.

(6) On receiving a direction under this section, the specified Minister may request the commission to review the direction if he or she considers that the amount specified in it is excessive having regard to— Pt.3 S.24

(a) in the case of a request for payment of legal costs necessarily incurred, the guidelines prepared under *section 23* and relevant factors referred to in *subsection (3)* of this section, and

(b) in the case of a request for payment of expenses incurred as described in *subsection (5)*, the ability of the witness who made the request to pay those expenses.

(7) On receiving a request to review a direction under this section, a commission may—

(a) reduce the amount specified in the direction, or

(b) confirm that amount.

(8) The specified Minister shall, in accordance with a direction of a commission, pay to a witness requesting payment of legal costs or other expenses—

(a) the amount specified in the direction, or

(b) if that amount is reduced under *subsection (7)*, the reduced amount.

25.—A written direction of a commission must be signed by— Signing of written directions.

(a) the chairperson or a member designated by the chairperson, or

(b) if the commission consists of only one member, by the sole member.

PART 4

OTHER POWERS RELATING TO INVESTIGATIONS

26.—(1) In relation to a commission, the following are authorised persons for the purposes of this Part: Persons authorised to exercise powers of entry, inspection, etc.

(a) any member of the commission;

(b) any person appointed under *section 8* and authorised by the commission in writing to exercise the powers given under *section 28* to authorised persons.

(2) Persons appointed under *section 8* may be authorised by a commission to exercise the powers given by this section in respect of a specified matter or event or generally for the purposes of the investigation.

(3) The commission shall provide each authorised person with a warrant identifying the person and indicating that he or she has authority to exercise the powers given under *section 28*.

[No. 23.] *Commissions of Investigation* [2004.]
Act 2004.

Pt.4 S.26

(4) When exercising powers under *section 28*, an authorised person shall, if requested by anyone affected, produce the warrant for inspection.

Governing principle
for exercise of
powers of entry,
inspection, etc.

27.—The powers given under *section 28* to authorised persons may be exercised only—

- (a) at the direction of a commission, and
- (b) if it considers that the exercise of those powers is reasonable and necessary for the purposes of its investigation.

Powers of entry,
inspection, etc.

28.—(1) Subject to *section 27*, any authorised person may do any or all of the following:

- (a) enter at any reasonable time any premises in which the authorised person has reasonable grounds to believe there are any documents, or there is information in any form, relating to any matter within the commission's terms of reference;
- (b) inspect any documents, or information in any form, on the premises;
- (c) secure for later inspection any documents, any information in any form and any equipment in which those documents or that information may be held, if the authorised person has reason to believe that the documents or information may be relevant to the investigation;
- (d) secure for later inspection the premises, or any part of the premises, but only if the authorised person considers it necessary to do so in order to preserve for inspection documents or information in any form that he or she has reason to believe may be kept there and may relate to the investigation;
- (e) take copies of or extracts from any documents or any electronic information system on the premises, including in the case of information in a non-legible form, copies of or extracts from such information in a permanent legible form;
- (f) remove for later examination or copying any documents, or information in any form, that the authorised person has reason to believe may relate to a matter under investigation and retain them for the period that he or she considers reasonable;
- (g) direct any person on the premises to produce to the authorised person any documents, or information in any form, kept on the premises;
- (h) direct any person on the premises having charge of, or otherwise concerned with the operation of, data equipment or any associated apparatus or material to provide the authorised person with all reasonable assistance in relation to the equipment, apparatus or material;
- (i) direct any person on the premises to give to the authorised person any information that the authorised person may

reasonably require with regard to a matter under investigation. Pt.4 S.28

(2) Despite *subsection (1)*, an authorised person may not enter a private dwelling or the part of any premises that is used as a private dwelling, except—

- (a) with the consent of the occupier, or
- (b) under the authority of a warrant issued under *section 29* by a judge of the District Court.

(3) When exercising powers under this section, an authorised person may be accompanied by a member of the Garda Síochána.

(4) The production of a document in compliance with a direction under this section does not prejudice a person's lien on the document.

29.—(1) If satisfied on the sworn information of an authorised person that there are reasonable grounds for suspecting that in any private dwelling or on any premises part of which is used as a private dwelling there are any documents, or there is information in any form, relating to a matter within a commission's terms of reference and required by the commission for the purposes of its investigation, a judge of the District Court may issue a warrant authorising a named authorised person to enter, on production of the warrant, the private dwelling or the part of those premises used as such a dwelling, at any time or times within one month after the date of issue of the warrant, for the purpose of exercising there the powers given by *section 28*.

Power of District Court to issue warrant authorising entry.

(2) The warrant issued by a judge of the District Court may also permit—

- (a) the named authorised person to be accompanied during the entry and inspection of the private dwelling or the part of the premises used as such a dwelling by such other authorised persons and members of the Garda Síochána as the named authorised person thinks necessary, and
- (b) the use of such reasonable force as is necessary for the purposes of entry.

30.—A person is guilty of an offence if the person—

Offence of obstructing, etc., authorised persons.

- (a) intentionally obstructs an authorised person in the exercise of any of his or her powers under this Part,
- (b) fails, without reasonable excuse, to comply with a direction given by an authorised person in the exercise of those powers, or
- (c) in purporting to give information required by an authorised person in the exercise of those powers—
 - (i) makes a statement knowing it to be false or misleading in a material particular, or
 - (ii) intentionally fails to disclose any material particular.

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Preservation of documents.

31.—(1) A person who has in the person's possession or power a document, or information in any form, relating to any matter within a commission's terms of reference shall preserve that document or information—

(a) until the commission is dissolved under *section 43(1)*, or

(b) if the commission is dissolved under *section 44(1)*, until the tribunal established to inquire into the matter that was within the commission's terms of reference has completed its inquiry.

(2) A person who contravenes *subsection (1)* is guilty of an offence.

PART 5

REPORTS AND RECORDS OF COMMISSIONS

Preparation and content of final reports.

32.—(1) On the conclusion of its investigation, a commission shall prepare a written report, based on the evidence received by it, setting out the facts it established in relation to the matters referred to it for investigation.

(2) If for any reason (including insufficient, conflicting or inconsistent evidence) a commission considers that the facts relating to a particular issue have not been established, the commission in its report—

(a) shall identify the issue, and

(b) may indicate its opinion as to the quality and weight of any evidence relating to the issue.

(3) A commission may omit from its report any information that identifies or that could reasonably be expected to lead to the identification of a person who gave evidence to the commission or any other person, if in its opinion—

(a) the context in which the person was identified has not been clearly established,

(b) disclosure of the information might prejudice any criminal proceedings that are pending or in progress,

(c) disclosure of the information would not be in the interests of the investigation or any subsequent inquiry, or

(d) it would not be in the person's interests to have his or her identity made public and the omission of the information would not be contrary to the interests of the investigation or any subsequent inquiry.

(4) The commission shall endeavour to submit the report to the specified Minister within the time frame specified under *section 5(2)*.

Interim reports.

33.—(1) If requested by the specified Minister, a commission shall make interim reports to him or her at the intervals stated in the request.

(2) The specified Minister may request an interim report on the general progress of a commission's investigation or on a particular aspect of the investigation.

(3) If a commission requests that the time frame for submitting its final report be revised under *section 6(6)*, the commission shall submit an interim report to the specified Minister with the request. Pt.5 S.33

(4) *Section 32(2)* and (3) applies also in respect of an interim report.

34.—(1) Before submitting the final or an interim report to the specified Minister, a commission shall send a draft of the report, or the relevant part of the draft report, to any person who is identified in or identifiable from the draft report. Draft reports to be sent to certain persons.

(2) The draft report must be accompanied by a notice from the commission specifying the time allowed for making—

(a) submissions or requests to the commission under *section 35(1)(a)* or *36(1)*, and

(b) applications to the Court under *section 35(1)(b)*.

(3) For the purposes of this section and *section 35*, a person is identifiable from a draft report if the report contains information that could reasonably be expected to lead to the person's identification.

35.—(1) A person who receives a draft report or part of a draft report from a commission under *section 34* and who believes that the commission has not observed fair procedures in relation to the person may, within the period specified by the commission— Amendment of draft reports for reasons relating to failure to observe fair procedures.

(a) submit to the commission a written statement setting out the reasons for the belief and requesting the commission to review the draft in light of the statement, or

(b) apply to the Court for an order directing that the draft be amended before the submission of the report to the specified Minister.

(2) After considering a statement submitted under *subsection (1)(a)* and reviewing the draft report, the commission may—

(a) amend the report, including by omitting any part of the report based on evidence received without observing fair procedures,

(b) apply to the Court for directions, or

(c) submit the report to the specified Minister without making any amendments.

(3) After hearing an application under *subsection (1)(b)* or *(2)(b)*, the Court may make any order or give any directions it thinks fit, including a direction to the commission to do one or more of the following:

(a) submit the draft report to the specified Minister without making any amendments;

(b) give a person specified by the Court an opportunity to give any evidence or make any submission that it considers

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Act 2004.

Pt.5 S.35

should, in the interests of fair procedures, be received by the commission before the draft report is finalised;

- (c) submit the draft report to the specified Minister after making such amendments as the Court may direct.

(4) Before submitting the report to the specified Minister, the commission shall give written notice of any amendments made under this section to any person who is identified in or identifiable from the report and who is affected by the amendments.

Amendment of draft reports to preserve confidentiality of sensitive commercial information.

36.—(1) A person who receives a draft of a report or part of a draft report from a commission under *section 34* may, within a period specified by the commission, request the commission to omit from the report any information provided by the person to the commission—

- (a) that the person considers to be commercially sensitive, and
- (b) the disclosure of which is not, in the person's opinion, necessary for the purposes of the investigation.

(2) After considering the request, the commission shall review the draft report and may, if satisfied that the information is commercially sensitive and that its disclosure is not necessary for the purposes of the investigation, omit the information from the report.

(3) For the purposes of this section, information is commercially sensitive if its disclosure could reasonably be expected to—

- (a) materially prejudice the commercial or industrial interests of the person who provided that information to the commission or of a group or class of persons to which that person belongs, or
- (b) prejudice the competitive position of a person in the conduct of the person's business, profession or occupation.

Confidentiality of draft reports.

37.—(1) A person who receives a draft of a report or part of a draft report from a commission under *section 34* shall not disclose its contents or divulge in any way that the draft or part of the draft has been sent to that person, except—

- (a) with the prior written consent of the commission, or
- (b) to the extent necessary for the purposes of an application to the Court.

(2) A person who contravenes *subsection (1)* is guilty of an offence.

Publication of final and interim reports.

38.—(1) Subject to *subsection (2)*, the specified Minister—

- (a) shall cause a commission's final report to be published as soon as possible after it is submitted to him or her, and
- (b) may, at his or her discretion and following consultations with the chairperson or, if the commission consists of only one member, with the sole member, cause an interim

report to be published, unless publication would hinder or impair the commission's investigation. Pt.5 S.38

(2) If the specified Minister considers that the publication of the final report or an interim report of the commission might prejudice any criminal proceedings that are pending or in progress, he or she shall apply to the Court for directions concerning the publication of the report.

(3) Before determining an application under *subsection (2)* in respect of a report of a commission, the Court shall direct that notice be given to the following:

- (a) the Attorney General;
- (b) the Director of Public Prosecutions;
- (c) a person who is a defendant in criminal proceedings relating to an act or omission that is mentioned in the report or that is related to any matter investigated by the commission and mentioned in the report.

(4) On an application under *subsection (2)*, the Court may—

- (a) receive submissions, and evidence tendered, by or on behalf of any person mentioned in *subsection (3)*, and
- (b) hear the application in private if the Court considers it appropriate to do so.

(5) If, after hearing the application, the Court considers that the publication of the report might prejudice any criminal proceedings, it may direct that the report or a specified part of it be not published—

- (a) for a specified period, or
- (b) until the Court otherwise directs.

39.—Section 4 of the Data Protection Act 1988 does not apply to personal data provided to a commission for as long as the data is in the custody of— Restriction of Data Protection Act 1988.

- (a) the commission,
- (b) the specified Minister after being deposited with him or her under *section 43(2)*,
- (c) a tribunal of inquiry after being made available to it under *section 45*, or
- (d) a body after being transferred to it on the dissolution of a tribunal of inquiry to which the data was made available under *section 45*.

40.—(1) The Freedom of Information Acts 1997 to 2003 do not apply to a record relating to an investigation by a commission unless— Restriction of Freedom of Information Acts 1997 to 2003.

- (a) the record was created before the making of the order establishing the commission, or

[No. 23.] *Commissions of Investigation* [2004.]
Act 2004.

PT.5 S.40

(b) the record relates to the expenses of the commission or the appointment of persons under *section 7* or *8* or other matters concerning the general administration of the commission.

(2) *Subsection (1)* applies whether the record concerned is held by—

(a) the commission,

(b) the specified Minister after being deposited with him or her under *section 43(2)*,

(c) a tribunal of inquiry after being made available to it under *section 45*, or

(d) a body after being transferred to it on the dissolution of a tribunal of inquiry to which the record was made available under *section 45*.

(3) In this section, “record” has the same meaning as in the Freedom of Information Acts 1997 to 2003.

Availability of records for inspection by public under National Archives Act 1986.

41.—(1) Records of a commission that constitute Departmental records within the meaning of *section 2(2)* of the National Archives Act 1986 are, on the expiry of 30 years after the date of the commission’s dissolution, deemed to have been prescribed under *section 8(11)* of that Act as a class of records to which a certificate granted under *section 8(4)* of that Act may relate.

(2) As soon as practicable after the date on which records of a commission are deemed to have been prescribed as described in *subsection (1)*, an officer of a Department of State authorised for the purposes of *section 8(4)* of the National Archives Act 1986 shall consider whether, subject to any consent required under that section, the commission’s records should be certified under that section.

(3) *Subsections (1)* and *(2)* apply whether the records concerned have been—

(a) deposited with the specified Minister under *section 43(2)*,

(b) made available to a tribunal of inquiry under *section 45*, or

(c) transferred to a body on the dissolution of a tribunal of inquiry to which they were made available under *section 45*.

(4) Subject to this section, the National Archives Act 1986 applies to records of a commission that constitute Departmental records within the meaning of *section 2(2)* of that Act.

PART 6

MISCELLANEOUS MATTERS

Privilege of members and persons appointed under *section 8*.

42.—The following are absolutely privileged:

(a) documents of a commission (including its interim, final and draft reports), wherever published;

- (b) documents of the members of a commission relating to the commission or its functions, wherever published; Pt.6 S.42
- (c) documents of persons appointed under *section 8* relating to a commission or its functions, wherever published;
- (d) statements made in any form by members of a commission or persons appointed under *section 8* in performing their functions under this Act and such statements wherever subsequently published.

43.—(1) Subject to an order under *section 44(1)*, a commission is dissolved on the submission of its final report to the specified Minister. Dissolution of commissions.

(2) Before the dissolution of a commission, the chairperson or, if the commission consists of only one member, the sole member shall deposit with the specified Minister all evidence received by and all documents created by or for the commission.

(3) For the purposes of *subsection (2)* and *section 45* “documents created by or for the commission” includes—

- (a) records of interviews conducted by persons appointed under *section 8* by the chairperson of the commission or, if the commission consists of only one member, by the sole member,
- (b) written reports to the commission prepared by those persons, and
- (c) statements provided to the commission at the request of those persons in the performance of the function described in *section 8(7)(e)*.

44.—(1) If a tribunal is established to inquire into a matter all of which is within a commission’s terms of reference, the Government shall, by order notified in *Iris Oifigiúil*, appoint the day on which the commission is to be dissolved. If a tribunal of inquiry is established.

(2) If a tribunal is established to inquire into only part of the matter that is within a commission’s terms of reference, those terms shall be amended either by the specified Minister who set them, or by the Government, to take account of the inquiry.

45.—(1) If a tribunal is established to inquire into a matter all or part of which was within a commission’s terms of reference, all evidence received by and all documents created by or for the commission relating to the matter or that part of the matter shall, at the request of any member of the tribunal, be made available to it by— Commissions’ evidence and documents to be available to tribunals.

- (a) the specified Minister, if the commission has been dissolved, or
- (b) the commission, if not already dissolved.

(2) Nothing in this section prevents a commission whose terms of reference are amended under *section 44(2)* from retaining copies of any evidence or documents made available by it to a tribunal of inquiry.

Pt.6 S.45

(3) Evidence that is received by a commission in accordance with this Act or with its rules and procedures and that is made available to a tribunal under *subsection (1)* is deemed to have been received as evidence by the tribunal in accordance with the Tribunals of Inquiries (Evidence) Acts 1921 to 2004.

Protection of
identifying
information by
tribunals.

46.—(1) If any evidence or document made available to a tribunal under *section 45* contains information omitted under *section 32(3)* from a commission's report because it identifies a person or could reasonably be expected to lead to the identification of a person, the tribunal shall not disclose that information in the course of conducting its inquiry or in its report or otherwise, except—

(a) as authorised under this section, and

(b) then only to the extent necessary for the purposes of its inquiry.

(2) A tribunal may decide to disclose information referred to in *subsection (1)* (other than information withheld by the commission by virtue of *section 12(2)*) if the tribunal—

(a) has notified the person concerned that it proposes to disclose the information,

(b) has given that person an opportunity to comment, by written or oral submissions, on the proposal and has considered the person's comments, if any, and

(c) is satisfied that, in the interests of fair procedures and in order to facilitate the inquiry, it is appropriate to disclose the information.

(3) If a tribunal decides under *subsection (2)* to disclose information, it shall notify the person concerned of—

(a) its decision, and

(b) the person's right to apply to the Court within the period of 14 days after being notified for an order under *subsection (5)* prohibiting the disclosure.

(4) A decision to disclose information under this section does not take effect—

(a) until the expiry of the period allowed under this section for applying for an order under *subsection (5)* prohibiting the disclosure, and

(b) if an application is brought within that period, until the Court determines the application.

(5) On the hearing of an application made within the period specified in *subsection (3)*, the Court may make any order or give any direction it thinks fit, including an order prohibiting the disclosure of the information concerned.

(6) An application under this section for an order prohibiting the disclosure of information may be heard in private if the Court considers it appropriate to do so.

[2004.] *Commissions of Investigation Act 2004.* [No. 23.]

47.—(1) The Court shall give such priority as, having regard to all the circumstances, it reasonably can to the disposal of proceedings in the Court under this Act. Pt.6
Proceedings in the
High Court.

(2) The Superior Court Rules Committee may, with the concurrence of the Minister for Justice, Equality and Law Reform, make rules to facilitate the giving of effect to *subsection (1)*.

48.—(1) Where a body corporate commits an offence against a provision of this Act, each person who was an officer of the body corporate when the offence was committed is guilty of an offence against this section if it is proved that he or she— Offences by bodies
corporate.

(a) willingly participated in, connived at or consented to the commission of the offence by the body corporate, or

(b) knowing that the body corporate was committing or about to commit that offence, failed to take all reasonably practicable steps to prevent its commission.

(2) A person may be proceeded against for an offence against this section whether or not the body corporate has been proceeded against or been convicted of the offence committed by that body.

(3) A person guilty of an offence against this section is liable to a fine not exceeding the fine for which the body corporate is liable for the offence.

(4) In this section “officer”, in relation to a body corporate, means a director, manager, executive officer, secretary or other person concerned in the management of the body corporate.

49.—(1) A prosecution for an offence against this Act may be brought only by or with the consent of the Director of Public Prosecutions. Prosecutions.

(2) Notwithstanding section 10(4) of the Petty Sessions (Ireland) Act 1851 proceedings for an offence against this Act may be instituted at any time within 2 years after the date alleged to be the date on which the offence was committed.

50.—(1) A person, other than a body corporate, guilty of an offence against *section 11, 16(8), 18, 30, 31 or 37* is liable— Penalties for
offences.

(a) on summary conviction to a fine not exceeding €3,000 or to imprisonment for a term not exceeding 12 months or both, or

(b) on conviction on indictment, to a fine not exceeding €300,000 or imprisonment for a term not exceeding 5 years or both.

(2) A body corporate guilty of an offence against *section 11, 16(8), 18, 30, 31 or 37* is liable—

(a) on summary conviction, to a fine not exceeding €3,000, or

(b) on conviction on indictment, to a fine not exceeding €300,000.

(2) If any other Minister is the specified Minister in relation to a commission, any expenses incurred by him or her in the administration of this Act shall, to such extent as may be sanctioned by the Minister for Finance, be paid out of money provided by the Oireachtas.

Appendix 2 – Statutory Instruments



STATUTORY INSTRUMENTS.

S.I. No. 454 of 2010

COMMISSION OF INVESTIGATION (BANKING SECTOR) ORDER
2010

(Prn. A10/1375)

COMMISSION OF INVESTIGATION (BANKING SECTOR) ORDER
2010

WHEREAS pursuant to section 3(1) of the Commissions of Investigation Act 2004 (No. 23 of 2004) the Minister for Finance made a proposal to the Government for the establishment of a commission to investigate the matters specified in Article 3(1) of the following Order and to make any reports required under that Act in relation to its investigation;

AND WHEREAS the Government by decision made on 6 July 2010 considered those matters to be of significant public concern;

AND WHEREAS a draft of the following Order has been laid before each House of the Oireachtas, together with a statement of the reasons for establishing the commission, and a resolution approving that draft has been passed by each such House;

NOW, the Government, in exercise of the powers conferred on them by sections 3, 4(1) and 7(2)(a) of the Commissions of Investigation Act 2004, hereby order as follows:

Citation.

1. This Order may be cited as the Commission of Investigation (Banking Sector) Order 2010.

Definition.

2. In this Order—

“Act” means the Commissions of Investigation Act 2004 (No. 23 of 2004);

“Commission” means the commission established in accordance with Article 3.

Establishment of Commission, etc.

3. (1) A commission is established to investigate the following specific matters considered by the Government to be of significant public concern and requiring, in the public interest, an expedited examination:

- (a) the main causes of the serious failure, during the period 1 January 2003 to 15 January 2009, within each of the covered institutions, to implement and adhere to, appropriate standards and controls (including checks and balances) in the context of corporate governance and prudent risk management policy and procedures such as would have avoided the requirement for the provision of exceptional financial support from the State;

*Notice of the making of this Statutory Instrument was published in
“Iris Oifigiúil” of 24th September, 2010.*

- (b) the main causes for the adoption, during the period 1 January 2003 to 15 January 2009, by the Boards of Anglo Irish Bank Corporation and Irish Nationwide Building Society of business models and strategies, and the implementation by the senior managements of those institutions of business and lending practices, which resulted in those institutions experiencing severe financial distress;
- (c) whether in respect of the period 1 January 2003 to 15 January 2009 the external auditors of the covered institutions commented in their audit reports or other communications to the institutions concerned on the failures referred to in subparagraph (a) or the business models and strategies and business and lending practices referred to subparagraph (b);
- (d) the main causes for the failures, during the period 1 January 2003 to 28 September 2008, in the performance of the statutory roles and responsibilities of the Central Bank and Financial Services Authority of Ireland in respect of the regulation and supervision of the covered institutions and the maintenance of financial stability, in particular in relation to the supervision and oversight of corporate governance and risk management policies and practices in the covered institutions, and the relevance in that regard of any advices or directions given by the Department of Finance to the Central Bank and Financial Services Authority of Ireland in relation to its supervisory role.

(2) The Commission shall complete the report or reports required in relation to its investigation no later than 6 months from the date of its establishment.

(3) In paragraph (1) “covered institution” means an institution that is a covered institution pursuant to the Credit Institutions (Financial Support) Scheme 2008 (S.I. No. 411 of 2008).

Authorisation, etc., of Minister for Finance.

4. The Minister for Finance—

- (a) is specified as the Minister responsible for overseeing administrative matters relating to the establishment of the Commission, for receiving its reports and for performing any other functions conferred on him or her under the Act,
- (b) is authorised to set the Commission’s terms of reference, and
- (c) is authorised to appoint the member or members of the Commission.

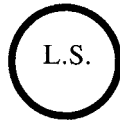
Commission’s working methodology.

5. The Commission shall adopt and implement a working methodology or framework to ensure that any report required in accordance with the Act is completed within the period specified in Article 3(2). The methodology or framework may include or provide for such sampling techniques or selection of examples as the Commission may determine.

Commission may rely on certain earlier reports.

6. The Commission may, as it considers appropriate, rely on the information and findings in the following reports:

- (a) the Regling & Watson report (A Preliminary Report on the Sources of Ireland's Banking Crisis) (May 2010, Klaus Regling & Max Watson);
- (b) the Honohan report (The Irish Banking Crisis and Regulatory and Financial Stability Policy 2003 — 2008, a Report to the Minister for Finance by the Governor of the Central Bank) (31 May 2010).



GIVEN under the Official Seal of the Government,
21 September 2010.

BRIAN COWEN, T.D.,
Taoiseach.

STATEMENT OF REASONS FOR ESTABLISHING A COMMISSION OF INVESTIGATION

(This statement of reasons is not part of the Order and does not purport to be a legal interpretation)

Section 3(1) of the Commissions of Investigation Act 2004 provides that following a proposal made by a Minister with the Approval of the Minister for Finance, the Government may, by order, establish a commission of investigation into any matter considered by the Government to be of significant public concern.

The Minister for Finance wishes to establish a commission under the Commissions of Investigation Act 2004 to investigate matters of significant public concern in respect of the period 1 January 2003 to 15 January 2009 in respect of (i) — (iii) and in respect of the period 1 January 2003 to 28 September 2008 in respect of (iv), namely, (i) in respect of the credit institutions that are covered institutions (pursuant to the Credit Institutions (Financial Support) Scheme 2008 (S.I. No. 411 of 2008), the main causes of the serious failures, within each of those institutions, to implement and adhere to appropriate standards and controls (including checks and balances), in the context of corporate governance and prudent risk management policy and procedures, such as would have avoided the requirement for the provision of exceptional financial support from the State; (ii) in respect of Anglo Irish Bank Corporation and Irish Nationwide Building Society, the main causes for the adoption, during the period 1 January 2003 to 15 January 2009, by their Boards of business models and strategies, and the implementation by their senior management of business and lending practices which resulted in those institutions experiencing severe financial distress; (iii) whether the external auditors of each of the covered institutions commented in their audit reports or other communications to the institutions on the failures referred to in (i) above or the business models and strategies and business and lending practices referred to in (ii) above; and (iv) the main causes for the failures in the performance of the statutory roles and responsibilities of the Central Bank and Financial Services Authority of Ireland in respect of the regulation and supervision of the covered institutions and the maintenance of financial stability, in particular in relation to the supervision and oversight of corporate governance and risk management policies and practices in all of the covered institutions and the relevance in this regard of any advices or directions given by the Department of Finance to the Central Bank and Financial Services Authority of Ireland in relation to its supervisory role.

At its meeting on 6 July the Government agreed the draft Order and Statement of Reasons for establishment of the Commission as defined in the Commissions of Investigation Act 2004.

BAILE ÁTHA CLIATH
ARNA FHOILSIÚ AG OIFIG AN tSOLÁTHAIR
Le ceannach díreach ón
OIFIG DHÍOLTA FOILSEACHÁN RIALTAIS,
TEACH SUN ALLIANCE, SRÁID THEACH LAIGHEAN, BAILE ÁTHA CLIATH 2,
nó tríd an bpost ó
FOILSEACHÁIN RIALTAIS, AN RANNÓG POST-TRÁCHTA,
AONAD 20 PÁIRC MIONDÍOLA COIS LOCHA, CLÁR CHLAINNE MHUIRIS,
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STATUTORY INSTRUMENTS.

S.I. No. 590 of 2010

COMMISSION OF INVESTIGATION (BANKING SECTOR)
(AMENDMENT) ORDER 2010

(Prn. A10/1834)

S.I. No. 590 of 2010.

COMMISSION OF INVESTIGATION (BANKING SECTOR)
(AMENDMENT) ORDER 2010

WHEREAS a Commission of Investigation was established by the Commission of Investigation (Banking Sector) Order 2010 (S.I. No. 454 of 2010);

AND WHEREAS the Government have agreed to amend the terms of reference of the Commission of Investigation established by that Order to extend the scope of its investigation;

AND WHEREAS the Commission of Investigation established by that Order has consented to that amendment of its terms of reference;

AND WHEREAS a draft of the following Order has been laid before each House of the Oireachtas, and a resolution approving that draft has been passed by each such House;

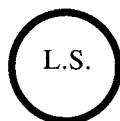
NOW, the Government, in exercise of the powers conferred on them by sections 4(2) and 6 of the Commissions of Investigation Act 2004 (No. 23 of 2004), hereby order as follows:

Citation.

1. This Order may be cited as the Commission of Investigation (Banking Sector) (Amendment) Order 2010.

Amendment of Commission of Investigation (Banking Sector) Order 2010.

2. Article 3(1)(d) of the Commission of Investigation (Banking Sector) Order 2010 (S.I. No. 454 of 2010) is amended by substituting “15 January 2009,” for “28 September 2008,”.



GIVEN under the Official Seal of the Government,
7 December 2010.

BRIAN COWEN,
Taoiseach.

*Notice of the making of this Statutory Instrument was published in
“Iris Oifigiúil” of 10th December, 2010.*

EXPLANATORY NOTE

(This note is not part of the Instrument and does not purport to be a legal interpretation.)

This Order amends the Commission of Investigation (Banking Sector) Order 2010 (S.I. No. 454 of 2010) by substituting 15 January 2009 for 28 September 2008 as the applicable end-date in the terms of reference for the Commission of Investigation's examination of the regulatory system and of the Department of Finance.

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Appendix 3 – Banking Crisis Timeline

Banking Crisis Timeline

Date

Base Rate Movements

2007

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8 US: HSBC announce US Loan writedowns

Iri: The Index of House Prices shows a decline for the first time in 5 years

2 US: New Century Financial bankruptcy

23 US: Bear Stearns \$3.2bn rescue of hedge fund

26 US: SEC begins investigation of 12 CDO issuers

BoE: 5.75%(+25bp)

9 ECB announces €95bn liquidity-providing fine-tuning operation

France: BNP Paribas freezes three funds due to US sub-prime valuation issues

17 Germany: Sachsen LB receives bailout from German savings association

22 ECB announces supplementary €40bn longer term refinancing operation (LTRO) with 3 months maturity

6 ECB announces futher supplementary liquidity-providing LTRO with 3 months maturity (€75bn)

10 UK: First mortgage lender failure - Victoria Mortgage Funding

UK: Bank of England provides emergency funding to Northern Rock

UK: Government guarantees Northern Rock deposits in response to run on bank

Fed: 4.75%(-50bp)

16 US: Citigroup begins first of major writedowns related to sub-prime mortgage assets

22 ECB announces intention to re-inforce policy of allocating more liquidity than benchmark

Fed: 4.50%(-25bp)

8 ECB announces renewal of Aug (€40bn) & Sep (€75bn) LTRO plus two further LTRO's of €60bn each

30 ECB announces extension of mid-December main re-financing operations from 28-Dec-07 to 04-Jan-08

BoE: 5.50%(-25bp)

11 Fed: 4.25%(-25bp)

12 US: Term Auction Facility (TAF) programme announced with swap lines with ECB (\$20bn) & SNB (\$4bn)

17 US: TAF programme commences for \$20bn of 28 day credit

Fed: 3.50%(-75bp)

29 US: Two major bond insurers (Ambac Financial & MBIA) at risk of downgrade

Fed: 3.00%(-50bp)

1 US: TAF programme increased to €30bn every two weeks

7 ECB announces renewal of supplementary Nov-07 (€60bn) & Dec-07 (€75bn) LTRO's

BoE: 5.25%(-25bp)

13 US: Economic Stimulus Act 2008 signed into law

UK: Northern Rock Nationalised

11 US: Term Securities Lending Facility introduced and swap lines with ECB & SNB increased

Bear Stearns reports a \$15bn (88%) drop in liquid assets

14 US: Fed approves Bear Stearns purchase by JP Morgan

16 US: Primary Dealer Credit Facility (PDCF) introduced

Banking Crisis Timeline

Date

Base Rate Movements

2008

18		Fed: 2.25%(-75bp)
19	US: Fannie Mae & Freddie Mac capital requirements eased to allow increased lending	
20	Irl: Anglo Share Price falls 18% over one week due to concerns over property exposure	
28	ECB announces 6 month LTRO's of €25bn each for 2 Apr & 9 Jul	Fed: 2.00%(-25bp)
A 10		BoE: 5.25%(-25bp)
22	UK: BoE unveils £50bn+ Special Liquidity Scheme to swap govt. bonds for mortgage assets up to Oct-08	
M 2	US: TSLF eligible collateral expanded to include AAA rated ABS US: TAF & swap lines increased	
6	US: Bank of America purchase of Countrywide approved	
J 6	US: S&P downgrades the two largest monoline bond insurers with €1trn of debt from AAA to AA	
16	US: Lehman reports second quarter loss of \$2.8bn	
J 9		ECB: 4.25%(+25bp)
11	US: FDIC takes over IndyMac which then experiences a run on deposits	
15	US Treasury requests Government funds to potentially support Fannie Mae & Freddie Mac	
30	US: 84-day TAF auctions introduced and ECB swap line increased	
A 7	US: Fannie Mae & Freddie Mac placed in Federal conservatorship	
10	US: Lehman reports third qtr loss of \$3.9bn	
14	US: Eligible collateral for TSLF & PDCF expanded US: 10 banks create \$70bn liquidity fund	
15	US: Lehman's files for bankruptcy US: AIG Debt downgraded by S&P, Moodys & Fitch	
	US: Bank of America purchases Merrill Lynch	
16	US: AIG given \$85bn loan from Government US: RMC money market fund "breaks the buck"	
17	UK: BoE extends Special Liquidity Scheme to Jan-09 UK: LloydsTSB agrees to rescue HBOS	
18	Irl: Shorting of financial stocks prohibited UK bans short sales, requires position disclosures	
	US: Swap lines increased by \$180bn	
19	France adopts short selling ban & disclosure US: AMLF (Asset Backed CP Mutual Liquidity Fund) established	
	US Treasury calls for government plan to purchase troubled assets (TARP) US SEC prohibits short selling	
	US Treasury establishes money guarantee program	
20	Irl: Deposit protection raised to €100k	
21	US: Goldman Sachs & Morgan Stanley approved as bank holding companies	
24	Ireland officially in recession	
25	US: Washington Mutual is acquired by OTS & FDIC, closed and its banking assets sold to JP Morgan for €1.19bn	
26	US: Swap lines increased with ECB (\$10bn) & SNB(\$3bn) with total lines now \$290bn	
29	Germany: Hypo Real Estate receives €35bn guaranteed financing	
	UK: Bradford & Bingley nationalised and partial sale of assets to Banco Santander US: Wachovia assisted	
	US: 84 day TAF allotments increased to \$75bn, \$150bn forward auctions introduced, swap lines doubled to \$620bn	
	US Treasury \$700bn bailout plan (TARP) rejected - Dow Jones falls 7%	
	Listed Covered Banks shares decline 27% ISEQ declines by 13%	

Banking Crisis Timeline

Date

Base Rate Movements

2008

30	Irl: State Guarantees €375bn of the liabilities of 7 domestic banks for a two year period	
	Irl: Listed Covered Banks recover 80% of previous days share losses	France: Govt recapitalizes Dexia with €3bn
O 1	Italy adopts temporary short selling ban	
3	US TARP \$700bn bailout plan passed raising deposit protection to \$250k	UK: Deposit Insurance upped to £50k
	Netherlands: Government nationalises banking and insurance activities of Fortis	
5	Germany: Government guarantees all private bank accounts	
6	Germany: Hypo Real Estate Guarantee set at €50bn	US: TAF increased to provide \$900bn of funding over year end
	France: BNP Paribas takes 75% stake in Fortis	
7	US: Commercial Paper Funding Facility (CPFF) established	Iceland: Landesbanki nationalised
O 8	UK: £500bn bank rescue package announced - lending £200bn , short term guarantees £250bn, capital £50bn	
	Italy: Govt states no banks will fail, no depositors to suffer losses	Fed: 1.50%(-50bp)
	France: Govt guarantees 36.5% of €150bn Dexia re-financing	BoE: 4.50%(-50bp)
12	US: Wells Fargo purchase of Wachovia approved	
13	France: €320bn loan fund & €40bn recapitalisation fund announced	
	Germany: €400bn loan fund & €70bn recapitalisation fund announced	
	Italy: Unspecified bank financing guarantee passed	UK: £37bn capital injected into Lloyds/HBOS, RBS
	Irl: Emergency Budget Introduced	US: Caps removed on swap lines with ECB, BoE & SNB
14	US: Treasury \$250bn capital injection plan, 9 banks sign-up, FDIC insures senior debt of regulated institutions	
15	ECB: widens collateral rules and slashes required ratings	ECB: 3.75%(-50bp)
20	France: Govt subscribes to €10.5bn sub debt of 6 banks	
14	US: Money Market Investor Funding Facility (MMIFF) is established	
24	UK: £23bn stimulus package announced	
27	Germany: Rescue fund SoFFin begins operation - powers to guarantee financing, buy assets and recapitalise firms	
28	UK: Government acquires 58% stake in RBS for £15bn	
29		Fed: 1.00%(-50bp)
31	Germany: SoFFin provides Hypo Real Estate with €35bn in guarantees	
N 2	Germany: SoFFin provides Commerzbank with €3.2bn of loan	
6		BoE: 3.00%(-150bp)
10	China: Government announces \$586bn fiscal stimulus package	
12		ECB: 3.25%(-50bp)
20	Iceland: The IMF approves a loan to Iceland for \$2.1bn following the collapse of its banking system	
23	US: Citigroup receives \$20bn in government assistance from Fed, FDIC & Treasury	
25	US: Troubled Asset Lending Facility (TALF) established for \$600bn to provide loans collateralised by ABS \$200bn	
	US: Treasury allocates \$200bn to target unfreezing of consumer credit	
28	Germany: BayernLB receives €7bn in capital from Bavaria	

Banking Crisis Timeline

Date

Base Rate Movements

2008

- D 3 Germany: SoFFin provides BayernLB with €15bn in guarantees
- 4 BoE: 2.00%(-100bp)
- 10 ECB: 2.50%(-75bp)
- 14 **Irl: Government announces €10bn allocated to recapitalisation of domestic banks**
- 15 UK: Credit Guarantee Scheme lengthened to 5 years
- 16 Fed: 0-0.25%(-75+bp)
- 18 **Irl: Anglo's Chairman and CEO resign following disclosures over directors loans**
- 20 International: Eleven of the world's largest banks are downgraded by S&P
- 21 **Irl: Government announces €5.5bn to be invested in preference shares in AIB, Anglo & Bol**
- 22 Germany: SoFFin provides IKB with €5bn in guarantees
- 28 UK: Bank of England estimates world credit loss at £1.8trn
- 29 US: Treasury injects \$5bn into GMAC

2009

- J 8 Germany: SoFFin provides a further €8.2bn of loans to Commerzbank and buys €1.8bn of equity BoE: 1.50%(-50bp)
- Irl: Minister for Finance announces the re-appointment of the Governor of the Central Bank**
- 9 **Irl: The Chief Executive of the Financial Regulator announces intention to retire on 31-Jan-10**
- 13 Germany: €50bn economic stimulus package unveiled
- 15 **Irl: Gov.t announces intention to nationalise Anglo due to weak funding position & "unacceptable practices"**
- 16 US: Fed, FDIC & Treasury aid Bank of America
- 19 **UK: Asset Protection Scheme (APS) announced where Treasury will cover 90% of losses over initial provision**
- UK: BoE to purchase £50bn of private sector assets**
- UK: Credit guarantee Scheme extended to debt issued up to year end 2008
- UK: Full or partial guarantee available to CGS eligible firms on AAA-rated ABS
- Irl: Bol announces retirement of CEO with effect from summer of 2010**
- 21 Germany: SoFFin provides Hypo Real Estate additional €12bn in guarantees ECB: 2.00%(-50bp)
- France: Second round of recapitalisation for another €10.5bn
- 24 US: Citigroup sells \$12bn in bonds guaranteed by US Government
- 26 US: Fannie Mae & Freddie Mac state \$51bn required from government to continue operations
- 30 **Irl: Sean Quinn reveals losses of €1bn arising from speculative trading on Anglo Irish stocks**
- F 5 BoE: 1.00%(-50bp)
- 10 **Irl: IL&P CEO & 2 directors resign over €7bn placed with Anglo in Sep-08 to boost Anglo's Balance Sheet**
- US: Fed expresses willingness to expand TALF to \$1tn and accept wider set of collateral
- 11 **Irl: Recapitalisation plans amended to invest €7bn in AIB & Bol from the National Pensions Reserve Fund**
- 17 **Irl: Chairman of INBS resigns** US President signs \$787bn economic stimulus plan into law
- 20 **Irl: Anglo's annual report reveals it lent €451m to 10 customers, on a non-recourse basis, to buy its own shares**
- 24 Germany: Two German states recapitalise HSH Nordbank
- 25 Italy: €12bn recapitalisation plan approved

Banking Crisis Timeline

Date

Base Rate Movements

2009

	26	France: Government provides €5bn in preference shares to two merging banks	
		UK: RBS agrees to participate in APS and receives capital injection of £13bn giving govt. 84% ownership	
M	1	US: AIG receives \$30bn in capital in exchange for government control of two divisions	
	2	US: AIG announces fourth quarter loss of \$61.7bn - Fed & Treasury announce AIG restructure	
	3	US: TALF launched	
	5	UK: Asset Purchase Plan increased to £75bn	BoE: 1.00%(-50bp)
	7	Germany: SoFFin provides HSH Nordbank with €30bn in guarantees	
		UK: LBG agrees to participate in APS and government preference shares are converted to common equity	
	8	US: Fannie Mae requests \$19bn from Treasury after \$23.2bn quarterly loss	
	11		ECB: 1.50%(-50bp)
	30	Germany: SoFFin purchases 8.7% of Hypo Real Estate for €60m	
		Irl: Standard & Poor's cut Ireland's long term rating by one notch to AA+ on back of deteriorating public finances	
A	2	International: Mark-to-market accounting rules relaxed by Financial Accounting Standards Board (FASB)	
		Irl: INBS announces the resignation of its CEO at the end of the month	
	7	Irl: National Asset Management Agency (NAMA) announced: €90bn of toxic assets to be swapped for bonds	
	8		ECB: 1.25%(-25bp)
	9	Germany: SoFFin makes bid for Hypo Real Estate - will nationalise bank in May if bid is not accepted	
	11	Germany: Finance Minister proposes "bad bank" plan to take illiquid assets	
	14	Germany: SoFFin extends €52bn in guarantees to Hypo Real Estate until mid-August	
	30	Irl: AIB announces the resignations of its Chairman, CEO & Finance Director	
M	7	ECB: announces €60bn in purchases of covered bonds	UK: Asset Purchase Plan increased to £125bn
	13		ECB: 1.00%(-25bp)
	19	Irl: Bol announces resignation of Chairman with effect from Jul-10	
J	3	Germany: Hypo Real Estate taken under full government control with €3bn capital injection	
	8	Irl: Standard & Poor's cut Ireland's long term rating by one notch to AA due to costly bank rescue package	
		Irl: Governor of Central Bank announces retirement with effect from Sep-10	
	17	US: President proposes a comprehensive regulatory reform plan	
J	3	Germany: IKB receives a further €3bn in guarantees	
	9	Irl: Government injects €4bn of funds in Anglo	
	10	Germany: Bad Bank bill passed - trades toxic assets for guaranteed debt but firms must repay losses over 20 years	
	24	US: TAF offer amount reduced to \$100bn	
	30	Irl: NAMA draft proposal released	
	31	Italy: Banco Popolare becomes first bank to use the Italian bank liability guarantee programme	
A	6	UK: Asset Purchase Plan increased to £175bn	
	28	US: TAF offer amount reduced to \$75bn for September auctions	

Banking Crisis Timeline

Date

Base Rate Movements

2009	S	9	Germany: Commerzbank announces it will return all of its unused debt guarantees
		10	Irl: NAMA Bill Published forecasting €77bn in loans to be acquired from 5 domestic banks
		17	US: SEC approves new rules to govern rating agencies
		24	US: TSLF & TAF offer amount reductions announced
		29	Italy: Unicredit to raise capital rather than avail of Gov.t funds France: BNP announces rights offer to repay state aid
	O	6	France: Societe Generale announces rights offer to repay government aid
	N	3	UK: LBG exits Asset Protection Scheme for a fee
		5	UK: Asset Purchase Plan increased to £200bn
	D	9	Irl: Cost cutting budget announced targetting savings of over €4bn per annum US: Treasury extends TARP to Oct-10 - Bank of America repays TARP funds
		21	Germany: Hypo Real Estate €43bn liquidity facility extended until Dec-10, €52bn in guarantees to expire Jun-10
2010		24	US: Citibank & Wells Fargo repay TARP funds
	J		
	F	2	US: The AMLF, CPFF, PDCF & TSLF are closed
		10	US: PNC Bank repays TARP funds
	M	15	US: Senator Dodd introduces the financial regulation bill to senate
		22	US: Senate Banking Committee passes the financial regulation bill
		26	Irl: Central Bank Reform Bill 2010 presented to unify CB & FR and confer additional powers to the CB
		30	Irl: NAMA Tranche 1 announced - €16bn at average discount of 47% to be transferred in Apr-10 Irl: After CB review (PCAR), revised recapitalisation plan announced and intention to take control of INBS & EBS Irl: Capital requirements for AIB (€7.4bn) & BoI (€2.7bn) to be raised through share issue & asset sales Irl: Promissory notes to be issued to Anglo (€3.3bn) & INBS (€2.6bn) & investment shares in EBS & INBS
		31	Irl: Anglo announces largest corporate loss in Irish history of €12.7bn
	A		EU: European finance ministers finalise European Stability Facility to assist countries in financial distress
		26	Irl: BoI announces plans to raise €3.4bn in capital through rights issue and placings with government backing
	M	2	Greece receives a bailout package of €110bn from the EU & IMF Irl: Government issues further promissory notes to Anglo for €2bn
		20	US: Senate passes Restoring American Financial Stability Act
		28	Irl: Government takes control of EBS with purchase of €100m in special investment shares
	J		Irl: Further promissory notes issued to Anglo for €3.4bn and buys special investment shares in EBS for €250m
		10	Irl: BoI completes capital raising programme, raising over €3.5bn
		29	US: Dodd-Frank Wall Street Reform and Consumer Protection Act passed
	J	17	Irl: Central Bank Reform Act 2010 signed into law - to take effect Oct-10

Banking Crisis Timeline

Date

Base Rate Movements

2010

- A 23 **Irl: NAMA Tranche 2: €12bn of loans acquired at average discount of 56%**
- 24 Irl: Standard & Poor's cut Ireland's long term rating by one notch to AA- with a negative outlook
- 31 Irl: Anglo's interim accounts show losses for the six months of 2010 of €3.2bn
- S 11 Irl: AIB agrees sale of Polish units to Santander improving it's capital position by €2.5bn
- 30 **Irl: Government announces costs of Anglo at least €29bn possibly rising to €34bn**
- Irl: CB confirms further capital requirement for AIB of €3bn following update of PCAR in light of NAMA transfers
- Irl: AIB announces termination of CEO's contract and resignation of Chairman
- O 29 [EU: German Chancellor suggests holders of sovereign debt should take losses as part of any debt restructuring](#)
- N 11 Irl: Spreads on 10 year Government bonds over German equivalents reach a new high of 6.65%
- 21 **Irl: Minister for Finance to recommend to Government that the country formally request a bailout package**
- 23 Irl: Standard & Poor's cut Ireland's long term rating by two notches to A on back of escalating bank bailout costs
- 28 **Irl: IMF/EU bailout deal announced giving Ireland access to €35bn in funding**
- D 7 Irl: Budget presented targeting initial €6bn in annual savings rising to €15bn over 4 year plan
- 20 **Irl: NAMA Tranche 3: €43bn of loans acquired at discount of 61%; Cumulative bank losses amount to €41bn**
- 23 **Irl: Gov.t to inject €3.7bn into AIB bringing its ownership to 93%**
- Irl: Further promissory notes issued to Anglo €6.4bn and INBS €2.7bn - Total gov.t capital in banks now €46bn**