Houses of the Oireachtas
Tithe an Oireachtais

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An Coiste um Chuntais Phoiblí

Tuarascáil maidir leis an nGéarchéim in Earnáil Bhaincéireachta na Tíre:

Réamhanailís agus creat le haghaidh fiosrúcháin baincéireachta

Iúil 2012

Houses of the Oireachtas

Committee of Public Accounts

Report on the crisis in the domestic banking sector:

A preliminary analysis and a framework for a banking inquiry

July 2012

31/CPAS/004

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Membership of the Committee

Committee of Public Accounts – 31st Dáil

Connaughton, Paul J.
(FG)

Deasy, John
(FG)

Donohoe, Paschal
(FG)

Fleming, Seán
(FF)

Harris, Simon
(FG)

McCarthy, Michael
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McDonald, Mary Lou
(SF)

McGuinness, John
(FF) – *Chairman*

Murphy, Eoghan
(FG)

Nash, Gerald
(Lab)

Nolan, Derek
(Lab)

O'Donnell, Kieran
(FG) – *Vice Chairman*

Ross, Shane
(Ind)

Orders of Reference of the Committee of Public Accounts

Standing Order 163 of Dáil Éireann

163. (1) There shall stand established, following the reassembly of the Dáil subsequent to a General Election, a Standing Committee, to be known as the Committee of Public Accounts, to examine and report to the Dáil upon—

(*a*) the accounts showing the appropriation of the sums granted by the Dáil to meet the public expenditure and such other accounts as they see fit (not being accounts of persons included in the Second Schedule of the Comptroller and Auditor General (Amendment) Act, 1993) which are audited by the Comptroller and Auditor General and presented to the Dáil, together with any reports by the Comptroller and Auditor General thereon:

Provided that in relation to accounts other than Appropriation Accounts, only accounts for a financial year beginning not earlier than 1 January, 1994, shall be examined by the Committee;

(*b*) the Comptroller and Auditor General's reports on his or her examinations of economy, efficiency, effectiveness evaluation systems, procedures and practices; and

(*c*) other reports carried out by the Comptroller and Auditor General under the Act.

(2) The Committee may suggest alterations and improvements in the form of the Estimates submitted to the Dáil.

(3) The Committee may proceed with its examination of an account or a report of the Comptroller and Auditor General at any time after that account or report is presented to Dáil Éireann.

(4) The Committee shall have the following powers:

(*a*) power to send for persons, papers and records as defined in Standing Order 83(2A) and Standing Order 85;

(*b*) power to take oral and written evidence as defined in Standing Order 83(1);

(*c*) power to appoint sub-Committees as defined in Standing Order 83(3);

(*d*) power to engage consultants as defined in Standing Order 83(8); and

(*e*) power to travel as defined in Standing Order 83(9).

(5) Every report which the Committee proposes to make shall, on adoption by the Committee, be laid before the Dáil forthwith whereupon the Committee shall be empowered to print and publish such report together with such related documents as it thinks fit.

(6) The Committee shall present an annual progress report to Dáil Éireann on its activities and plans.

(7) The Committee shall refrain from—

(*a*) enquiring into in public session, or publishing, confidential information regarding the activities and plans of a Government Department or office, or of a body which is subject to audit, examination or inspection by the Comptroller and Auditor General, if so requested either by a member of the Government, or the body concerned; and

(*b*) enquiring into the merits of a policy or policies of the Government or a member of the Government or the merits of the objectives of such policies.

(8) The Committee may, without prejudice to the independence of the Comptroller and Auditor General in determining the work to be carried out by his or her Office or the manner in which it is carried out, in private communication, make such suggestions to the Comptroller and Auditor General regarding that work as it sees fit.

(9) The Committee shall consist of thirteen members, none of whom shall be a member of the Government or a Minister of State, and five of whom shall constitute a quorum. The Committee and any sub-Committee which it may appoint shall be constituted so as to be impartially representative of the Dáil.

Chairman's preface

I welcome the publication today of this Report by the Committee of Public Accounts: It is an important document as for the first time, in one comprehensive piece of work, the issues that require public scrutiny by way of an inquiry and the means by which an inquiry can be held are set out.

The Report calls for such an inquiry. On cost factors alone an inquiry is necessary as there are still too many unanswered questions. The scope of the various examinations to-date have not given the State and its citizens a comprehensive set of answers about:-

1. the bank guarantee
2. what went wrong in our banking sector and
3. how it was allowed to happen.

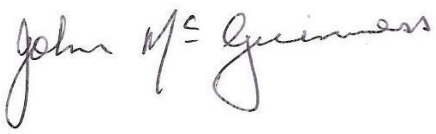
The Report also calls for the Inquiry to be conducted by the Committee of Public Accounts. The PAC has the reputation for getting public accountability. It has established a track record which will give a degree of confidence to the public that it will get the full facts. Finally it has a standing that will enhance co-operation from potential witnesses.

As the Report outlines, an inquiry by the PAC is not a straight forward matter given the restrictions placed on the Oireachtas by the *Abbeylara* judgement and the fact that some key decisions are bound by rules of cabinet confidentiality. It would be entirely wrong to suggest however that these obstacles make an inquiry by a Committee of the Oireachtas impossible or not worth doing. As is outlined in the recommendations and in the legal framework in this Report there is scope to do a comprehensive inquiry. Public Accountability is central to this.

This Report is a necessary first step to holding an inquiry as it contains a review which synthesised the issues covered by the various reports to date; the findings and recommendations contained in these reports; and a legal framework for holding an inquiry. That review enabled the Committee to conduct an analysis of the issues that were not covered by these reports and the list of issues that subsequently emerged was submitted for peer review by national and international experts. The Report has grouped the outstanding issues into distinct areas and has made clear recommendations on how an inquiry can be structured so as to deal quickly and effectively with these. The next step is to engage in a wider consultation process with the Dáil and the Government so as to enable terms of reference to be drafted for the inquiry.

The Committee, and in particular the sub-group appointed to bring forward this Report, has put in a huge effort in identifying the issues that require further scrutiny and the ways and means of conducting an inquiry. The Committee acknowledges the help it received from the staff of the Houses of the Oireachtas Service, from the peer reviewers and from the legal advisors, all of whom proved a great resource to the Committee.

This Report has both identified the issues and provided the road map for an inquiry and I commend it to Dáil Éireann.



John Mc Guinness TD
Chairman of the Committee of Public Accounts

5th July, 2012

Introduction and Executive Summary

The need for a public inquiry

"One of the costliest banking crises in history"

Patrick Honohan, Governor of the Central Bank

The collapse of the domestic banking sector in Ireland has created the greatest challenge to the State since it was founded in 1922. In March 2011, the Governor of the Central Bank of Ireland described it as "one of the costliest banking crises in history".[1]

The circumstances that led to the collapse have been the subject of numerous reports and debates since 2008. However, while we now know a lot more about what caused the collapse as a result of the various official reports, many issues remain to be addressed and many questions remain to be answered. In particular, those who had central roles in banking and oversight have not been requested to explain publicly the issues they faced or their decisions and actions in the lead up to and during the crisis. There is also a need to examine the range of legislation that have been put in place by the Houses of the Oireachtas since the crisis, to assess whether it is sufficiently robust and comprehensive to deal with future problems in the banking sector.

Having regard to all of these issues, the Committee strongly believes that a parliamentary inquiry into the banking crisis should be held. It also believes – on foot of the advice of Senior Counsel – that an inquiry can be undertaken successfully under the existing constitutional and statutory framework. It recognises, however, the limitations of an inquiry as a result of the complex legal landscape created by the *Abbeylara* judgment as well as issues such as Cabinet confidentiality and possible criminal proceedings.

The cost of the crisis

The direct and indirect costs of the Irish banking crisis are unprecedented.

The direct cost to the State – through the recapitalisation of the banks – is now estimated to be €64.1 billion. This has been funded in part through using the State's own resources in the

[1] Central Bank briefing on the stress tests 31 March 2011, see http://www.rte.ie/news/2011/0331/banks-business.html#video

National Pensions Reserve Fund (NPRF), from which €20.7 billion has been invested in Allied Irish Bank (AIB) and Bank of Ireland (BoI). However, the majority of funding has come from borrowing. The general government debt *directly* related to the bank bailout is €43.4 billion, a figure that includes the €31 billion in promissory notes used to fund the liabilities of Anglo Irish Bank (Anglo), the Irish Nationwide Building Society (INBS) and the Educational Building Society (EBS).

To put this cost in context, the direct cost of €64.1 billion is equivalent to —

- 41% of GDP in 2011;
- Approximately seven times what the State spends annually on education;
- Over four times what it spends annually on health;
- Over three times what it spends annually on social protection; and
- Almost twice the State's total tax revenue.

Another cost, as the Comptroller and Auditor General (CAG) recently pointed out, is the implicit subsidy to the banks. The State has established the National Asset Management Agency (NAMA), which is financed through the issue of Government guaranteed bonds. NAMA has to date paid the banks €32 billion for property development loans valued at €74 billion. However, the CAG estimates that for the first five tranches of loans transferred, NAMA paid 23% over their current market value, subsidising the banks by approximately €5 billion.[2]

Finally, there is the very significant loss to some citizens of the value of bank shares held directly or through pension funds. The European Commission estimates that, since January 2007, some €50 billion in shareholder value has been lost as Irish banks' share prices collapsed in the wake of mounting losses resulting from the escalating property crisis, and the subsequent recapitalisations.

Bank guarantee

Many of these costs were precipitated by decisions in September 2008 to guarantee the

[2] See Comptroller and Auditor General, *Special Report 79: National Asset Management Agency – Management of Loans, see* http://www.audgen.gov.ie/viewdoc.asp?DocID p19.

liabilities of the banks. The Deposit Guarantee Scheme (DGS) was extended to cover deposits up to €100,000, giving exposure to a potential liability of €83 billion on deposits in the covered banks. The Credit Institutions (Financial Support) Scheme (the CIFS scheme) announced on 29 September 2008 covered €345 billion worth of liabilities, giving an overall exposure as at September 2008 of €428 billion.

The CIFS scheme has since been superseded by the Credit Institutions (Eligible Liabilities Guarantee) Scheme (the ELG scheme). We know that the level of exposure from guarantees has since been lessened as bank funding from the European Central Bank/Central Bank of Ireland is not covered by the guarantees. At the end of 2011, the contingent liability from guarantees stood at €173 billion (110.3% of GDP) and the latest figures available to the Committee suggest that the total liability under guarantees fell by approximately €6 billion in Quarter 1 2012.

Approach of the Committee in identifying the issues

A significant amount of analysis has been undertaken since 2008 into the collapse of the domestic banking sector. It is the Committee's strong view that while there is a clear need for a public inquiry, it should build on what has already been learnt and not duplicate the work that has been undertaken to date.

This Report forms part of the necessary preparatory work that will assist in the holding of an effective and efficient public inquiry into the collapse. In preparing it, the Committee commissioned independent legal advice on the constitutional and other legal issues impacting on a parliamentary inquiry. This is contained in Appendix 1 to this Report. The Committee also worked in a rigorous and systematic manner over the past six months to identify the issues that require further scrutiny, approaching this task in two distinct phases:

Phase 1 – Review of examinations undertaken since 2008

As a first step the Committee, through a sub-group of its Members, reviewed reports and examinations already undertaken. A substantial amount of work has already been done by domestic and international experts in investigating the causes of the crisis. In total five major reports have been published. In addition, the Committee, the Joint Committee on Finance and the Public Service and the Joint Committee on Economic and Regulatory Affairs have

separately held hearings involving some of the main stakeholders; and papers on the crisis have been submitted to the Committee by the Department of Finance. A full list of the documents reviewed is contained in Appendix 2 to this Report. As part of this review the Committee commissioned a comparative review from the Oireachtas Library & Research Service of parliamentary inquiries carried out in other jurisdictions in response to the banking crisis. This review is contained in Appendix 3 to this Report.

The purpose of the Committee's review of published reports etc. was to establish and synthesise into one composite document the "existing state of knowledge" of the banking crisis, including the findings and recommendations made by the various experts who have investigated it.

In this report, Part 1 of each chapter contains a summary of the "existing state of knowledge", with Parts 2 and 3 containing the findings and verbatim recommendations, respectively, in previous reports.

Phase 2: Identification of issues that require further examination.

The second phase of the Committee's work involved identifying the issues that require further examination. These include issues that were not covered in the original reports because they were outside their terms of reference and issues that were covered but where questions still remain to be answered. In regard to both sets of issues, the Committee understands that the inquiries to date were not intended to be definitive examinations of the crisis.

In parallel with this process, a comparative study was undertaken of parliamentary inquiries into banking crises in other states.

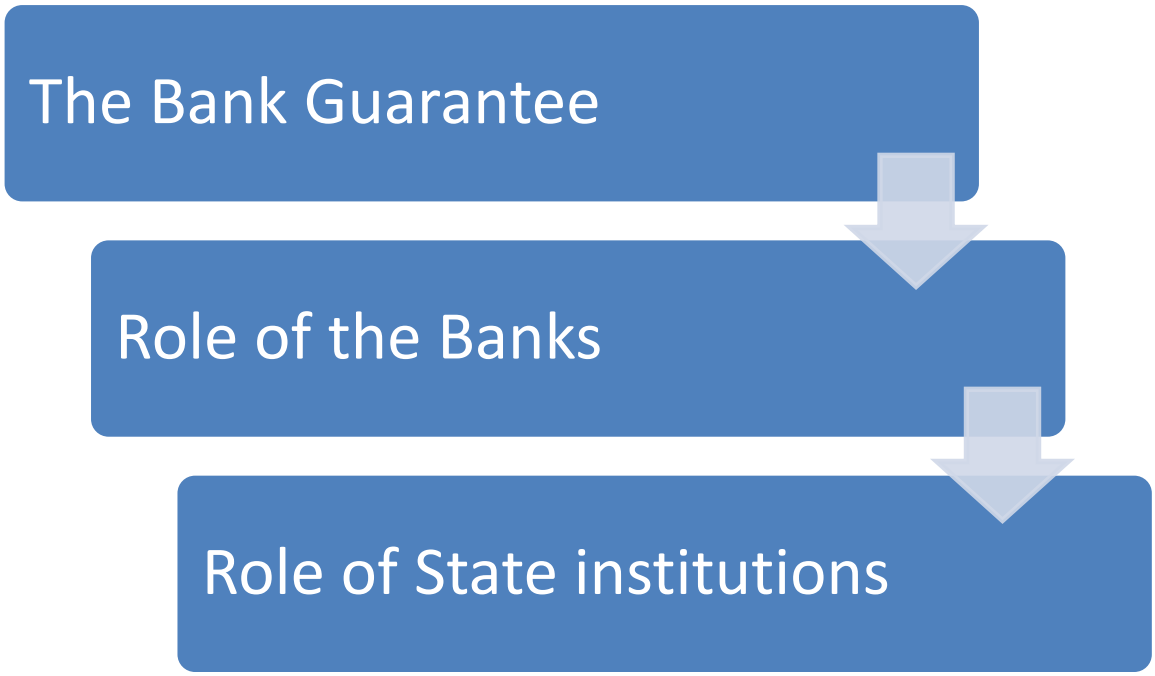
The issues that the Committee identified were sent for peer review to 14 international and domestic experts from the fields of economics, banking and finance, corporate governance, accounting and auditing, public administration and political science. The peer review provided a critique of the initial analysis and identified other issues that should be included in an inquiry. The Committee is grateful for the input of those involved in the peer review. A condition of participation in the peer review was that all contributions would be anonymous.

Summary of the issues identified as requiring further examination.

The issues requiring further examination are presented in Part 4 of each chapter as a series of questions. However, the Committee believes that there is a logical sequence to the investigation of the outstanding issues identified in the Report. Three separate pillars of inquiry are apparent:

- The bank guarantee including actions and events prior and subsequent to it;
- The role of banks in the domestic banking crisis (and in this context, the effectiveness of oversight by external auditors); and
- The role of State institutions in the domestic banking crisis (Central Bank, Department of Finance and the Financial Regulator).

Diagram 1: Pillars of inquiry



The Committee is of the view that the essential starting point of any inquiry into the crisis is an examination of the bank guarantee, its origins and effects. The Committee will therefore recommend completing the first pillar of inquiry, identified above, as phase one of the inquiry model.

A short summary of the outstanding issues identified by the Committee is outlined below

Crisis management and the bank guarantee

Notwithstanding all the reports complied, a major knowledge gap remains in relation to the events leading to the bank guarantee.

The Department of Finance papers that were provided to the Committee give an unclear and incomplete picture of how events unfolded. There are many questions about what transpired in the period leading up to and on 29 September 2008 (the night of the guarantee). Some of the issues identified by the Committee that require further examination include:

- What was the precise sequence of events in the period of weeks leading up to the guarantee?
- To what extent was there an adequate evaluation of alternatives to the bank guarantee carried out by Government?
- Was the guarantee the optimal policy choice given the alternatives available?
- To what extent was the scope of the guarantee the optimal policy decision given the other options available to the Government?
- What role, if any, was played by the Cabinet in the run up to the events of the night of 29 September 2008?
- To what extent do written records exist of the events leading up to the guarantee, and the guarantee itself?
- Who were the external advisors (formal and informal) during the crisis management period and what were their roles?

Crisis management after the guarantee

The Committee is of the view that the events since 29 September 2008 including the recapitalisation of the banks, the nationalisation of Anglo, the establishment of NAMA and the change programmes that have been initiated in the Department of Finance, the Central Bank and the Financial Regulator all need to be further examined. A particular concern of the

Committee is that appropriate structures and personnel are put in place to ensure that the situation does not recur in the future.

Some of the questions that the Committee has identified in this area are —

- To what extent was the recapitalisation of the banks the optimal policy option given the alternative policies available to the Government?
- To what extent have the necessary personnel changes to the management and boards of our banks taken place to ensure an appropriate mix of people with different skills?
- What are the lending practices of the banks following their recapitalisation and in particular to what extent are they lending to businesses and individuals?
- Was the decision to establish NAMA fully evaluated against alternative policy options, and if so to what extent?
- What is the business strategy of NAMA and in particular what are NAMA's prospects for a return on its investments?[3]

The role of banks in the crisis in the domestic banking sector

A central element in any inquiry will be to understand more fully how banking policies contributed to the crisis (see Appendix 4 to this Report for further information on trends in funding for banks). In particular there is a need to ascertain how and why systems of internal control failed. Some of the issues identified by the Committee as requiring further inquiry include —

- What caused the failures in corporate governance in Irish banks? (For example, was the competence and independence of board members a factor?)
- To what extent was the over-concentration of property-related loans deemed a risk factor by the banks?
- Why did banks and other financial institutions deviate significantly from well-established credit policies?

[3] See CAG Special Report 79: National Asset Management Agency – Management of Loans http://audgen.gov.ie/viewdoc.asp?fn=/documents/vfmreports/NAMA-Mgmt-Loans-Special-Report-79.pdf

- Why was there a failure by banks and other financial institutions to take adequate security as collateral?
- Why was there an apparent lack of understanding of the two main risks faced by banks: the possibility of development projects failing and their own over-reliance on short-term funding arrangements?
- Why was there an apparent failure of internal audit systems of banks to raise concerns regarding funding and lending?
- What, if any, was the role of remuneration in incentivising reckless lending practices?

The role of external auditors in the crisis in the domestic banking sector

It remains unclear whether the external auditors of banks had concerns about the sustainability of bank business in the period prior to the 2008 guarantee and/or if such concerns were raised with the banks. We know that clear audit certificates were given, but little knowledge is available about the dialogue between external auditors and bank executives.

The period between 2003 and 2007 saw very significant expansion in both bank lending and in the extent to which this was financed through the interbank markets rather than by deposits. We also now know that the paperwork behind much of this lending was not comprehensive. Accordingly, the question arises as to whether the audits were highlighting the risks that were being taken by those who were approving massive loans especially in the property sector. There are also very legitimate concerns about auditor independence in the light of the provision of non-audit services, and prolonged relationships between audit firms and banks. Among the specific questions and issues that arise therefore in this regard are the following:

- How does the fact that shareholder investment was virtually wiped out in all our banks equate with clear audit reports in the years from 2003 onwards?
- To what extent did the work of the external auditors give comfort to the external regulators of banks in relation to banks' business models and lending practices?
- What were the management letters of auditors telling senior management in the years from 2003 onwards?

- Were concerns relating to bank governance raised at any stage, especially in Anglo and Irish Nationwide?
- Were audit contracts the subject of rotation or change at these financial institutions?
- What role did behavioural factors (including groupthink and the lack of acceptance of divergent views) play in the crisis?

The role of the Irish Financial Services Regulatory Authority (IFRSA) in the crisis in the domestic banking sector

The Reports published to date on the banking crisis highlight many deficiencies in the approach taken by the Irish Financial Services Regulatory Authority (IFRSA). It was unduly deferential; it lacked adequate training and resources; it downplayed independent assessments of risks and it failed to follow through where serious weaknesses were identified. As a result a major failure in regulation occurred. Against this background some of the issues identified by the Committee requiring further examination include —

- Why was the tone of enforcement so deferential?
- Why did IFRSA fail to bring enforcement action in respect of breaches of regulation?
- What was the nature of the information conveyed by IFRSA to the Minister and Department of Finance and Central Bank about the bank lending?

The role of the Central Bank in the crisis in the domestic banking sector

The Central Bank of Ireland was responsible for protecting the overall stability of the financial system. However, previous reports have found that it consistently took the view that risks to financial stability would not materialise. Its Financial Stability Reports were "too reassuring in tone" and it was too deferential, partly because it feared undermining market confidence. Ultimately there was a major failure to protect financial stability. So in this context the Committee believes that there is a need to examine —

- Why was there a failure by the Central Bank to fully appreciate the risks posed by the aggregate lending exposure by banks?
- What was the basis for the Central Bank's belief in the autumn of 2008 that the crisis

was one of liquidity rather than of solvency?

- What was the reason for the downplaying of risk and the favouring of a "soft landing" scenario by the IFRSA in the Financial Stability Reports?
- To what extent did the Central Bank communicate concerns to the Minister for Finance and the Department of Finance?

The role of the Department of Finance in the crisis in the domestic banking sector

The Department of Finance was the key advisor to the Government both before, during and after the crisis. The evidence indicates that the Department had an insufficient understanding of the banking sector and relied heavily on the IFSRA and the Central Bank. It was therefore ill-equipped to deal with the problem. The evidence also indicates that there were significant weaknesses in the way it handled budgetary matters particularly the manner in which it gave advice, prepared forecasts and dealt with growing risks. The Committee therefore believes that the issues requiring examination include —

- Why did the Department of Finance not play a more significant role in financial stability issues?
- What was the advice and analysis prepared by the Department of Finance on fiscal and monetary effects of property incentives?
- Did the Department of Finance prepare specific reports to Government on the problems in the banks and the potential impact on the economy?
- What was the role of the Department of Finance in managing the crisis?
- What was the precise role of the Department of Finance in relation to the bank guarantee including its contacts with the ECB, European Commission and other EU member states?
- What is being done to develop the expertise in the Department and its capability to challenge Government Ministers on macro policy issues?
- What is the capacity of the Department of Finance now to provide robust advice to

Government?

Effectiveness of Oireachtas oversight

In the lead up to and during the banking crisis, a number of Oireachtas Committees held meetings with officials from State Institutions and the Banks. In a modern democracy, parliament must play a strong and effective role in holding Government and State institutions to account. In this context, the role of the Dáil and its committees needs to be reviewed and some of the questions identified by the Committee include —

- Is the Oireachtas effective and efficient in fulfilling its role?
- Did the Oireachtas do its job effectively?
- What is the role of the Oireachtas in the scrutiny of key government decisions?
- What is the capacity of the Oireachtas to scrutinise public policy in a meaningful way?
- To what extent does the Oireachtas receive information in a timely and useful manner?

The Legal Framework

Appendix 1 of this Report outlines the legal framework in place for inquiries by Oireachtas Committees.

Legal advice was given to the Committee, and the sub-group thereof, by Michael Cush SC and the Parliamentary Legal Adviser to the Houses of the Oireachtas Mellissa English BL. Douglas Clarke BL prepared the Annex to the written legal advice (Appendix 1a).

Legal Counsel was asked to advise on the legal framework and the appropriate legal form for a proposed inquiry into matters connected with the banking crisis in Ireland. In summary, the Committee was advised as follows:

<u>The extent of the ruling in *Maguire v Ardagh* [2002] 1 IR 385:</u>

The Supreme Court, in *Maguire,* held that the Houses of the Oireachtas do not have an express or inherent power to hold an inquiry such as was at issue in the *Maguire* case, namely, an inquiry that is capable of leading to adverse findings of fact and conclusions as to the personal culpability of an individual who is not a member of the Oireachtas, thereby impugning his or her good name.

In the *Maguire* case the Supreme Court differentiated between an adjudicative inquiry of the type at issue in that case (which was unlawful) and inquiries traditionally carried out by Committees of the Houses in aid of their functions (which are lawful). Counsel advises that neither the *Maguire* case nor the rejection of the proposed thirtieth amendment to the Constitution by the people means that all forms of Oireachtas inquiry are precluded.

<u>Two possible forms of inquiry:</u>

In light of the Supreme Court judgement in *Maguire*, two forms of inquiry appear to be permissible:

The first is an "inquire, record and report" type of inquiry. By that is meant an inquiry whereby evidence is called, recorded and reported to Dáil Éireann. No findings or conclusions of any nature are to be made, nor opinions of any nature to be expressed. The second is one that envisages findings, including findings leading to implied blame being attached to particular individuals.

Although an "inquire, record and report" type of inquiry is not without risk or potential difficulties (including, for example, the risk of prejudicing criminal proceedings), Counsel advises that the second form of inquiry is much more difficult to operate; the reason being that if the Committee's Terms of Reference envisage findings being made, and the possibility of implied blame attaching to individuals, the various rules requiring the application of fair procedures and the right to natural and Constitutional justice come into play.

Forms of statutory inquiry:

Counsel advises that two forms of statutory inquiry should also be noted. The first is an inquiry by a Tribunal and the second is a Commission of Investigation; the latter form of inquiry having produced one of the reports into the banking crisis. Counsel also advises that the possibility of new legislation should also be noted by the Committee but notes that it is clear from the judgments in *Maguire* that any such legislation would have to be very carefully framed and, even then, the legislation or certain aspects of it may be constitutionally vulnerable.

Terms of Reference:

The decision as to the Terms of Reference for the Committee is a matter of policy for Dáil Éireann. The setting of these terms will have both practical and legal implications. The narrower the Terms of Reference are, the greater the prospect of conducting an efficient inquiry and the greater the prospect of generating a coherent body of evidence. An inquiry which seeks to cover all of the outstanding issues identified in this Report is unlikely to achieve either prospect. Counsel advises that the Terms of Reference be clearly and rationally connected with the constitutional functions of the Houses of the Oireachtas.

Standing Order 163:

The existing Standing Orders of Dáil Éireann, relative to the role of the Committee, do not provide for the holding of an inquiry of the type envisaged and will require amendment.

Compellability powers:

Once the Terms of Reference of the proposed inquiry have been set, it will be necessary to secure compellability powers within the meaning of and in the manner provided for in the Houses of the Oireachtas (Compellability, Privileges and Immunities of Witnesses) Act, 1997.

Exempt evidence and cabinet confidentiality:

The exemptions set out in section 5 and 6 of the Houses of the Oireachtas (Compatibility, Privileges and Immunities of Witnesses) Act, 1997 will require consideration when drawing up the Terms of Reference for any proposed inquiry. Whether proposed lines of inquiry by the Committee are liable to meet with any obstacle posed by these sections will require consideration and, specifically, the extension within those sections of the constitutionally protected concept of cabinet confidentiality.

Natural / constitutional justice and fair procedures:

An inquiry which takes the "inquire, record and report" form would significantly reduce the scope for issues concerning the rights to natural / constitutional justice and fair procedures that trouble many forms of inquiry. While section 10 of the 1997 Act provides certain protections and issues concerning the rights to natural / constitutional justice and fair procedures that may well arise during the course of the inquiry, the nature of an "inquire, record and report" model of inquiry is such that, *in principle*, the full panoply of *In re Haughey* rights, including the right of cross examination, is unlikely to arise.

If it is envisaged that the Committee will report its opinion to the Dáil and in so doing could impinge upon the good name of witnesses, as was envisaged in the inquiry into the fall of the Reynolds Government, the various rules requiring the application of fair procedures, the right to natural and constitutional justice and the rule against bias will come into play.

Bias:

The judgements in *Maguire* point to a risk that the integrity and/or objectivity of a parliamentary inquiry can be compromised by purely political considerations and/or an appearance of bias. Counsel advises that members accept a self-denying ordinance that will, for example, prevent them from carrying out any media appearances or interviews dealing with the subject matter of the inquiry both before and during its currency and take care not to be unduly hostile in their questioning of a particular witness.

Recommendations

Recommendation 1: There is an urgent need for a parliamentary inquiry into the crisis in the domestic banking sector

The Committee is of the view that there is an urgent need for a parliamentary inquiry into the banking crisis for three key reasons:

1. The crisis has given rise to unprecedented costs for both the State and its citizens: the bank recapitalisation alone has cost €64.1 billion and an estimated €50 billion in shareholder value has been lost.
2. Despite the inquiries and reviews undertaken to date, there are still significant gaps in public knowledge: there are many issues requiring further scrutiny and many questions remaining to be answered. Furthermore, those who were in central roles before, during and after the crisis have not been called upon to explain publicly their decisions and actions.
3. The legislative and policy responses to the crisis need to be critically examined and if necessary further measures put in place. As the sole body charged by the Constitution with legislative powers, the Oireachtas has a duty to ensure that the legislative framework regulating the financial sector is sufficiently robust.

Recommendation 2: The Committee of Public Accounts should conduct the Parliamentary Inquiry

The Committee of Public Accounts is the most appropriate body to conduct a parliamentary inquiry into the banking crisis. It has built up a reputation for securing accountability and, through its non-partisan approach, is best placed of all the parliamentary committees to run one effectively.

The Committee is a fundamental part of the parliamentary infrastructure, working to ensure that the Government accounts for its operating policies, actions, management and use of public resources. The work of the Committee, while always focused on financial probity and regularity, is now primarily related to examining effectiveness of programmes in terms of achieving objectives.

On cost factors alone, the need to put €64.1 billion into our domestic banking sector requires examination, accountability from the State and explanations from those involved in the practice and regulation of banking.

The public has previously seen an Oireachtas inquiry that secured accountability for a major public scandal when a sub-committee of the Committee of Public Accounts conducted the DIRT inquiry into tax evasion. This led directly to legislative and parliamentary reform. The Committee believes that it can perform a similar function in relation to the banking crisis and if so requested will undertake its work in a fair, transparent and rigorous manner.

Upon a definitive decision by Dáil Éireann to proceed with a parliamentary inquiry by the Committee Standing Order 163, which currently governs the Committee's functions, will need to be amended to facilitate the holding of an inquiry (see Recommendation 4).

The Committee favours the immediate establishment of a sub-committee of its members to build on the preliminary analysis in this Report. This sub-committee would focus exclusively on the necessary preparatory work with a view to commencing public hearings, to be conducted by the Committee of Public Accounts in early 2013.

Recommendation 3: The optimal legal framework for the Parliamentary Inquiry

The Committee accepts that an inquiry by an Oireachtas Committee has limitations. It cannot make adverse findings of fact against an individual and must be based on the legal framework outlined in Appendix 1. The Committee also recognises that the constitutional principle of Cabinet confidentiality must be respected, and there will be a need to avoid prejudicing ongoing or future investigations.

Nevertheless, the Committee believes that parliamentary inquiries can and do work. The Oireachtas is also best placed to assess past weaknesses and failures in the legislative and regulatory framework with a view to reform; and Dáil Éireann enjoys a unique constitutional role in relation to the use of public money.

As detailed in the legal advice commissioned by the Committee and contained in Appendix 1, a number of options are open to the Committee in terms of the inquiry model it may adopt. Each model has its own strengths and accompanying risks, and each must be underpinned by the legislative function of the Oireachtas.

The first option is the so-called "inquire, record and report" model detailed in Appendix 1 and adopted during the Wallace Inquiry in 1994. This model allows the hearing and recording of detailed evidence from appropriate persons in public and has the benefit of ensuring all outstanding questions are asked and of placing that information on the public record. While this model does not entail the making of findings by the Committee it provides a basis from which to draw lessons and assess the need for reform. It also poses fewer risks given the complex legal landscape created by the *Abbeylara* judgment.

The second option is an inquiry that would potentially make certain findings, though these would not adversely affect the good name of individuals. This model has the advantage of allowing the Committee to distil the evidence and isolate the weaknesses and failures identified with a view to recommending future legislative reforms. It is, however, a higher risk model given the complexity of the *Abbeylara* ruling and the resulting need to avoid the direct or indirect attribution of blame to individuals.

The Committee recommends the adoption of the "inquire, record and report" model as the basic legal framework for a parliamentary inquiry. On balance, the Committee believes that the advantages of this model are clear in a number of respects:

- **Risk**: This model is less vulnerable to potential legal challenges than a model involving the making of findings;
- **Time**: The reduced legal risks associated with this model allow the inquiry to proceed efficiently;
- **Cost**: Reduced legal risks will also result in a more cost effective inquiry;
- **Outcome**: This model offers the best prospect of addressing all outstanding issues and placing them on the public record.

Recommendation 4: The scope and structure of the Parliamentary Inquiry

The Committee, in this Report, has outlined a large number of outstanding issues that remain to be examined. While some areas have received detailed treatment in reports published to date, others have not. As well as deciding on the optimal legal model to underpin the inquiry, it is necessary to decide on the appropriate scope of the inquiry's terms of reference.

The Committee believes that there is a logical sequence to be followed in the conduct of an inquiry and in this context has identified three separate pillars of inquiry:

- The bank guarantee: A significant number of questions remain to be urgently answered regarding the available policy options and decision-making processes used during the period of weeks around the guarantee. As outlined above, the direct cost to the State of the banking crisis is now estimated to be €64.1 billion. There is also a need to examine the policy and legislative responses arising from the guarantee;
- The role of banks: A major element of responsibility for the crisis lies with the banks. A significant number of outstanding questions remain on a diverse range of issues, as outlined in chapter 1. In addition, there is a need to examine how external auditors performed their functions as this role did not feature heavily in the reports published to date.
- The role and effectiveness of State institutions: This area has received the most attention in the reports published to date and a number of reforms have taken place on foot of their findings. Questions remain to be answered as to the effectiveness of these reforms especially with regard to future capacity.

The Committee is of the view that the essential starting point of any inquiry into the crisis is an examination of the bank guarantee, its origins and effects. The Committee therefore recommends that work urgently commence of the first pillar of inquiry identified above.

The Committee believes that separate terms of reference can be drafted for each pillar with a view to carrying out a focussed and phased public inquiry process. Tightly defined terms of reference tailored to the legal and practical issues that arise for each pillar are essential to a successful inquiry. In that regard, the Committee recommends a review of Section 5 of the Committees of the Houses of the Oireachtas (Compellability, Privileges and Immunities of Witnesses) Act, 1997 with a view to giving the broadest possible access to papers and records relating to the bank guarantee.

Recommendation 5: The resourcing of the Parliamentary Inquiry

It is important to highlight at this stage that the undertaking of an inquiry, while not costly in overall terms, will require additional resources in order to work efficiently and effectively.

A certain amount of specialist expertise will be needed, particularly legal and financial. Additional administrative back-up will also be required in order to effectively manage issues such as the flow of documentary evidence that is a feature of the work of any detailed inquiry.

Once up and running, the inquiry will place significant pressure on the back-up services such as broadcasting, communications, recording and security that are a feature of the work of Oireachtas Committees.

The Committee is of the view that a parliamentary inquiry into the banking crisis should not disrupt the ongoing and important work of the Houses and its Committees; and this requirement also has implications for the level of additional resources required.

The Houses of the Oireachtas Commission has a key role, in consultation with the Department of Public Expenditure and Reform, in ensuring that a budget is made available to the Committee to enable it to perform its functions.

Finally, it is important to state that the extent of such resources will of course vary depending on the chosen legal model and scope of the inquiry.

Recommendation 6: Further debate on this Report

The crisis has had, and continues to have, a fundamental impact on Irish people of all backgrounds and generations. Given the complexity of the policy choices outlined above, and the non-partisan ethos of its approach, the Committee recommends that the views of the wider membership of the Dáil be sought in order to build consensus, clarify expectations and design an inquiry that successfully addresses as many issues as possible.

This Report will be formally submitted by the Committee to the Minister for Public Expenditure and Reform on publication and laid before Dáil Éireann.

Terminology, References and Abbreviations

Throughout this paper, the word "bank" is used to refer to both banks and building societies, unless a distinction is deliberately drawn.

To avoid excessive use of footnotes, references to frequently cited sources are given in line with main text, followed by relevant page or paragraph numbers, for example "(Nyberg 5.3.1 – 5.3.4)". References to "Department of Finance Document [number]" are to the numbered documents sent to the Clerk of the Committee of Public Accounts by Mr Kevin Cardiff, Secretary-General of the Department of Finance, on 8 July 2010.

Abbreviations

AIB	AIB Bank
Anglo	Anglo-Irish Bank
BoI	Bank of Ireland
CAG	Comptroller and Auditor General
CBFSAI	Central Bank and Financial Services Authority of Ireland
DSG	Domestic Standing Group
EBS	Educational Building Society
ECB	European Central Bank
Ecofin	Economic and Financial Affairs Council
ELA	Emergency Liquidity Assistance
ESRI	Economic and Social Research Institute
FME	Financial Regulator (Iceland)
IFSRA	Irish Financial Services Regulatory Authority (the Financial Regulator)
FSA	Financial Services Authority (UK)
ILP	Irish Life & Permanent
INBS	Irish Nationwide Building Society
LTV	Loan-to-value
PAC	Committee of Public Accounts, Dáil Éireann
PwC	Pricewaterhouse Cooper

1: The role of banks in the crisis in the domestic banking sector

The reports published on the crisis to date have found that a major element of the responsibility for the crisis lies with the directors and senior management of the banks. The reports have found that the problems in banks were myriad: bank assets were concentrated in property, particularly commercial property; lending and credit policies were relaxed and frequently ignored in the interests of growth; risks relating to high loan-to-deposit ratios and the use of wholesale funding were poorly understood; risk management was ineffective and contrarian views were inhibited by competitive pressures and consensus views. Against this background the Committee believes it is essential to comprehensively examine the role of the banks themselves in the period leading up to and during the crisis.

This chapter deals with the role of Irish banks in the banking crisis. Part 1 consists of a summary of the issues addressed in the reports published to date in so far as they relate to the banks including bank governance, remuneration, lending and credit policies, funding, liquidity and capital issues, risk management, internal audit and behavioural factors that contributed to the crisis. Part 2 contains the findings of those official reports followed by Part 3, which summarises the recommendations made in those reports. Part 4 outlines the matters that, in the Committee's view, merit further investigation including the role of directors, shareholders, lending and credit policies, internal review capacity, behavioural factors and the exposure of State or semi-State bodies to failures in the property market.

Part 1: Summary of issues addressed in the published reports

1.1 Background

In the late 1990s the Irish banking market was dominated by Allied Irish Bank (AIB) and Bank of Ireland (BoI), both full-service banks with extensive retail networks, large commercial customer bases and international operations.

Anglo-Irish Bank (Anglo) was a business bank with a small branch network. Its business focused mainly on commercial mortgages and secured lending. It had a small customer base mainly comprising property developers. Its retail funding came largely from deposits from the

UK and corporations, and from wholesale market borrowings.

Irish Nationwide Building Society (INBS) was originally a mortgage lender but, following changes to the Building Societies Acts, gained access to wholesale funding markets and increasingly focused on lending to residential developers. Its business model was similar to that of a venture capitalist; it would finance the acquisition of zoned sites that did not have planning permission with a view to selling the site once planning permission had issued. To this end, it commonly entered into profit-sharing arrangements with its developer customers, taking 10-25% of the uplift in value. Security was commonly limited to the development site only, putting the investment at risk if planning application or onward sale failed.

Other lenders included The Educational Building Society (EBS) and The Irish Permanent Building Society, later Irish Life & Permanent (ILP). In the early 1990s these concentrated on mortgage lending to private customers and did not operate in the commercial property market, though EBS began to do so in 2005.

Public and political perception of the banks was strongly influenced by scandals such as those revealed by the DIRT inquiry and by increasing consumer awareness and assertiveness in the Irish public. The view that Irish banks were uncompetitive and consumer-unfriendly was widely held. The entry of foreign (mainly UK-based) banks into the Irish market was broadly welcomed as providing a stimulus for competition.

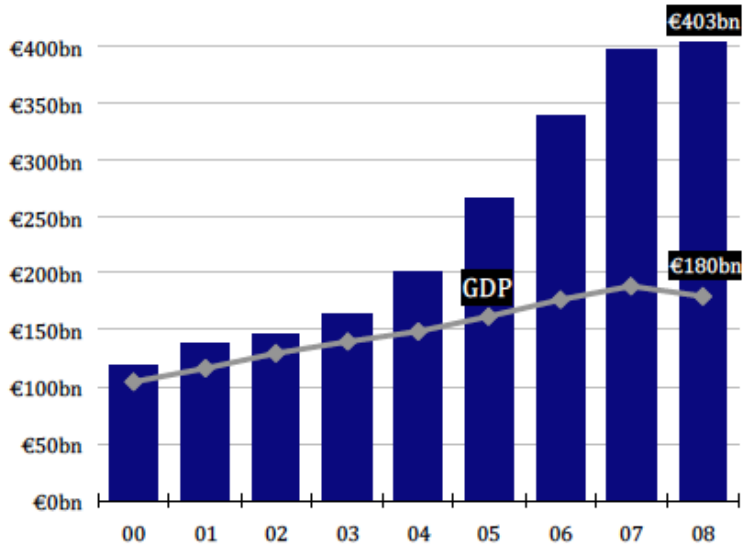
The banking model

The period from the late 1990s saw increasing integration of international financial markets, facilitating cross-border investment and borrowing. In Europe the European Monetary Union (EMU) project led to the introduction of the Euro in 1999, eliminating currency exchange risks on transactions within the Eurozone. In the Eurozone and elsewhere there was a strong pro-growth sentiment, which induced central banks – including the ECB, the US Federal Reserve and the Bank of England – to keep interest rates low, especially when inflation was low.

In Ireland low interest rates and increasing demand triggered a significant rise in house prices from about 2000. At the same time wage levels started to rise and competitiveness deteriorated. House prices developed their own momentum and buyers increasingly bought in

expectation of capital gains or to avoid imminent price rises. New entrants to the residential mortgage market brought products such as higher loan-to-value (LTV) mortgages (such as the 100% mortgages introduced by Bank of Scotland (Ireland)), while the introduction of mortgage brokers further increased competition for share of the mortgage market while shrinking lenders' profit margins.

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



Source: Annual Reports & Eurostat

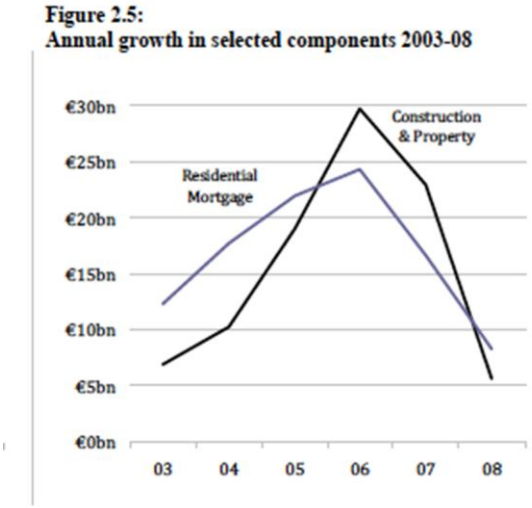
Growth in advances to bank customers, taken from Nyberg Fig. 2.1

An important feature of Irish banks' strategies was to maintain market share and independence. Declining margins and reduced scope for increasing their shares of the domestic mortgage market induced Irish lenders to increase the number of loans they offered, with a consequential reduction in the quality of loan appraisals, and an increase in the LTV ratios they were prepared to accept (Honohan 2.18, Nyberg 2.1.14). The search for higher-yielding investments also induced them to increase their appetite for risk and to look outside their traditional lending markets.

The main area into which banks seeking higher yields expanded was commercial property. This trend was led by Anglo but the other banks (except for IPBS) followed at various stages between 2000 and 2005. Property-related credit grew from 45% of all credit at the end of 2002 to 60% in December 2008.[4] Following management changes in 2005, Anglo rapidly accelerated its pace of growth. Its loan book grew from €23.7 billion in September 2004 to €72.2 billion in September 2008 (Nyberg 2.4.1 – 2.4.4). INBS also accelerated its commercial property lending, possibly in anticipation of demutualisation, which was expected to take place in 2008 (Nyberg 2.4.6 – 2.4.10). AIB and BoI, faced with the rapid expansion of Anglo's market share and balance sheet, followed suit.

From 2004 there was a strong shift towards speculative property lending (that is, where no construction or rental contract is in place); this segment of the total lending market (which, it must be noted, also grew rapidly) rose from 8% in 2002 to 20% in 2008 (Nyberg 2.2.8 – 2.2.9). Overall, domestic property-related credit (including both residential and commercial) grew by nearly €200 billion between 2003 and 2008, representing 80% of all growth in credit (Nyberg 2.2.5).

[4]See Nyberg, Fig. 2.4, p.15



Annual growth in property lending by sectors, taken from Nyberg Fig. 2.5

1.2 Bank governance

The board of a bank is responsible to shareholders/members and to depositors for the soundness of the bank. The Chairman leads and directs the board, while the Chief Executive Officer (CEO) implements board policies within defined policies and limits, and advises the board on operational matters and developments. In banks a number of board committees receive reports directly (i.e. independently of the CEO) on matters including risk and compliance, funding, remuneration and audit. These are unique responsibilities of the directors; it is up to them to ensure that they receive relevant and correct information and act on it.

Sound bank governance requires appropriate systems and procedures to ensure that:

- operations are carried out within legal, regulatory and board-approved limits;
- relevant data is available to decision makers to identify emerging risks and opportunities;
- full and correct returns are made to regulators;

- a true and fair picture of the state of the bank's affairs is presented to shareholders and the public in published accounts (Nyberg 2.5.1 – 2.5.3).

Governance in Anglo

Anglo had poor governance structures and procedures and risk controls during its period of high growth. Weaknesses in these areas were identified by auditors and regulators in 2003, 2006 and 2008. For example, the Chief Risk Officer function was merged with that of the Finance Director in 2007, undermining the priority attached to the risk function. In 2005, at the time of the change of management, the CEO moved directly to the position of Chairman, in contravention of best practice. The major change in personnel at that time may have contributed to a changing interpretation of governance principles (Nyberg 2.5.6).

Management showed a lack of awareness of risk and focused their attention on business growth. They did not perceive their existing systems and procedures as inadequate. While the board had appropriate sub-committees, some board members were experienced in fields other than banking and depended on senior management for insight into the need for reporting systems.

Directors (including non-executive directors) and management had large shareholdings in the bank, which may have coloured judgement at a time of high growth (Nyberg 2.5.5 – 2.5.8).

Governance in INBS

Governance in INBS was problematic from an early stage in Ireland's period of economic growth. It adopted a very flat management structure in 1997 when the board delegated its powers for the practical, effective and efficient management, promotion and development of INBS to the Managing Director. It is not clear what if any limits there were to this power, and many staff reported directly to the Managing Director.

INBS did not have a number of standard board committees, and those that it did have operated with poor regard to appropriate structures and procedures, despite repeated representations from the Financial Regulator. Risk control functions were limited to selecting trustworthy commercial borrowers to lend to and evaluating the potential of their sites. The credit function was dominated by lenders, preventing it from taking an adversarial stance.

INBS board members had little banking experience and were often called on to approve large loan proposals with limited documentation or evaluation. Few proposals were refused. Non-executive directors apparently assumed that past successes validated the INBS's strategy and procedures. Repeated requests by the Financial Regulator to improve governance and procedures were noted but resulted in little change.

The lack of robust structures and risk management meant that INBS did not have even basic analysis or reporting of internal sector limits, concentration risk or the adequacy of security. The lack of internal controls and management procedures was evident from INBS's extremely low cost-income ratio – 10% in 2007 – compared with 56% in the EBS or the median for UK building societies of 70% (Nyberg 2.5.9 – 2.5.13).

Governance in other banks

The quality of governance structures and procedures in Banks, other than Anglo and INBS, deteriorated as pressures increased to grow the size and number of loans processed.

Some bank CEOs seem not to have had a full appreciation of the risks involved in lending, while credit and risk management expertise was not given due emphasis. A sales culture grew in which issuing a loan came to be treated as a sale rather than the acquisition of a potentially risky asset.

In AIB large commercial property loans were handled by the retail division rather than a specialist corporate lending division. Divisional structures placed competitive pressures on the Republic of Ireland division to maintain high growth and profits. This undermined the quality of evaluation and supervision given to Irish commercial property loans. Credit supervision was carried out on a divisional basis, making it harder to assess emerging risks (such as sectoral concentration) across the AIB Group.

BoI had a centralised Group Credit Committee, which allowed it to reallocate loans to specialised divisions that could give them more appropriate attention. While this was not always done, it may have saved BoI some of the exposures later faced by AIB.

EBS had appropriate governance structures and procedures but these were poorly implemented, leading to significant impairments (Nyberg 2.5.14 – 2.5.18).

1.3 Remuneration

While financial incentives are unlikely to have been the major cause of the crisis, they contributed to the expansion of bank lending. Remuneration was generally based on models developed by specialist consultants and benchmarked against comparable Irish and UK companies. The models did not take account of risk and rewarded rapid loan asset growth. This incentivised volume at the expense of quality. CEO remuneration in Anglo and INBS was significantly higher than in other Irish banks while, relative to the size of its loan book, that in AIB was lower than in other banks (Nyberg 2.6).

Among lower-level staff, rewards such as bonuses based on turnover, divisional growth or sales targets also militated against quality of loan assessments (Regling & Watson, pp. 17, 35).

1.4 Lending and credit

A bank's credit policy is set by its board and defines its risk appetite, lending limits and the credit products that it offers. All banks deviated significantly and materially from their stated credit policies (Nyberg 2.7.1 – 2.7.2).

Anglo

Responding to competitive pressure, Anglo relaxed its credit policy three times between 2005 and 2007. Anglo had poor credit management processes with a strong emphasis on accommodating problematic applications, speed of approval and on not losing its existing customers to competitors. It sometimes relied on personal guarantees without properly investigating borrowers' net worth or commitments to other lenders.

Exceptions to Anglo's credit policy were reported as a percentage of Anglo's loans rather than by reference to customer or the market segment. There was poor reporting of arrears and impairments. As a result the board may not have been aware of the deterioration of Anglo's asset base.

In 2006 Anglo moved to "de-risk" its balance sheet by deciding not to take on new customers for development finance. However, it continued to make large loans to its existing customer base.

In July 2008 Mr Willie McAteer, Executive Director of Anglo, told the Joint Committee on Finance and the Public Service that Anglo's lending for construction and land purchases had been "prudent", and he rejected the suggestion that the banks had been "foolhardy in recklessly lending and driving up values". He said that the quality of Anglo's assets could be seen in its audited results: "the figures speak for themselves in that regard".[5]

INBS

INBS's loan approval and administration were not up to accepted banking standards and lacked any essential check and balances or appropriate IT systems that could have helped reveal developing risks. Files were poorly maintained and loans were not regularly or properly reviewed. Commercial property loans for developments in Ireland, the UK and Europe grew to dominate INBS's business between 2002 and 2007. INBS had inadequate or very flexible credit policies and no effective credit risk management function.

INBS's loan book grew from €3.5 billion in 2002 to €12.3 billion in 2007, of which commercial property loans comprised €7.4 billion or 60%. Its policy of lending to a small group of long-term commercial property developers caused INBS to have large exposures to those developers. Its top 25 customers accounted for 51% of its commercial loan book. This high concentration risk was exacerbated by INBS's policy of limiting its security to the development site (i.e. without collateral security) and relying on uncertain grants of planning permission and the sale of the site.

Other banks

As competitive pressures forced banks towards riskier lending, they relaxed their credit policies. These changes to policy tended to evolve by exceptions becoming standard practice – what has been termed "procedures creep".

As the pressure to lend increased, credit policies became slacker and in some cases these became guidelines rather than strict rules. AIB and BoI increasingly shifted their focus towards speculative property construction development and site financing. While these offered high returns they carried greater risks. There was a slow slide towards larger and riskier lending, with increasing LTV ratios, rising loan sizes and practices such as rolling up

[5]Joint Committee on Finance and the Public Service Deb. 2 July 2008, pp. 32 - 33

interest or lending on an interest-only basis. Risky products such as remortgages, buy-to-let loans, equity-release products, tracker mortgages and more complex types of credit became increasingly common. Pressure to win and retain customers increased banks' risk appetite.

Donal Forde of AIB commented to the Finance Committee in July 2008 that his bank's decision to lend was not determined purely by the value of the asset that the lender sought to buy, but by the lender's ability to pay from their own resources. "We are a country of free choice … people have paid what might be regarded as foolhardy sums for assets but, from our perspective, the funding of the asset is coming from somewhere entirely different."[6]

Banks did not seek or enforce limits to lending based on their exposure to connected parties or particular sectors of the market. Loans were approved on the merits of the particular case without regard to the wider state of the bank's own exposure or that of other banks to the same market. Banks also were reluctant to syndicate loans with other lenders. Apart from spreading the risk associated with the loan, doing so would have allowed members of the syndicate to understand borrowers' exposures to other banks on other projects and so the extent to which banks' security may have been impaired (Nyberg 2.7.12, 2.7.29).

Regling & Watson observe that some EU countries address this risk by means of credit registers, which can collate information on borrowers' exposures and ability to pay and allow banks to understand exposure across the board.[7]

1.5 Funding, liquidity and capital

The Irish banks' customer deposits were increasingly inadequate for funding their growing lending. The alternative source used was wholesale funding, which, in a climate of low interest rates and high liquidity, offered a cheap and seemingly inexhaustible source of funds (Nyberg: Fig. 2.17).[8] This exposed banks to fluctuations in international interest rates and changes in market sentiment, as well as lenders' perception of their borrower, which can be very volatile. A negative impression of any one Irish bank was liable to affect the perceived creditworthiness of all ("In wholesale funding there is only one depositor" – i.e. when one lender leaves, all follow).

[6] *Ibid.* pp. 33 - 34
[7] Regling & Watson p. 43
[8] See Nyberg, Fig. 2.17, p. 39

Where a bank's treasury function was regarded as a profit centre, a conflict developed between the need to supply longer term (and hence more stable) funding for the banks and, on the other hand, to look for loan capital with lower interest rates, which often had shorter maturity terms. Such conflicts should not have been allowed to arise.

Although the increasing reliance on wholesale funding created a liquidity risk if those funds dried up, the Irish banks were satisfied that relying on a variety of overseas markets mitigated that risk. However, the decline in global liquidity following the Bear Sterns rescue in 2007 placed the Irish banks under increasing liquidity pressure, with credit having shortening maturity dates and higher interest rates. This intensified dramatically in 2008 when negative perceptions of Irish banks became widespread and wholesale markets declined to lend to them.

Increased use of wholesale funding changed the loan-to-capital ratios of the banks, reducing the proportion of shareholder funds and increasing that of subordinated loan capital.[9] One effect of this was that, while the banks generated profits, the earnings per share of the banks increased as the portion of their capital represented by shares declined. Despite the weakening of their capital structures by their reliance on loan capital, higher earnings per share valuations forced up banks' share prices. Regling & Watson observe that the question of manipulation of share markets may deserve consideration, though they do not suggest that this was a generalised feature of Irish financial services.[10]

The International Accounting Standard Rule IAS 39 was introduced in 2005. This applied an "incurred loss" model to the way in which bank accounts treated impaired loans. Under this Rule banks could no longer make provision for loan impairments that might arise but that had not yet actually taken place. Instead, such impairments could be provided for in accounts only when they arose. The effect of this was pro-cyclical in that it treated all loans as healthy until actually impaired. Conversely, a downturn that impaired loans would provoke a sharp fall in banks' asset bases. If banks had been able to make an impairment provision of as little as 1.2%, it might have reduced the attractiveness of low-margin loans and caused them to increase provisioning for risks. Another approach to this problem would have been to adopt a

[9]Subordinated debt is interest-bearing loan capital that either matures on a particular date ('dated loan capital') or is undated, i.e. repayable on demand or upon the occurrence of specified conditions.
[10]Regling & Watson, p. 36

dynamic provisioning model similar to the one introduced by the Bank of Spain for Spanish banks in 2005, whereby provision can be made against losses at the time that a loan is made (rather than when it occurs), based on statistical models of the probability of losses (Nyberg 2.8.8 – 2.8.14).

1.6 Risk management

Management and boards did not, in general, appreciate the two main risks to which banks were exposed:

- the risk that development projects would not obtain the funding required to repay the bank's investment; and
- volatility in the bank's own funding.

Inadequate governance and systems also exposed banks to operational risks.

Most banks had inadequate and ineffective Management Information Systems (MIS). It did not always provide timely and adequate information to highlight property-related risks.

The introduction of Basel II recommendations on capital standards and similar projects may have reduced resources available for risk assessment. Also, there seems to have been undue confidence in quantitative models.

There was insufficient attention to diversification; many banks considered a spread of property investments in different market segments or countries to have been adequate. When stress tests were conducted, the most severe shock scenarios were discounted because banks believed that their portfolios were sufficiently diversified. Similarly, there was no consideration of risks to both property investments and liquidity arising simultaneously. Good risk management should consider all scenarios including the most unexpected.

Anglo

The risk management function in Anglo was inadequately resourced and enforced. There were frequent deviations from the credit policy, but there is no evidence that IT systems were ever appropriately interrogated for risk analysis. The Financial Regulator raised the inadequacy of Anglo's risk function but it is not clear that the Risk Committee or the board ever saw these letters.

INBS

INBS had no formal risk management function or relevant information systems. The only risk mitigation measures were to deal with known and trusted developers and to evaluate the sites they proposed to develop.

Other banks

All had risk management structures, but the quality of implementation and resourcing varied. AIB and BoI had well-resourced risk functions that were given appropriate attention by management. However they were hampered by poor implementation and changing lending targets and credit policies. There was a general lack of appreciation of concentration risk. MIS systems were unable to demonstrate this risk or to consolidate information on sector exposures.

ILP's risk management system and processes functioned very well and lending was strictly controlled. EBS's system was not well resourced and lacked influence with its board (Nyberg 2.9).

1.7 Internal audit

Internal audit is the third line of defence after business unit control functions and risk and compliance functions. Its purpose is to give assurance of the effectiveness of the corporate governance and control environments.

All banks had internal audit functions with clearly defined mandates. All reported to the CEO or Audit Committee of the board in accordance with best practice. Internal audit was carried out with varying degrees of effectiveness and professionalism in the banks.

Anglo

Anglo's internal audit function was assessed by external consultants in 2004 as a "strong performer" but with scope for improvement. Subsequent internal and external reviews were positive. However, Anglo's Risk and Compliance Officer was responsible for overseeing Credit and Treasury risks, which is where many of Anglo's difficulties arose. This reassignment weakened internal audit ability to challenge credit decisions.

In 2009 Anglo's Head of Internal Audit, Mr Walter Tyrell, appeared before the Joint

Committee on Economic and Regulatory Affairs. He explained that his function was focused mainly on verifying that governance procedures were followed rather than assessing the qualitative nature of transactions.[11] His role involved review of Anglo's Credit Committee minutes, which disclosed the names of borrowers and the sizes and purposes of their loans. However, despite loans to Mr Seán Fitzpatrick, Executive Chairman of Anglo, not being listed in the bank's annual report, he did not flag the evident anomaly.

INBS

The internal audit function in INBS was inadequate for a growth-oriented commercial property lender and much of this function had to be outsourced. The Financial Regulator identified significant weaknesses in the internal audit function and made numerous requests and recommendations for improvement, including a request for an external evaluation of it.

Other banks

Challenges existed in relation to the audit practices in other banks where the remit of Audit Committees tended to be limited in relation to reviewing the effectiveness of risk management. In some cases, recommendations were set aside on the basis of representations by management, undermining the internal audit function (Nyberg 2.10).

AIB's Internal Auditor, Mr Eugene McErlain, investigated certain irregularities in 2001 and 2002. The first concerned a share dealing structure for AIB's stockbroking subsidiary, Goodbody. The second concerned refunds to customers of overcharged administration fees. AIB notified both matters to the relevant authorities. Shortly afterwards, Mr McErlain left AIB in circumstances that he claimed amounted to constructive dismissal. AIB apologised to Mr McErlain in 2009.[12]

1.8 Behavioural factors

There were widespread indications of herding[13] and groupthink[14] (including "disaster

[11] Joint Committee on Economic and Regulatory Affairs, Deb. 3 February 2009, p.28
[12] Joint Committee on Economic and Regulatory Affairs, Deb. 21 May 2009
[13] '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.' (Nyberg p.103)
[14] '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.' (*Ibid.* p. 102)

myopia"[15]) in Irish banks between 2003 and 2008. This could be heightened where dominant personalities led companies or divisions. Conforming to team values was expected. Contrarian or even divergent views became unwelcome, met resistance and even sanction. There was a general denial of accumulated risk.

There was a willingness to follow the lead of competitors without questioning the wisdom of either the competitor's choice or the decision to follow it. None of the banks seems to have considered alternative or contrarian strategies. This is indicative of herding behaviour. Similarly, the lack of challenging discourse or analysis suggests groupthink within the banks.

Non-executive directors lacked relevant experience or expertise. There seems to have been a wish to avoid dissension at boards such that, despite sometimes vigorous debate, management proposals were rarely rejected.

The widespread belief in a "soft landing"[16] for the property market persisted into 2008 despite the absence of detailed analysis supporting that view. Even where boards were presented with analysis showing the potential for a property crash or loss of wholesale funding, these were regarded as too extreme. In consequence there seems to have been no resulting action by boards. This can be seen as a consequence of groupthink.

These positive views of the property and funding markets – and hence the banks' tendency to maintain them – were supported until late in the day by the majority of economists, commentators, Government, regulators and the media (Nyberg 2.11).

Part 2: Findings contained in published reports

2.1. The major responsibility for the crisis lies with the directors and senior management of the banks that got into trouble (Honohan 1.6).

2.2. Mortgage brokers and other intermediaries probably contributed (Honohan 1.6).

2.3. A critical weakness was in the concentration of bank assets in property, particularly commercial property, and in the concentration on a relatively small number of large borrowers (Regling & Watson p. 35).

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[15] 'A tendency over time to underestimate the probability of low frequency shocks (i.e. "low probability / high impact risks')." (*Ibid.*)

[16] 'A term used to describe the shift of economic growth from high to low, or potentially flat, while avoiding recession.' (*Ibid.*)

2.4. The widespread confidence in continuing growth and – when markets began to fall, that there would be a soft landing ("disaster myopia") - points to the existence of a national speculative mania in Ireland between 2003 and 2008, centred on the sale and acquisition of property (Nyberg 5.4.3).

2.5. Competitive pressures, strong personalities and "bandwagon effects" inhibited contrarian opinions or analysis and contributed to groupthink and herding behaviour. Within bank divisions "silo thinking"[17] inhibited wider analysis that might have disclosed risks at the organisational level (Nyberg 2.11.1 – 2.11.3).

2.6. At least some financial market professionals must have had doubts on the sustainability of banks' practices but did not voice them because of the pressure of consensus (Nyberg 5.5.13).

2.7. There were extensive and system-wide failures of governance in banks, some of which were deliberate and intentional. Failures included weak boards that valued consensus too highly, inexperienced non-executive directors, failure to question management opinions or decisions, and unwarranted trust in policies and procedures (Regling & Watson p. 35; Nyberg 5.2.4).

2.8. Remuneration in banks placed insufficient emphasis on risk (Nyberg 5.2.6).

2.9. Lending and credit policies were relaxed and frequently ignored in the interest of growth. Sectoral and individual lending limits, particularly in relation to commercial property, were regularly exceeded (Nyberg 5.2.6).

2.10. Rising property prices went unchallenged and created confirmation bias. Equity release products reduced collateral buffers available to banks when overheated markets cooled (Nyberg 5.2.8).

2.11. Treasury departments that were treated as profit centres were incentivised to prefer low-cost short-term funding at the expense of more stable longer-term funding (Nyberg 5.2.10).

2.12. The risks of increased loan-to-deposit ratios and of using wholesale funding were

[17] 'Acting within a narrow legal or organisational mandate with little or no concern for overall needs or developments.' (Nyberg p. 103)

not always understood; limitations on the ability to use bank assets as collateral were not appreciated (Nyberg 5.2.11).

2.13. Risk management was ineffective, poorly understood and not given due priority. Concentration risks in particular were misunderstood. Mitigation strategies such as syndication were not used (Nyberg 5.2.12).

2.14. The principles-based regulatory model fostered a belief that banks were better able to judge prudential matters than regulators. This, and a perception that regulation focused mainly on consumer issues, diminished the priority accorded to regulatory matters (Nyberg 5.2.13).

2.15. Non-compliance with prudential rules and guidelines frequently went unsanctioned by the Financial Regulator. Banks drew undeserved comfort from the Regulator's acquiescence (Nyberg 5.2.14).

2.16. Authorities entered into a "loop of excessive reliance" on accounting standards, internal risk structures, credit rating systems and board sub-committees. This was a systemic failure that allowed danger to grow until it was too late (Nyberg 5.2.15).

Part 3: Recommendations contained in published reports

In this section the recommendations of the various reports are presented verbatim.

3.1. "There is a need to probe more widely the scope of governance failings in banks, whether they were of a rather general kind or (apparently in far fewer instances) connected with serious specific lapses, and whether auditors were sufficiently vigilant in some episodes." (Regling & Watson, p. 6)

3.2. "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.

3.3. 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.

3.4. 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.

3.5. 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." (Nyberg, pp. ix - x).

3.6."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." (Nyberg p. x)

3.7. "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.

3.8. In this regard, it is noteworthy that the Bank of Spain (BoS) had introduced a dynamic provisioning (DP) model for Spanish banks in 2000. BoS required the Spanish banks to continue using DP after 2005 notwithstanding the EU-mandated IFRS adoption." (Nyberg 2.8.13, 2.8.14)

3.9. "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." (Nyberg 3.5.6)

3.10. [Requiring financial institutions to issue annual Directors' Compliance Statements] "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." (Nyberg 4.5.12)

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

The Committee, having assessed the published reports and committee debates, is of the view that there are a range of outstanding issues in relation to the management of the banks.

4.1 Bank governance

The Committee believes that available documentation demonstrates that banks pose special corporate governance problems. It is the Committee's view that failures in corporate governance within the banks during the boom and in the subsequent crisis led to significant questions regarding board members. Such questions surround the competence and independence of board members, both individually and collectively; their appointment, background, diversity, understanding of banking issues, how they were briefed and by whom.

In the Committee's view the following questions on bank governance remain to be answered:

Q1. Should good corporate governance in financial institutions also require boards to consider the public interest generally, as well as the interests of shareholders, depositors and other creditors, in order to mitigate serious moral hazard problems?

Q2. Have the conditions of corporate governance that facilitated the banking crisis been remedied? In particular, how have banks responded to the findings and recommendations of the Regling & Watson, Honohan and Nyberg reports?

Role of Directors leading up to the crisis

Q3. Who made appointments to bank boards and how were they selected?

Q4. Who were the bank directors and officers who approved major transactions and governance decisions that contributed to the crisis?

Q5. Are such actions by individuals subject to regulatory, professional or legal sanction?

Q6. Do those who still work in financial institutions meet current standards of fitness and probity?

Q7. What experience and qualifications did the non-executive directors of the Irish banks have in the period leading up to the crisis?

Q8. How did the procedures for the nomination and appointment of non-executive directors work in practice?

Q9. What were the levels of diversity among bank non-executive directors ? Were the banks drawing from a wide enough pool of truly independent non-executive directors?

Q10. What was the typical time commitment for bank non-executive directors?

Q11. How did bank boards function in practice? Were they (too) collegiate and consensus-seeking? Were professionally argued contrarian views encouraged?

Q12. Did the structure of bank boards have an impact upon their ability to both foresee and then deal with the crisis?

Q13. There was almost total male domination of bank boards and senior management. Research suggests that there are distinctive differences in the risk taking and risk appreciation capacity and processes of men and women. Was the male dominance of the bank boards and senior management a contributory feature?

Q14. Has the gender diversity in boards and senior management of banks changed since the crisis? Have the banks taken steps to enhance female participation in decision making and senior banking positions?

Q15. Were bank boards collectively, or directors individually, sufficiently independent of internal dominant personalities or external parties such as borrowers, developers or estate agencies?

Q16. Were dissenting opinions suppressed by bank boards and top government regulators? If so, how?

Role of directors since the crisis

Q17. What is now being done to ensure that, in future, the environment within the bank boardroom is one of effective challenge of the executive?

Q18. Has appropriate provision been made for non-executive directors to receive the induction, training and support they need in order to function effectively?

Q19. Are there any new protocols on experience required in order to become a board member?

Q20. Have time commitments increased?

Q21. Has the position of the chairman of a bank been strengthened?

Q22. Has the role of Senior Independent Director become part of the corporate governance of Irish banks?

Q23. What procedures have been put in place for bank boards to conduct formal evaluations of their own performance, including the use of external facilitators?

4.2 Remuneration

It is the Committee's view that the role of remuneration in incentivising reckless lending practices by bank employees, as well as levels of remuneration agreed by board members for senior management merit further examination. In particular:

Q24. Did inappropriate compensation schemes undermine lending process controls?

Q25. Have incentivisation models changed since the crisis?

4.3 Shareholders

The Committee is of the view that there are a number of issues regarding shareholders to be examined. The evidence from banking crises internationally indicates that in the years leading up to the crisis, equity investors around the world failed to act as stewards in relation to the companies in which they held shares and therefore did not hold managers properly to account. Market disciplines were weak, short-termism was predominant and, while profits continued, there were few incentives for shareholders to challenge management practices. A further issue was the increased use of complex financial instruments by equity investors. The Committee believes that there were similar problems in Ireland and that the management of some of the Irish banks displayed comparatively weaker corporate governance practices than would have been tolerated by shareholders in other jurisdictions.

Questions arising from this issue include the following:

Q26. What was the pre-crisis structure of ownership of the Irish banks? Were there particular features of the Irish equity markets that exacerbated weaknesses in the corporate governance of banks?

Q27. Did bank directors' shareholdings in their banks contribute to the crisis?

Q28. To what extent did complex financial instruments such as contracts for difference contribute to difficulties in Irish banks?

Q29. What risks do such complex financial instruments pose in the future?

4.4 Lending and credit

The Committee notes that reports published to date have found that all banks deviated significantly and materially from their stated credit policies (Nyberg 2.7.1 – 2.7.2). A number of questions have arisen in the aftermath of the crisis regarding lending criteria that relate to evidence of dissent, both internally and externally, from academia and journalism, the collateralisation of loans, credit rating and credit registers. The Committee believes that the following questions should be addressed:

Q30. How did banks deal with breaches of internal governance procedures and of lending criteria? (See Regling & Watson p. 35, Nyberg 2.5) Existing reports describe accommodation of these by banks as being due to competitive pressures. In addition, what evidence exists of countervailing arguments or of internal dissent on poor-quality lending and governance? (See Nyberg 5.5.13)

Q31. What evidence exists that other parties (e.g. credit unions and mortgage brokers) undermined attempts to regulate lending criteria, for example by assisting retail borrowers to overstate income and using credit union borrowings to enhance LTV ratios?

Q32. Did estate agents and valuers provide sound valuations for properties for which loans were provided?

Q33. There is clear evidence that the banks did not take proper security as collateral for loans advanced. Did policy on loan collateral and security change? If not, why did the normal checks and controls fail? (Relevant factors include due process, registration of liens, solicitors undertakings etc.)

Q34. Did banks monitor reports from external actors in academia and journalism flagging the increasing concerns about property and related lending? What was the banks' response to these?

Q35. Was there sufficient external academic/research capacity in Irish universities/research institutes to independently and critically analyse the financial strains being caused by Irish banks' increasing reliance on complex financial instruments?

Q36. Would a national credit register have helped to avoid or mitigate the effects of the

crisis?

Q37. Does the credit rating system now provide transparent and effective external credit ratings of banks and financial instruments?

Q38. How have the internal credit risk assessments of the banks changed?

4.5 Funding, liquidity and capital

The Committee believes that in Ireland lending expansion made the interbank market a more important funding source than depositors. A more detailed explanation is required as to the changes of funding composition throughout the years leading up to the bank crisis, and the following questions need to be answered (see Appendix 4 for further information on funding in the banking sector):

Q39. During the crisis, how did bank-to-bank lending contribute to risk exposure to market volatility, such as the fluctuation of international interest rates?

Q40. What controls were in place at EU and European Central Bank level to draw official attention to the rapid increase in funding to Irish institutions in the years prior to 2008?

Q41. During the autumn of 2008 it was believed that there was a liquidity rather than a solvency issue in the banks. How was this conclusion reached? In particular, what evidence supported it?

Q42. Why did it not become apparent at that time that the security and documentation underlying the future NAMA portfolio was weak?

Q43. Why was individual loan concentrations so poorly understood?

Q44. Why were estimated haircuts so much less than the haircuts that were subsequently applied?

4.6 Risk management

The Committee notes that previous reports on the banking collapse have found that management and boards did not, in general, appreciate the two main risks to which banks were exposed: that development projects would not create a return on a bank's investment; and volatility in a bank's own funding.

The Committee is of the view that the following questions remain to be answered as to how

such a lack of appreciation was allowed to persist:

Q45. Why were the concerns of regulators in relation to risk management not reflected in tighter risk controls by the banks?

Q46. How did banks select their risk models? Were more suitable models available and, if so, why were they not chosen? How have risk models currently in use been revised?

Q47. What research, if any, was contracted from academia or research consultants in Ireland or abroad on the sustainability of the emergent business model?

Q48. How did banks deal internally with individual and systematic breaches of regulatory norms brought to their attention by IFSRA? (See Honohan 4.47, 5.23; Nyberg 2.10.3, particularly with regard to INBS). Were disciplinary measures imposed? What remedial action was taken?

Q49. Did banks seek to overturn regulators' decisions by means of representations to senior regulators? (Honohan 1.13).What, if any, evidence is there of this practice?

Q50. What procedures have been put in place for bank boards to conduct formal evaluations of their own performance, including the use of external facilitators?

Q51. How can banks' risk and credit models be strengthened so as to prevent misjudgement and failures such as those that led to the crisis?

4.7 Internal review capacity

The Committee is of the view that a major weakness in controls arose from the failure of internal audit systems to raise the alarm from 2001onwards when funding and lending went seriously awry. The Committee considers that a number of questions need to be answered in relation to the background, training, reporting structure and mandate of internal auditors and other reviewers within the banks, in particular:

Q52. Had the banks' internal economic and analyst personnel the ability or capacity to independently analyse the organisations or the industry in Ireland?

Q53. Why did Anglo's internal audit function fail to highlight and act on irregularities including directors' loans and the ILP transfers? Did it detect them?

Q54. Was Anglo's internal audit steered away from examining directors' loans? (Joint Committee on Economic and Regulatory Affairs Debate, 3 February 2009, pp. 22-

23)

Q55. Are banks' internal audit functions sufficiently independent and resourced, and do they have means of flagging concerns where management does not respond suitably to those concerns? (Nyberg 2.10.4)

Q56. How can whistleblowers or dissenting voices in banks be assured appropriate attention? (Nyberg 5.5.12 – 5.5.13)

4.8 Behavioural factors

The Committee is of the view that evidence of behaviour, such as groupthink and herding mentalities, raises questions on the training and working environment within which bankers operate.

Q57. What is the role of the professional formation of bankers, in terms of their formal education and their professional qualifications? Is there sufficient behavioural, ethical and critical/logical thinking embedded in these formations?

Q58. The presence of foreign banks in Ireland is said to have provided a stimulus for competition. Competition could create moral hazard problems and incentivise more risk taking. How was bank competition changed in the lead up to the crisis, and how has foreign bank presence played a role in creating competition and affecting domestic banks' risk taking behaviour?

4.9 Role of State or semi-State bodies

The Committee is concerned about the effect of the failure of the property market on State or semi-State bodies. In particular:

Q59. Were State-owned, or State-sponsored bodies involved in speculative or failed property transactions with covered banks? Which bodies were involved and what is the State's exposure?

2. The role of external auditors in the crisis in the domestic banking sector

Introduction

The Committee notes that the banks that required State support during the financial crisis received unqualified audit reports throughout the years leading up to the bank crisis. In this context, the Committee believes that the question of why the Irish banks required support needs to be answered. The reports published on the crisis to date have found that auditors should have recognised the risks posed by banks' business models, property and funding exposures and governance failings and that, in the absence of a specific requirement to do so, auditors did not challenge banks on risks deducible from audit findings. Against this background the Committee believes that it is essential to comprehensively examine the role and performance of external auditors in the period leading up to the crisis.

Part 1 of this chapter provides a summary of the published reports around the key themes of external audit reports to shareholders, communications by external auditors with client banks and the IFSRA. Parts 2 and 3 highlight the findings and recommendations contained in the published reports. Finally, Part 4 outlines issues identified by the Committee that require further investigation, namely; auditing before and during the crisis, auditor-client relationships and the duties of auditors.

Part 1: Summary of issues addressed in published reports

1.1 External auditors and client banks

Auditors rely on information/evidence provided to them by their clients the banks. The financial statements are the product of the accounting methods (called 'accounting policies') selected by the board of directors. The auditors audit whether the numbers in the financial statements are the product of application of the accounting policies selected by the board of directors. It is not the auditors' job to challenge those accounting policies, unless they do not comply with accounting standards.

The financial statements subject to audit are essentially historic in nature, describing the state of the company as at the end of the previous accounting period and including largely historic

amounts, particularly for assets. However, audited bank financial statements are generally produced very promptly after the accounting period to which they relate.[18]

Exacerbating the problem is that some recent accounting standards attempting to curb some accounting abuses became 'pro-cyclical', i.e., they were unable to curb the impact of the boom business cycle. For example, in the boom period banks were precluded by accounting standards from setting aside provisions for bad debts when there was no evidence such provisions were needed. Accounting standards such as IAS 39 Financial Instruments also added pro-cyclicality by introducing 'fair value' accounting, further inflating bank balance sheets.

Auditor's opinions on financial statements, contained in audit reports, follow standard wording based on guidance in auditing standards. Thus, most audit reports contain almost identical wording. Audit reports/auditor opinions are either 'unqualified' (i.e. clean) or qualified (i.e. the auditor has reservations and cannot provide a clean audit report). Qualified audit reports are relatively rare, and certainly were rare during boom economic conditions. Qualified audit opinions can have very adverse consequences for clients.

Audited financial statements are relied on by investors, and are also read by regulators and the public. Many of these users do not understand the inherent limitations of the information in audited financial statements (Nyberg 3.5.5).

1.1.1 External audit reports to shareholders

Under the Companies Acts, auditors' reports are addressed only to the shareholders of the company (albeit copied to other stakeholders). The purpose of the external audit is 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" 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.

Audit reports to shareholders did not express concerns about the failings in Irish banks until

[18]Ongoing obligations for companies listed on the stock market require that a fund must issue an annual report and accounts and an interim report. The annual accounts must be circulated within six months of the end of the financial period to which they relate. The interim report must be published within four months of the end of the period to which it relates (see http://www.ise.ie/Investment-Funds/Ongoing-Obligations/Ongoing-Obligations.html).

well into the crisis. This must partly reflect limitations inherent in the nature of auditing. Financial accounting and auditing is highly subjective, despite the appearance of numerical precision in income statements and balance sheets. However, given external auditors' 'privileged positions' (Nyberg 3.2.4) the questions remain – why did the banks require State support in 2008 so soon after all of them had received unqualified audit reports from various auditing firms? (Nyberg 3.2.2)

1.1.2 Interactions between external auditors and the management and boards of banks

External auditors have a number of avenues of communication with the management of companies including annual audit plans and management letters. These contained, in varying degrees, details of the banks' business models, but without comment on their possible implications. Discussion by auditors of these matters would have been of considerable value to the management of banks and may have influenced them accordingly (Nyberg 3.9.5 – 3.9.6).

In retrospect, the Committee believes that auditors should have had concerns where their client banks had growing property and funding exposures combined with material governance failings. The risk models used should have raised concerns about the sustainability of the banks' business. It should have been possible for auditors to raise these concerns about sustainability with their clients without precipitating the change in relationship that arises where an auditor qualifies the report on the bank's ability to produce true and fair financial statements on a going concern basis. Such communications are the only constructive way to air such concerns so as to remedy the failings identified. In the recent financial crisis this approach was used successfully with US and UK banks but not Irish ones (Nyberg 3.6.3). Accordingly, such communications must take place early in the audit year and before the potential problems become material. If the bank does not address the concerns raised, the auditor should resign.

Auditors' concerns about the developing financial crisis emerged in January 2008. This led to discussions with the Financial Regulator and additional audit work on 2007 financial statements, including 'going concern' reviews. However, by that stage the insolvency problems were deep-rooted and little could be done to remedy them (Nyberg 3.6.1 – 3.7.2).

1.1.3 Interactions between external auditors and the Financial Regulator

Bank external auditors are obliged to return various types of information to the Financial Regulator but had no right to report other matter (Nyberg 3.6.1). This information includes audit findings reports, management letters, and M46 letters.[19] This was done in all cases and the returns contained sufficient information to deduce the banks' business models and lending practices, including those of Anglo and INBS. They did not, however, contain any discussion or comment on the implications of the returned information; nor did auditors and the Financial Regulator engage in dialogue regarding audit finding reports. Such comment or dialogue could have highlighted emerging problems before they became acute (Nyberg 3.8.1 – 3.8.6).

Furthermore, Auditing Practice Note 19(I) contains prudential sector lending limit guidelines for the covered banks. Four of the covered banks exceeded the property and construction sector prudential limit guidelines during the run up to the crisis. Nyberg reports that one bank auditor reported the sector limit excess to the Financial Regulator. The other three failed to do so because they were unaware of the standard or felt the Regulator was aware of the standard.

Addressing the Committee in 2010, Mr Matthew Elderfield, the newly appointed Head of Financial Regulation, broadly welcomed a suggestion by the CAG that auditors provide annual positive assurance of corporate governance regimes, including risk management. However, he cautioned that this would require careful consideration and should not impose excessive overheads or standards to be audited that are vague or too extensive.

Bank auditors communicate in varying levels of formality with the Financial Regulator. While they are required to report certain matters to the Financial Regulator, client confidentiality prevents them (unlike their UK counterparts) from reporting other concerns (such as concerns about the risks associated with the business models used). However, client confidentiality does not prevent such communication with their client bank.

Part 2: Findings contained in published reports

2.1. The Financial Regulator found serious issues in certain auditors' work, which have been referred to relevant accounting bodies (CAG Special Report 72, para. 2.41).

[19] M46 letters are based on ICAI guidance for auditor reporting to the Financial Regulator and are drawn up in consultation with the Financial Regulator (see Nyberg, footnote 83). See also http://www.cpaireland.ie/reporting to the FR.pdf.

2.2. In the absence of a specific requirement to do so, auditors did not challenge banks on risks deducible from audit findings. Such challenges would enhance the contributions that auditors make (Nyberg 3.9.4 – 3.9.5).

2.3. Auditors should have recognised the risks posed by banks' business models, property and funding exposures, and governance failings. They should have communicated these concerns to their client banks' boards and to the Financial Regulator before the 'going concern' basis of accounting was put in question. When such concerns are raised but not adequately addressed, the auditors should resign (Nyberg 3.6.2 - 3.6.3).

2.4. While auditor returns to the Financial Regulator gave sufficient information to deduce risks in business models and in credit and lending practices, they included no comment on the implications, which would have helped to identify and react to risks (Nyberg 3.8.5 – 3.8.6, 3.9.3).

2.5. Accounting and audit reform work should address the complexity of financial statements and reporting, improve sharing of information between auditors and regulators, and extend the scope of statutory audits (Nyberg 3.5.5 – 3.5.6).

2.6. Public assurance in financial institutions could be strengthened by an annual positive assurance by auditors regarding each bank's governance regime, including risk management functions (CAG Special Report 72, p.10).

Part 3: Recommendations contained in published reports

In this section the recommendations of the various reports are presented verbatim.

3.1. "There is a need to probe more widely the scope of governance failings in banks, whether they were of a rather general kind or (apparently in far fewer instances) connected with serious specific lapses, and whether auditors were sufficiently vigilant in some episodes." (Regling & Watson, p. 6)

3.2. "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.

3.3. 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.

3.4. 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.

3.5. 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."

(Nyberg, pp. ix - x).

3.6. "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." (Nyberg 3.5.6)

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

Bank boards are responsible for ensuring that there is in place an adequate system of internal control. This includes a system for the management of business risks, clear allocation of responsibility for implementation of controls, adoption of appropriate policies and a system to monitor and (where necessary) to enforce compliance with the controls.

External auditors of banks have a primary responsibility to shareholders to provide an opinion on whether the financial statements issued by the banks give a true and fair view. The phrase 'true and fair view' is included in the Companies' Acts, but is not defined and so is ambiguous. As a consequence auditing is an activity prone to concerns around issues of judgement. In assessing the risks that there may be misstatement in the financial statements, the auditors are required under auditing standards to identify and review the relevant internal controls in order to design appropriate audit procedures to allow them to express a 'true and fair' opinion in regard to the financial statements. They are not required to express an opinion on the effectiveness of internal controls. However, if in the course of audit they identify significant deficiencies in internal control, they must report them to the bank's management and board (usually through the audit committee).

External auditors of financial institutions have additional statutory, professional and stock exchange reporting responsibilities. Specifically, they are required to send their communications to management about control issues to the Financial Regulator. In theory, this should inform the Regulator about control weaknesses, and provide early warning about risks of control failure. The use of such information by the Regulator in prudential assessment is considered in the following chapter on the Financial Regulator.

Recent academic literature points to pervasive unconscious bias experienced by auditors through association with their clients, which undermines the quality of audits. Such bias has

been shown to be linked to the payment of fees by clients to auditors, including the payment of fees for non-audit as well as audit work, and to the perceived cosy relationship that can develop between the auditor and the client as a result of long audit tenure.

Many of the inherent limitations of auditing discussed above were covered during a Review Group on Auditing in 2000 that arose from the DIRT inquiry. [20] This Review made many recommendations on ways to improve auditing especially the auditing of banks and other financial services. Nonetheless, the problems identified above arose.

In the light of the collapse in shareholder value and the manifest failures in banks' control systems, it is the opinion of the Committee that questions have to be asked as to whether external bank auditors properly fulfilled their role. A second area for consideration is whether external auditors provided enough information to the Financial Regulator, and if so whether the Financial Regulator failed to comprehend or react to this information.

Furthermore, the Committee is of the view that questions remain about the extent to which auditors ensured a comprehensive and sufficient account of the financial health of banks, especially with regard to the reporting of uncertainty in the valuation of assets, and in the adequacy of the control systems within the banks.

Finally, there are opportunities to reform auditing to reduce the effect of these limitations. The European Union has published a green paper that proposes significant changes to the conduct of audits in the EU.

There is a series of questions that the Committee believes needs further investigation:

Auditing before and during the crisis

Q60. When did external auditors start to have suspicions that certain banks were not going concerns? This question is especially pertinent given the covered banks' auditors' privileged positions, which provided exceptional access to both sensitive bank information and to bank management.

Q61. Did auditors alert the board or management of banks, IFSRA and the shareholders of any such suspicions?

[20] See http://www.djei.ie/publications/commerce/2004/auditing/chapters.htm.

Q62. Did the adoption of the accounting standard on accounting for loans (IAS 39) mean that audited financial statements did not reflect a 'true and fair' view?

Q63. Why was there a lack of awareness of Auditing Practice Note 19(I)?

Q64. Was adequate attention given to risk assessment underpinning audit planning?

Q65. Was adequate attention given to the value of loans to a limited number of clients?

Q66. Was there adequate testing of collateral used for loans?

Q67. Was the treatment of back-to-back loans adequate?

Q68. Did auditors make sufficient use of explanatory sections in their reports to the Financial Regulator concerning situations of uncertainty in financial institutions?

Q69. Were there adequate means of communicating the fact of growing risks to the Financial Regulator and their clients? (Regling & Watson, pp. 6, 35; Nyberg 3.8.6, 3.9)

Q70. Have auditors' regulatory bodies identified any failings or deficiencies in the practice of bank auditors in the years leading up to the bank crisis?

Q71. What has been the response of banks' external auditors to the findings and recommendations of the Regling & Watson, Honohan and Nyberg reports?

Q72. What has been the response of banks' external auditors to the recommendations of the Report of the Review Group on Auditing?

Q73. Did auditors review post year-end transactions in order to identify the possibility of window-dressing transactions?

Q74. Was there sufficient expertise and experience within audit teams and how did they interact with their internal management structures'.

Auditor-client relationships

Q75. Was there sufficient rotation of external auditors (of firms and of engagement partners) so as to avoid audit capture?

Q76. What procedures did audit firms have in place to mitigate against audit capture, for example, audit partner rotation or second partner review procedures?

Q77. What level of fees did audit firms earn from banks in terms of audit and non-audit work? Could their independence be compromised as a result?

Q78. What level of employment crossover has taken place between audit staff and bank personnel? Should this be restricted?

Duty of auditors

Q79. Is the remit and duty of external auditors of banks appropriately drawn? Is the scope of a statutory audit function too narrow and limited?

Q80. Is there a need for greater clarity on the role and responsibility of bank auditors in the regulatory process?

Q81. Is there a need for an explicit legal statement of auditor's responsibilities with respect to the banks and disclosures to the regulator?

Q82. How can the knowledge that auditors accumulate through their close working relationship with a bank be absorbed more effectively into banking supervision?

Q83. External audit does not have a role at the front line of systematic risk management within banks. Should it have such a role?

Q84. What, if any, changes to bank audit practice and regulatory reporting have been proposed or implemented since 2009?

Q85. How are Irish stakeholders contributing to international accounting and audit reform work? (Nyberg 3.5.5)

Q86. Does the dominance of the 'big four' accounting firms stifle debate on how the accounting standards work?

3. The role of the Irish Financial Services Regulatory Authority in the crisis in the domestic banking sector

Introduction

Regulatory failure has been identified as a major contributory factor to the crisis. The reports published on the crisis to date have found that the Irish Financial Services Regulatory Authority (IFSRA) lacked resources and training, was unduly deferential when dealing with the banks, failed to follow through when serious weaknesses were identified and downplayed independent assessment of risk. Against this background the Committee believes it is essential to examine comprehensively the role and performance of the Financial Regulator in the period leading up to and during the crisis.

Part 1 of this chapter provides a summary of the published reports around the key themes of organisational background, principles-based regulation and micro-prudential supervision. Parts 2 and 3 highlight the findings and recommendations contained in the published reports. Finally, Part 4 outlines issues identified by the Committee that require further investigation, namely: people and corporate culture; regulatory approach; risk models; action and inaction; and critical review.

Part 1: Summary of issues addressed in the published reports

1.1 Organisational background

The Irish Financial Services Regulatory Authority, also known simply as the Financial Regulator (FR), was established in 2003 as an autonomous organisation alongside the Central Bank within an overall structure named the Central Bank and Financial Services Authority and Central Bank of Ireland (CBFSAI). The Financial Regulator had its own statutory authority and legal personality, while its actions carried the authority of, and were taken in the name of, the CBFSAI. A majority of the Financial Regulator Board were *ex officio* members of the CBFSAI Board, which was chaired by the Governor of the Central Bank.

This complex structure reflected a compromise between a unitary model (in which a single entity would both oversee financial stability and regulate financial institutions) and one in which the Financial Regulator would be entirely separate and independent of the Central Bank. However, the Financial Regulator's assertion of operational autonomy caused some

friction with the CBFSAI Board concerning the cost and quality of resources available to the Financial Regulator. However, Honohan doubts that this contributed materially to the major failings that occurred. There was no reluctance or inability of the Financial Regulator to share information with the Central Bank. All Financial Regulator information that might affect financial stability was available to the CBFSAI Board (Honohan 3.21 – 3.23; Regling & Watson p. 37).

Like its counterparts in some other financial regulators abroad, both the CBFSAI and FR boards comprised generalists rather than experts in banking or economics. This may have inhibited board members from taking a more contrarian stance or from detecting emerging risks. However, an expert model has its own weaknesses (Honohan 3.15).

The three main responsibilities of the Financial Regulator were consumer affairs, licensing and supervision of financial institutions and the enforcement of regulations. It was required to act consistently with Central Bank policy on financial stability and to consult with the Central Bank on any regulatory decision that affected financial stability.

The Financial Regulator's primary focus after its establishment in 2003 was upon consumer affairs, in which it was active and effective. However, prudential issues were not ignored and the senior official with responsibility for prudential regulation attended FR board meetings (Honohan 3.20).

The Financial Regulator faced competition for personnel from the growing banking industry and the high salaries available in the private sector. This made it difficult for the Financial Regulator to find and keep suitably qualified and experienced regulators.[21]

1.2 Principles-based regulation

The Financial Regulator's approach to regulation and enforcement was constructed around the idea of 'principles-based regulation'. Under this approach the Financial Regulator sets a limited number of high level principles that are to be adhered to and focuses on the behaviour of service providers and the outcomes the Financial Regulator seeks rather than trying to achieve them by specifying detailed rules for a wide variety of circumstances. For a number of years principles-based regulation had been favoured in the USA, UK and elsewhere as tending to minimise bureaucratic overheads and allowing firms to innovate. The reduced

[21] Comptroller and Auditor General, Special Report 57; Committee of Public Accounts Deb. 22 May 2008 p. 15.

compliance costs under principles-based regimes were frequently stressed. It was also consistent with Government policy on regulation.[22] However, in Ireland as in other principles-based regulatory regimes, the distinction between principles-based and "rules-based" regulation is one of degree. Irish banks at all times had to comply with a large body of detailed rules (Honohan 4.2 – 4.14).

The Financial Regulator's approach to principles-based regulation relied very heavily on ensuring that firms had appropriate governance structures, procedures and systems, and in that sense might more usefully be described as "process-based". The trust that the Financial Regulator reposed in firms to operate those processes may have led to a somewhat diffident attitude on the part of the Financial Regulator in relation to challenging decisions of institutions it regulated (Honohan 4.3).

The principles behind the Financial Regulator's regime were not set out clearly and firmly until 2006 when nine principles were stated in the Financial Regulator's annual report for that year. Unlike the Financial Regulator's Consumer Protection Code, these were not formally stated as a code under the Financial Regulator's statutory authority, and so were not capable of enforcement through the administrative sanctions procedures that had been created in 2004. Adherence to the principles was not made the subject of systematic checks or review (Honohan 4.9).

Three examples indicate the limited success the Financial Regulator had in creating governance architecture for principles-based regulation:

(1) Directors' Compliance Statements

Directors' Compliance Statements had been recommended by both the DIRT inquiry and the Review Group on Auditing. These would require the directors of banks and other financial institutions to certify their companies' compliance with relevant regulatory standards and would represent a significant increase in the strictness of the regulatory regime. In 2004 the Financial Regulator was given statutory authority to require financial institutions to issue such statements whenever the Financial Regulator considered it appropriate. Between November 2004 and November 2005 the Financial Regulator considered holding a consultation process on requiring financial institutions to issue them

[22]Government White Paper, "Regulating Better", Government Publications, Dublin, 2004

annually. At the end of that time the Financial Regulator decided to hold an informal private pre-consultation process instead of issuing a public consultation document. In the face of opposition from financial institutions during that process, and following representations from the Department of Finance on the competitiveness issue, the matter was deferred (Honohan 4.16 - 4.25).[23]

(2) Fit and Proper Requirements

In 2005 the Financial Regulator issued a public consultation document on updating the required standards of fitness and probity of directors and managers of financial institutions. Later that year the Oireachtas Joint Committee on Finance and the Public Service recommended that the Financial Regulator's proposals be adopted as a way of preventing unsuitable persons playing a role in Ireland's financial services industry. Following a further consultation document in 2006 a new set of standards was adopted by the Financial Regulator, which took effect in 2007. The standards applied only to new appointments and existing staff moving to new positions, but they succeeded in creating a standardised approach to fitness and probity regulation (Honohan 4.26 – 4.29).

(3) Corporate Governance Code

Proper corporate governance is a core issue in principles-based regulation. Seeking to update the governance standards in Irish financial institutions, the Financial Regulator prepared a consultation document in 2005, which drew on international best practice. Before issuing it the Financial Regulator conducted an informal pre-consultation exercise. Following industry representations (and resistance from domestic firms, but not IFSC-based ones) the Financial Regulator held another pre-consultation in 2006. Finally, in 2007 the initiative was shelved pending the results of EU-wide discussion on the matter. In 2007 the Financial Regulator adopted an informal governance code for the IFSC reinsurance industry, which had attracted unfavourable comment in the US media[24] (Honohan 4.30 – 4.33).

Enforcement of PBR

The statutory enforcement measures that the Financial Regulator could employ included

[23]See also the discussion on page **[XX]**] concerning the relationship of the Department of Finance to the Financial Regulator.
[24]See "For Insurance Regulators, Trails Lead to Dublin", New York Times, 1 April 2005, available at http://www.nytimes.com/2005/04/01/business/worldbusiness/01irish.html

increased capital requirements, financial penalties, the power to attach conditions to or withdraw banking licences, and the power to require a bank to carry out (or not carry out) particular tasks. As previously noted, from 2004 it could require a financial institution to issue a directors' compliance statement at any time. It also received authority to impose administrative sanctions in respect of breaches of statutory rules or statutory-backed codes that took place after August 2004. The sanctions included penalties on corporations of up to €5 million and on individuals of up to €500,000 and included power to declare a person disqualified from being concerned in the management of a financial institution. The Financial Regulator also had discretion to refer appropriate matters to the Director of Corporate Enforcement (Honohan 4.44).

Despite the broad range of sanctions available to it, the Financial Regulator's approach to enforcement focused on "moral suasion". This was a continuation of the approach taken by the Central Bank in the years before the Financial Regulator was created in 2003. This approach reflected the principles-based philosophy of avoiding, as far as possible, rigid enforcement of rules or intrusive intervention into banks' activities. It seems to have been based on the assumption that rational directors and managers would understand that it was in their own best interest to maintain standards and avoid possible sanctions, and that ensuring that the bank had appropriate governance structures and procedures was the best way of bringing about the desired outcome. The Financial Regulator should therefore seek to use dialogue and constructive engagement before recourse to penalties (Honohan 4.40).

Honohan notes that "There would appear to be no *a priori* universally applicable enforcement strategy consistent with principles-based regulation." He cites the approach of the UK's Financial Services Authority (FSA) as one that sought to take a strict approach to monitoring and to sanction breaches of principles (Honohan 4.35).

The ineffectiveness of the moral suasion approach is illustrated by the Financial Regulator's protracted engagement with INBS concerning the effectiveness and strength of INBS's board and governance structures, the lack of appropriate systems and controls, and inadequate internal audit function. Problems were repeatedly identified, letters written to the board, assurances received and accepted, and "a protracted and somewhat inconclusive correspondence extended over many years. In the end, the identified problems had not been corrected before the crisis" (Honohan 5.32). A condition was imposed on INBS's licence at

one stage, and detailed consideration was given to a prosecution, but ultimately the moral suasion approach was reverted to and the problems in INBS persisted (Honohan Box 4.2, 5.32; Nyberg 2.5.12, 4.3.4).

Despite the ineffectiveness of its enforcement regime, the Financial Regulator received a highly favourable rating from the IMF in its Financial Sector Assessment Programme (FSAP) report in 2006. Nyberg says "[t]he FSAP methodology itself suffered from weaknesses, especially a concentration on process rather than substance" (Nyberg 4.3.12).[25]

According to the Comptroller and Auditor General, by May 2007 only 10% of FR staff had received training on administrative sanctions.[26] No sanctions proceedings were issued in 2005; two sanctions were imposed in 2006, five in 2007, ten in 2008 and nine in 2009. The Financial Regulator indicated to the CAG in 2007 that, before pursuing an administrative sanction, it would consider, among other factors, "the previous compliance record of the financial service provider".[27] For example, administrative sanctions proceedings were initiated against INBS only once, and then after the financial crisis, despite its long and difficult history with the Financial Regulator.[28]

Nyberg states "It appears that the general policy of the Financial Regulator was not to risk action unless a legally watertight case could be made" and notes: "Even should the Financial Regulator have lost a legal case, this would have been useful in clarifying the Financial Regulator's powers or in demonstrating the need for additional legislative powers to fulfil its mandate". Nyberg points out that there is no evidence of the Financial Regulator requesting legislative support from the Department of Finance for greater enforcement powers (Nyberg 4.3.3 - 4.3.7).

The Financial Regulator may have been concerned that rigid enforcement may have diminished Irish banks' ability to compete with less stringently regulated competitors. Nyberg believes any such fear to have been overstated and that, if necessary, cooperation from foreign regulators could have been sought. Moreover, the Financial Regulator's mandate to promote Irish financial service industries was subordinate to the overriding objective of financial

[25] The IMF FSAP examined (a) overall stability including risk assessment; (b) the effectiveness of IFSRA; and (c) the regulatory and supervision framework for insurance and the proposed one for re-insurance. The full report is available at www.imf.org/external/pubs/ft/scr/2006/cr06292.pdf

[26] Comptroller and Auditor General, Special Report 57, para. 3.80.

[27] *Ibid* para. 3.78

[28] The sanction was imposed in 2008 for an inappropriate email soliciting deposits on foot of the guarantee.

stability. A regulatory stance that might have affected the attractiveness of the IFSC could always be justified where it was taken against banks that were systemically important to Ireland (Nyberg 4.3.10).

Honohan observes that early action by a regulator to establish its credibility and reputation as an enforcer creates an expectation as to how rules, codes and principles will be interpreted and applied. Doing so influences the behaviour of the regulated entities. Conversely, if the perceived possibility of sanctions is considered low, regulated credit institutions may not pay much attention to ensuring compliance. In the case of the Financial Regulator, he characterises its reluctance to take decisive action as "displaying both deference and diffidence to the regulated entities" (Honohan 4.40 – 4.42, 4.50).

1.3 Micro-prudential supervision

The Financial Regulator's mandate to regulate financial institutions was designed to be exercised in a manner consistent with the Central Bank's policies on the financial stability of the State. Micro-prudential information – that is, concerning various aspects of the financial positions of banks individually – fed into the Central Bank's overall assessment of the macro-prudential situation. All relevant information obtained by the Financial Regulator was provided to the Central Bank and, as mentioned above, officers of the Finanical Regulator were members of and duly attended meetings of the CBFSAI Board.

Risk rating and resources

Consistent with its principles-based philosophy, the Financial Regulator allocated supervisory staff according to the risks it perceived in the financial system. The risk rating model used by the Financial Regulator examined (CAG, SR 57, 3.27) data supplied by each financial institution under a variety of headings, including governance, supervisory complexity, business and occupational risk, credit and market risks, and contagion/related party risk. Scores were then used to group banks, according to their risk levels, into the 'top ten', 'next ten' and so on. Based on their ratings under this system, and reflecting the Financial Regulator's staffing problems, two staff members of the Regulator were responsible for day-to-day supervision of AIB and ILP, and three for BoI and Anglo (Honohan 5.7). Mr Elderfield put it bluntly, describing the two staff members who had responsibility for supervising two of

the country's major banks as "hopelessly outgunned".[29]

In its 2007 Special Report the CAG pointed out that the Financial Regulator's approach resulted in available resources, rather than risk exposure levels, determining the extent of supervision that a bank received. It also did not give aggregate risk levels for groups of companies (as opposed to individual members of those groups). The CAG recommended that the model be improved by categorising risk based on threshold levels, and defining supervisory stances appropriate for each level disclosed. Additionally, it would allow changes in the risk rating of individual banks and sectors to be monitored from period to period. The Financial Regulator objected to this recommendation, saying that the model was designed to show the risk of one bank relative to another, not an absolute level of risk, and that moving to threshold values "would create difficulties".[30]

The resources available to the Financial Regulator for micro-prudential supervision may have been constrained by work to introduce new Basel II standards including the EU's 2006 Capital Requirements Directive and by meetings intended to promote Irish financial services. The Financial Regulator also responded to requests for advice from accountants, solicitors and other advisors, and to general requests for information on regulations (Honohan 5.13). The last of these was noted by the CAG in his 2007 report, which recommended that the Financial Regulator's website be upgraded to improve the accessibility of information and so relieve staff of the need to do so in person.

The CAG recommended that the Financial Regulator commission an independent review of its prudential processes including inspections and resource levels, and seek to benchmark them against comparable regulators in the EU.[31] This was subsequently carried out by Mazars; the report was delivered in 2009 but not published. The CAG's 2009 Special Report cites issues highlighted by the Mazars report, including the need for the Financial Regulator to allocate resources away from support roles and towards prudential work.[32] Honohan concludes that "effective banking supervision simply cannot be performed with the thin staffing that was applied to frontline operations of the Financial Regulator" (Honohan 5.14).

[29]Committee of Public Accounts Deb. 13 May 2010 p.14
[30]Comptroller and Auditor General, Special Report 57, para. 3.30
[31]Comptroller and Auditor General, Special Report 57, para. 3.85
[32]Comptroller and Auditor General, Special Report 72, p. 30

Prudential returns

All financial institutions sent information to the Financial Regulator in periodic returns of varying frequency. The frequency of returns sought depended on the institution's risk rating. The Financial Regulator's Banking Supervision Division also received audit reports and (when auditors identified issues involving governance or internal controls) management letters. The CAG found in 2007 that the system of returns for credit institutions operated broadly as intended, but, being paper-based, was inefficient and potentially inaccurate. He noted the Financial Regulator's commitment to introduce an electronic collection, validation and analysis system by December 2007.

Nyberg concludes that, notwithstanding the inadequacies of the Financial Regulator's risk-rating system, prudential returns received by the Financial Regulator gave sufficient information to arouse suspicion about trends in the property and financial markets. Similarly, the CAG noted the Financial Regulator's own finding in 2009 that the controversial director's loan arrangement between Anglo and INBS could have been identified through timely examination of prudential returns.[33] Honohan points out that insufficient quantitative analysis was carried out by the Financial Regulator on prudential return data. For example, an analysis of the pro-cyclical effect of IAS39 when it was introduced in 2005 could have highlighted the inadequacy of provisions against a downturn in the property market. Instead, satisfactory loan payments were accepted as sufficient indication that provisions were adequate, even as property prices and liquidity were deteriorating (Nyberg 4.3.6, Honohan 5.24).

Nyberg sums up the failure to identify and act on risks that was readily identifiable as indicating a lack of professional scepticism or suspicion on the part of the Financial Regulator that "all things might not be as well as they seemed on the surface". This attitude seems have pervaded much, if not all, of the Financial Regulator (Nyberg 4.3.6).

Inspections

The number and type of on-site inspections carried out by the Financial Regulator was determined by financial institutions' risk ratings. In his 2007 Special Report the CAG found that the number of credit institution inspections fell significantly below target in 2005. He recommended that this be addressed along with the risk rating system in the report

[33] *Ibid*, para 2.69

subsequently carried out by Mazars.[34]

The low number of inspections was due in part to the Financial Regulator's lack of resources, but also to the Financial Regulator's approach to regulation. In evidence before the Committee concerning the CAG's 2007 Special Report, Mr Patrick Neary said that on-site inspections were only part of the risk-rating approach and that inspections were mainly to evaluate "systems of controls, check and balances". Together with banks' financial returns, the inspections carried out by the Financial Regulator had allowed it to identify weaknesses in liquidity during the 2007 credit squeeze and direct corrective action.[35]

Another problem related to on-site inspections was the qualification and seniority of Financial Regulator personnel. These were often of no more than middle-management level and tended not to have experience or qualifications comparable to the senior bank management with whom they engaged (Honohan 5.5).

Inspection reports revealed that Financial Regulator inspectors concentrated their efforts on procedural matters such as compliance with governance rules and procedures. Patterns of behaviour that could (and did) cause risk were identified, but the banks were not second-guessed as to how to go about their business (Honohan 5.22).

Inspectors noted very serious failures of governance such as rapid balance sheet growth, regular breaches of credit policies and rising LTV ratios, excessive reliance on personal guarantees, grossly inadequate appraisals of major loan applications, and failure to analyse loans in terms of their effect on the entire bank rather than on their own individual merits (Honohan 5.22-23). Inspection reports of the Financial Regulator on Anglo in 2004 and 2007 both identified serious prudential deficiencies (Nyberg 4.35). However, the severity of these was not judged to be high priority (Honohan 5.29).

Enforcement

Identification of micro-prudential concerns did not provoke decisive remedial action either by the Financial Regulator or within the banks. With few exceptions the Financial Regulator took the moral suasion approach but without determination to see matters through to their conclusion. Correspondence on identified issues was very slow and problems with persistent offenders such as INBS were not escalated to more rigorous enforcement measures. Where a

[34]Comptroller and Auditor General, Special Report 57, para. 3.61
[35]Committee of Public Accounts Deb. 22 May 2012, p. 32

remedial action plan was agreed with a bank, the Financial Regulator trusted the bank to implement it and did not verify for itself that the underlying problem had been resolved (Honohan 5.26). Honohan also states that "it would have been known within the Financial Regulator that intrusive demands from line staff could be and were set aside after direct representations were made to senior regulators" (Honohan 1.13).

The Financial Regulator's trust in banks' ability to run their own businesses and its lack of rigorous and determined enforcement of micro-prudential regulation had three important consequences:

- the impression was created and sustained in banks, the Financial Regulator and among policy makers that there were no major problems in banks individually or the financial system generally (Honohan 5.33);
- the banks' perception of prudential regulation and of the Financial Regulator as an effective regulator was undermined (Honohan 5.30 Box 5.2, Nyberg p.viii);
- FR staff members were influenced to prefer non-intrusive measures to strict enforcement and critical evaluation of banks' commercial decision, even where the latter would have been appropriate (Honohan 1.13).

Part 2: Findings contained in published reports

A major failure occurred in bank regulation and maintenance of financial stability (Honohan 1.17).

2.1. A belief in principles-based regulation caused the Financial Regulator to rely excessively on process over outcomes. It engendered an unwarranted degree of complacency about the likely performance of well-governed banks (Honohan 1.9, Nyberg 5.3.3).

2.2. The Financial Regulator downplayed independent quantification and assessment of risks (Honohan 1.11).

2.3. The Financial Regulator lacked resources and training that could have offset the banks' advantage in skills (Honohan 1.12, Regling & Watson p. 38, CAG Special Report 72 p. 9).

2.4. An unduly deferential approach led regulators to demonstrate insufficient

intrusiveness and assertiveness in challenging banks. This is symptomatic of "regulatory capture". Where intrusive demands were made, they were liable to be set aside following representation to senior regulators (Honohan 1.13).

2.5. There was a pattern of inconclusive engagement and lack of decisive follow through even where the Financial Regulator identified serious weaknesses. This was reflected in reluctance to take legal action, even where an unsuccessful attempt could have highlighted a need for additional powers (Honohan 1.14, Nyberg 5.3.4 – 5.3.5, Regling & Watson p.38).

2.6. Where the Financial Regulator found itself without necessary powers to act, it should have called on the Central Bank for backing (Nyberg 5.3.5).

Part 3: Recommendations contained in published reports

In this Part the recommendations of the various reports are presented verbatim.

3.1. "Depending in part on the results of the parallel report by Governor Honohan, [regulatory supervision of banks] is an area for further investigation to determine what degree of censure is warranted for the failures of supervision." (Regling & Watson, p. 6)

3.2. "Clearly, one key goal of banking investigations is to pursue such cases [of "lamentable failures of bank governance over lending practices" observed in some countries during the crisis], identifying the responsibility for those extreme governance failures."(Regling & Watson, p. 16)

3.3. "In euro area members, fiscal and prudential policies must take into account, and seek to mitigate, a mismatch between monetary conditions and the national business cycle. This can be especially important during the period of transition to euro area membership, as the economy adjusts under the euro to a new steady state.

3.4. The management and surveillance of euro area economies must take fully into account the imbalances and risks that can build up in both the private and the public sector of national economies, including "external" imbalances vis-a-vis other euro area members, and the way those imbalances are funded. So long as fiscal and labour market policies remain national to an important extent, the national balance of

payments is a meaningful economic concept even within the euro area.

3.5. The design of fiscal policy needs to build in sufficient allowance for temporary revenues, and the tax base should not be eroded (especially for distortive goals). The introduction of independent institutional sources for economic and fiscal projections would appear useful. It may also be helpful, after the immediate phase of crisis management, to explore the use of a domestic fiscal rule, such as a medium-term expenditure ceiling, to supplement the EU Stability and Growth Pact.

3.6. In an adaptive financial system, there is a case for principles-based supervision, in conjunction with clear rules. But the "light-touch" approach to supervision has been discredited: it sent wrong signals to banks and left supervisors poorly informed about banks' management and governance, potentially impairing crisis response capacity also.

3.7. Supervision needs to be based on a deeper analysis of the links between risks in different types of asset and liability: these include the legal links between connected borrowers; the economic links between classes of assets that may deteriorate sharply at the same time; and the risk that asset problems may in turn trigger funding shortfalls. A credit register ("centrale des risques"), following the model of some other EU countries, could be one important tool in this connection.

3.8. Financial stability analysis must be more strongly integrated into supervision. It needs to capture liquidity as well as solvency risks, and it must explore in a more contrarian way various macro-financial scenarios for the economy, including economic correlations among assets, and between assets and liabilities, of the kind referred to above. There is need for a more interactive, and at times a more confrontational culture, in the inter-agency discussions that explore risks during fiscal and supervisory policy design.

3.9. Supervisory coordination in the EU needs to become much more intense and operational; and it needs to address cross-border risks of a macro-prudential kind, not just a micro-prudential kind that emerge in national markets." (Regling & Watson, pp. 43, 44)

3.10. "Overwhelmingly the most important issues to investigate are those that seem to

have involved very serious specific breaches of corporate governance. It is not clear that such failures were limited to one institution only, although there is no suggestion that they were in any sense system-wide. It seems important to identify how such very serious governance failures were initiated; how and why internal checks and balances failed in restraining the management of certain banks; whether there were failures of auditorial vigilance; whether supervisors knew of the events (and if not, why not); and why the response of supervisors was not more forceful. It is relatively clear also that supervisors were not in a position to warn top policy-makers of the major asset risks or of some crucial problems of governance in banks, on the eve of the crisis – a failure that had very serious implications – but the circumstances surrounding this deserve fuller investigation to confirm the picture.

3.11. The second set of issues deserving investigation potentially relates to a wider number of institutions, though to differing degrees. These issues concern breakdowns in risk management approaches and in some cases the unwarranted or excessive overriding of internal guidelines. At the broad level of risk management and governance in the Irish financial system, it appears particularly surprising that there was not a stronger reaction within the banks themselves and among supervisors to lending trends that saw a progressive build-up of concentrated loan exposures to and within the commercial property sector. It would be valuable to establish the reasons for the absence of reaction, within banks and in the regulatory authority, since this was a critical factor that contributed to the overall level of risk exposure in the system. Again, it should be established how and why internal checks and balances failed; whether supervisors perceived the risks; and why the response of supervisors was not more forceful." (Regling & Watson, p. 45)

3.12. "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.

3.13. 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.

3.14. 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.

3.15. 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." (Nyberg, pp. ix - x).

3.16. "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 Department of Finance for it to be able to actively fulfil its part of the stability mandate, including cooperating closely and professionally with the CB and internationally." (Nyberg p. x).

3.17. "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." (Nyberg p. x)

3.18. "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.

3.19. In this regard, it is noteworthy that the Bank of Spain (BoS) had introduced a dynamic provisioning (DP) model for Spanish banks in 2000. BoS required the Spanish banks to continue using DP after 2005 notwithstanding the EU-mandated IFRS adoption." (Nyberg 2.8.13, 2.8.14)

3.20. "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." (Nyberg 3.5.6)

3.21. "The [Financial Stability Report] was, in theory, a cooperative effort by the CB and

the FR but, in practice, it was almost entirely written by CB staff. [Footnote: The reassignment of FR staff from this process is particularly regrettable given their familiarity with individual institutions and relevant issues of a regulatory nature.]" (Nyberg 4.4.6).

3.22. [Requiring financial institutions to issue annual Directors' Compliance Statements] "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." (Nyberg 4.5.12)

3.23. "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." (Nyberg 5.6.6)

3.24. "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." (Nyberg 5.6.9)

3.25. "Overall, in order to make regulation more accountable, consideration might be given to requiring that the Regulator give an annual statement relating to supervisory matters to Dáil Éireann. At the level of financial institutions, while recognising that it

would have some cost implications, an annual positive assurance by their auditors in regard to the functioning of the internal corporate governance regime in each institution including the risk management function could strengthen public assurance.

3.26. At the level of systems, procedures and practices adopted by the Regulator, it would be appropriate to consider incorporating a greater emphasis on testing of transactions and balances into its inspection work since risk based systems can only function optimally when informed by on-the-ground evidence based on actual transactions. This would need to be balanced with a top down analysis of the sustainability of the business models and associated strategies of individual institutions." (CAG Special Report 72 p. 10)

3.27. "COREP, FINREP, Large Exposures and Impairments Returns are now received monthly for the covered institutions as opposed to quarterly during 2008. The covered institutions are also required to submit a monthly guaranteed liabilities return and a monthly summary financial return. The summary financial return details key balance sheet, risk metric and lending information. Further work on IT is needed to not only facilitate the extraction of key data for reporting to senior management (upon which a project is underway), but more generally to fully assess and utilise information across all departments of the Central Bank and Regulator." (CAG Special Report 72, para 2.19)

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

The Committee is of the view that the published reports on the banking crisis highlight deficiencies in the operation and practice of regulation by the IFSRA in the build up to and during the crisis period. Important questions remain to be answered in relation to how the Authority discharged its functions. These include its corporate culture, regulatory approach, risk models used, and actions taken before, during and after the banking crisis.

The Committee believes that any further investigation into the banking crisis will need to discover:

Q87. The approach taken by the Financial Regulator to the supervision of non-covered financial institutions, and whether this discloses any further failings of regulation

or differences in regulatory approach;

Q88. The Financial Regulator's response to the findings and recommendations of the Regling & Watson, Comptroller and Auditor General, Honohan and Nyberg reports;

Q89. The actions taken after September 2008 in response to the crisis, including enforcement proceedings against banks and individuals, reviews of Financial Regulator staff performance, and changes in regulatory powers, resources and approach.

The Committee also believes that there are further questions about the operation of regulation around several key themes discussed below.

4.1 People and corporate culture

Q90. What evidence is there that intrusive demands from line staff could be and were set aside by the Financial Regulator after direct representations were made to senior regulators? (Honohan 1.13)

Q91. What evidence is there on how dissenting opinions were suppressed by senior regulators?

Q92. Was the performance of Financial Regulator staff adequately managed during the period leading up to the crisis? Was underperformance of Financial Regulator staff a contributing factor to the crisis?

Q93. Has the Financial Regulator taken disciplinary or similar action against any of its personnel on account of performance or actions that contributed to the crisis?

Q94. Was the "revolving door" system perceived to be a problem at the Financial Regulator? (The revolving door system is where individuals switch between the public and private sector over the course of their career, which has certain advantages but also drawbacks in that there is a risk that public officials may act in a self-interested fashion to advance their future career prospects within the private sector.)

Q95. What are the budgetary implications of providing more attractive remuneration packages to supervisors to deliver the desirable improvements in Irish financial services supervision?

Q96. To what extent have personnel and institutional changes, aimed at creating a new

dynamic at top levels at the centre of government regulatory and fiscal administration, been successful in enhancing the challenge function and in strengthening independent advice?

Q97. How has the Financial Regulator addressed questions of expertise of its Board and staff?

4.2 Regulatory approach

Q98. Why did the Financial Regulator adopt a light-touch, principles-based approach to regulation (PBR)? To what extent were alternative regulatory approaches developed and considered?

Q99. Using this PBR approach was it possible to bring formal enforcement action in respect of the breach of a principle?

Q100. Did the Financial Regulator feel the need to build up a significant number of "demonstration" cases with a view to fostering a reputation for credible deterrence?

> For instance, from around 2004 onwards there was a change of approach within the FSA (UK). Spearheaded by a drive to secure criminal convictions for insider dealings, the FSA sought (with some success) to shake off its reputation for light (or soft) touch regulation and to become known instead as an enforcement-led regulator.

Q101. To what extent did the Financial Regulator engage with auditors for the banks?

Q102. To what extent did Ireland's common law system and its Constitution (which curtails the capacity of actors other than the courts with respect to the imposition of sanctions) impact on the Financial Regulator's enforcement approach?

Q103. Does the Financial Regulator perceive remaining gaps in its legislative remit or authority? Have changes since 2009 been adequate?

Q104. Has the more intense supervisory approach now adopted in Ireland, including the new statutory fitness and probity regime, led to a more judgment-led and intensive style of supervision?[36]

[36] The FSA, in pursuit of a more judgment-led and intensive style of supervision, has assumed a proactive role with respect to appointments to "significant influence functions" in banks. Competence and capability have assumed greater prominence, alongside probity and integrity, in the application of the fit and proper test to candidates for key roles. At a practical level, in-depth interviews with supervisors have been introduced as part of the FSA's process for assessing the competence and capability of candidates for key roles.

Q105. To what extent has the Financial Regulator developed the full suite of regulatory toolkit/cyclical regulatory tools?[37]

Q106. Is there a danger of creating an overlarge and overly intrusive financial regulatory regime, with over-stringent rules as a backlash to the too small and too light approach before the crisis, particularly given that the banks and regulated financial institutions are going to be compromised in their ability to lend and will in fact be shrinking?

Q107. What processes are there within the Financial Regulator to deliver a balanced approach to regulation? Who is in charge of them and what is their role to ensure that the Financial Regulator is large and effective enough and no more or no less?

Q108. What strategies are being adopted to prevent supervisory backsliding, that is, a return to a more deferential and diffident attitude towards regulated firms when economic conditions improve, and political and public interest moves on to other matters?

4.3 Risk models

The risk model used by the Financial Regulator to allocate supervisory staff has received critical scrutiny.

Q109. How was it intended for the model to operate as a basis for the systematic determination of operational priorities and for resource allocation? How did it actually work? How has the methodology changed since 2009?

Q110. Are derivative activities a major concern with regards to the financial stability of Irish banks? Are the risk models for managing these effective? And if not, how have risk models changed since the crisis?

4.4 Action and inaction

Q111. On the foot of warnings about the potential falls in Irish house prices in 2007 what actions did the Financial Regulator take?

Q112. Concerns within the Financial Regulator and Central Bank about the banks' exposure to excessive lending were not sufficiently addressed or communicated

[37] See IMF, Rethinking Macroeconomic Policy, p. 10, http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf

to the Department or Minister for Finance. Are there mechanisms in place for ensuring that the Department of Finance is aware of all viewpoints now emerging from within the Financial Regulator?

Q113. Following the failure to introduce industry-wide Directors' Compliance Statements in 2006, why did the Financial Regulator not seek them in individual cases where it had concerns (e.g. INBS), as it had the power to do? (Nyberg 4.5.12, 4.5.14)

Q114. What were the Financial Regulator's procedures for investigating regulatory issues disclosed by inspections? What were the Financial Regulator's procedures for investigating regulatory issues disclosed by whistleblowers or otherwise?

Q115. Were proceedings proposed but stopped in either case? (Honohan 4.46-4.47, 5.23; Nyberg 5.3.4)

Q116. Has the Financial Regulator taken, or does it propose to take, regulatory action against banks or bank personnel concerning matters that contributed to the crisis?

Q117. Has the Financial Regulator examined any internal bank reports on the causes of or relevant to the crisis? If so, do they deal with matters that the Financial Regulator was not aware of, or raise new regulatory issues?

Q118. When did the Financial Regulator become aware of the irregular treatment by Anglo of any directors loans? What was its response? What were the findings of the Financial Regulator's internal enquiry into such loans? What was the result of the Financial Regulator's investigation of the involvement of INBS? (See generally CAG 72 p. 34)

Q119. When did the Financial Regulator become aware of the deposit arrangement between Anglo and ILP?[38] Who did they share this information with and when did they share this information? What was its response? By whom and to whom was any such response given?

Q120. Who decided that the report on Anglo showing prudential deficiencies was not high priority?

Q121. Did members of the Financial Regulator whose approval was required for sign-off of the Central Bank's annual Financial Stability Reports express reservations

[38] This deposit is sometimes referred to as a 'back-to-back loan'.

about any aspect of those reports?

Q122. What concerns were expressed by the board about prudential deficiencies in individual banks or across the banking system? What was the extent of consideration of these matters at board meetings?

4.4 Critical review

Q123. Has the Financial Regulator critically reviewed its own performance, examined the actions it took (or failed to take) that contributed to the crisis or that failed to mitigate their effects, and put the results of those inquiries into the public domain?

Q124. Is there any formal obligation on the Financial Regulator to investigate and report on possible regulatory failures?

Q125. To what extent has networking with foreign regulators on issues of mutual concern been developed? Does the Financial Regulator benchmark practices (inspection and enforcement levels) against other regulators? To what extent has benchmarking of issues, such as the number and type of inspections carried out, staffing levels and enforcement routines, been adopted?

Q126. Is there a need for the Financial Regulator to work with the auditing profession to ensure that financial statements of financial institutions provide as clearly as possible an image of all relevant conditions, including possible risks and uncertainties with regard to continuity?

4. The role of the Central Bank in the crisis in the domestic banking sector

Introduction

The Central Bank was charged with protecting the overall stability of the financial system as well as communicating to the Government risks relating to the financial system and the broader economy. It can be considered to have failed with regard to both tasks. The reports published on the crisis to date have found that the Central Bank was hesitant and ineffective even after clear warning signals were available that there were significant risks to financial stability as the boom continued. The Central Bank was overly deferential and was influenced by the international environment of trust in self-regulating financial markets.

Against this background the Committee believes it is essential to comprehensively examine the role and performance of the Central Bank in the period leading up to and during the crisis.

This chapter looks at the behaviour of the Central Bank in the period leading up to and during the crisis. Part 1 summarises the issues addressed in the published reports regarding the Central Bank, with a focus on organisational background, Financial Stability Reports and macroeconomic policy implementation. Parts 2 and 3 highlight the findings and recommendations contained in the published reports. Part 4 outlines issues identified by the Committee that require further investigation, including the Central Bank's understanding of the crisis, Financial Stability Reports, the role of international institutions, and the board, governance and staff of the Central Bank.

Part 1: Summary of issues addressed in the published reports

1.1 Organisational background

Following the legislative changes in 2003 that created the Financial Regulator, the Central Bank operated under the auspices of the CBFSAI. The Governor of the Central Bank was Chairman of the CBFSAI Board. Executive members of that board were the Director General of the Central Bank, Chairman and Chief Executive of the Financial Regulator, the Secretary-General of the Department of Finance and seven non-executive directors were nominated by the Minister for Finance, a majority of whom were required to be members of the FR.

Financial stability and macro-prudential policy were the primary responsibilities of the

Central Bank. The Governor was responsible for liaison on financial stability with the European System of Central Banks. In relation to Irish financial stability the Central Bank acted in coordination with the Financial Regulator, which was obliged to act in a manner consistent with Central Bank financial stability policy. Regulatory decisions of the Financial Regulator that might affect financial stability required Central Bank agreement. The Central Bank and the Financial Regulator maintained this coordination through a joint Financial Stability Committee and by regular supply to the CBFSAI Board of information derived from prudential and other returns made to the Financial Regulator. These included a Chief Executive's report and a "prudential pack". Documents were shared smoothly and there was no difficulty in raising any issues having implications for financial stability (Honohan 3.22).

The Governor had powers to authorise any CBFSAI employee to investigate and inspect credit institutions, and – with the CBFSAI Board - could issue guidelines to the Financial Regulator on policies and principles. These powers were not used in the period before the banking crisis (Honohan 3.9).

1.2 Financial Stability Reports

Financial Stability Reports (FSRs) were one of the main macro-prudential instruments available to the Central Bank. These were highly influential annual publications containing analysis and assessment of the overall health of the financial system. The Central Bank published FSRs from 2004 to 2008.

FSRs were stated to be prepared by the Central Bank in cooperation with the Financial Regulator. However, from 2005 onwards, pressure on FR resources caused mainly by Basel II implementation reduced the Financial Regulator's involvement in preparatory work for FSRs. While Central Bank staff had full access to relevant FR data, they did not have the benefit of preparing FSRs with FR staff accustomed to working with and interpreting that data (Honohan 6.6).

Issues covered in FSRs included the international and domestic situation and short-term prospects. Household and non-bank commercial indebtedness indicators including those related to property were also discussed. Bank-related issues examined in FSRs included credit and financial health of the banking sector as reflected in asset quality, profitability, solvency, liquidity and credit ratings. As banks came to rely more heavily on wholesale credit, that issue was introduced into FSRs. Similarly, developments in residential (and to a lesser extent) commercial property prices were included in FSRs.

Analytic content

Honohan observes that the range of issues covered in FSRs seems broadly appropriate, but notes that indicators discussed in them used aggregate data and so did not permit early identification of emerging problems. While it would not have been possible to present data that identified individual banks, it could have been possible to show a distribution of the ranges of, for example, capitalisation in banks. Vulnerabilities will tend to emerge first among banks that are outliers, not among those close to the average (Honohan 6.8).

Another weakness was the lack of discussion of harder-to-quantify risks such as rapid balance sheet growth and relaxed lending standards. Anecdotal evidence existed of problems related to these issues, but they were not addressed to any great extent (Honohan 6.9).

While the difficulties posed by rising house prices, increasing indebtedness and banks' funding structures were noted in successive FSRs, the general outlook was consistently expressed in positive terms. The "health indicators" on which that assessment was based could equally have been understood as consistent with those that could be observed in the middle or late stages of a bubble. A clearer disclaimer of the inherent limitations of those indicators would have been appropriate (Honohan 6.11).

FSRs reported results derived from extensive research that Central Bank staff conducted into the property market. The 2004 FSR noted the hardship and destabilising effects that a substantial fall in house prices would have. It quoted an IMF assessment that large house price rises tend to be followed by steep falls, and that house price increases on the Irish scale had never been known to happen without "a subsequent large correction". However, the FSR went on to point out that previous periods of house price increase in the 1980s and 1990s had not been followed by falls, and that the Irish banks had adequate capital to absorb a modest fall.

The 2004 FSR also pointed out that price-rental ratios indicated house price overvaluation of between 55% and 63%. However, the 2004 FSR presented, in a "Special Comment" section, an analysis based on McQuinn (2004)[1], which, according to the FSR, indicated "a failure to uncover conclusive evidence of overvaluation". Honohan criticises this model for, among other things, incorrectly treating the average size of mortgages as a "fundamental". He points out that applying other models to FSR data gives ranges of overvaluation of between 6% and

[1] McQuinn, K. (2004). A model of the Irish housing sector, Research Technical Paper 1/RT/04, Central Bank and Financial Services Authority of Ireland.

73% for differing market segments between 2003 and 2006. Subsequent FSRs also pointed out the signs of overheating based on more traditional models but continued to rely on updating the McQuinn model to downplay the probability of overvaluation (Honohan 6.13, 6.14).

The 2007 FSR did not include an updating of the house price calculations. However, an internal study by Central Bank economists using one of the models included in FSRs had concluded that house price overvaluation had reached 35% by mid-2007 (Honohan 6.16). Nevertheless, it did include commentary downplaying negative comments on the economy that had been published by the ESRI, IMF and OECD, including the well-publicised views of Professor Morgan Kelly. The FSR argued that, contrary to these commentators' views, and notwithstanding that prices had begun to fall, "[t]he central scenario is, therefore, for a soft, rather than a hard landing".

Honohan points out that the FSR cites no quantitative analytical evidence for this conclusion (Honohan 6.17). The assumption seems to have been that the banks were adequately capitalised to absorb the shocks caused by any fall in house prices, but there was no systematic investigation of that position. Had there been, the vulnerability of the banks and the financial system might have been recognised (Honohan 6.43, Nyberg 4.4.6).

The 2007 FSR also included an analysis of commercial property and noted a growth in price-earnings ratios that implied overvaluation. As the 2006 FSR had noted, prices in different segments of the property market tend to be correlated. The 2007 analysis therefore gave grounds for serious concern of a downturn in commercial property following the 2007 drop in residential prices (Honohan 6.19). This warranted, but did not receive, intensive analysis of commercial property data – drawing if required upon more detailed information available through the Financial Regulator – which could have highlighted increasing exposures arising from property-related lending. The positive message conveyed in the 2007 FSR could be characterised, according to Honohan, as a "triumph of hope over reality" (Honohan 6.45).

The analysis in FSRs of the state of the financial system and banks' robustness drew on two types of stress test. One, known as "bottom-up" tests, was conducted by banks using pessimistic macroeconomic scenarios. The scenarios included house price inflation, falls in GDP and employment levels. The results of the bottom-up stress tests indicated a need for some increased provisioning due to slowing of asset and loan growth, but that profitability, solvency and liquidity would remain robust. The other, known as "top-down" tests, were

conducted by Central Bank staff who applied the same scenarios as in the bottom-up test, but on data derived from regulatory returns and public information. These gave similar results to those produced by the banks (Honohan 6.21 – 6.27).

While these tests followed international standards, they had inherent limitations, which were acknowledged by the Central Bank in FSRs. It was not possible for the Central Bank to verify the models used by the banks. Honohan also questions whether the shocks used in them were appropriately chosen or of a sufficiently negative degree. Nyberg describes the models used in the banks' bottom-up tests as "unsophisticated and of little value" and notes that they did not subject dependence on wholesale funding to serious testing. Finally, the results were presented in FSRs in aggregate form rather than in a way that might have disclosed weaknesses among outliers (Honohan 6.27, Nyberg 4.4.7).

Views of outside observers

External economists and commentators did not play a formal part in the preparation of FSRs. However the views of bodies such as the IMF and the OECD played a significant part in formulating the consensus view in the Central Bank, which was expressed in FSRs (Honohan 6.28).

From the early 2000s up to 2006, assessments by the IMF of the Irish economy were uniformly positive, though they did express some caution in relation to house prices, citing internal Central Bank analysis that cast doubt on the McQuinn (2004) model. In 2007, as house prices began to fall, the IMF stated that cross-country comparisons indicated that sharp increases in house prices are followed by falls in 40% of cases.

The IMF also evaluated Ireland's financial system and regulation in 2000 and 2006 as part of its Financial Stability Assessment Program (FSAP). The 2006 FSAP reports noted the risks posed by household indebtedness and a slowdown in growth. However, it accepted the results of stress tests indicating that the banks had adequate capital buffers, and described the outlook for the financial system as "positive" (Honohan Box 6.1, p.90). The regulatory system was praised for implementing the FSAP 2000 recommendations: "the main challenge was seen as ensuring continuation of existing high standards" (Honohan 6.35).

The effect of this assessment was to dispel concerns about the effectiveness of regulatory supervision, and to isolate the few dissident voices within the CBFSAI. Honohan concludes: "In hindsight such an unwarrantedly favourable report by an international body was clearly unhelpful" (Honohan 6.36).

The OECD conducted reviews in 2006 and 2008, noting that house prices had overshot their fundamentals. In 2006 it could not rule out a hard landing but predicted a soft one as more likely. In both 2006 and 2008 it concluded that the banks were sufficiently well capitalised to be able to absorb any likely shocks. It added that the CBFSAI had identified the major vulnerabilities and taken action to mitigate them.

FSRs: Conclusion

The optimistic assessments in FSRs from 2004 to 2008 disclose an unduly optimistic view of the property market and an underestimation of the vulnerability of the financial system. While there was genuine uncertainty early on as to whether houses were significantly overvalued, the fact, if not the extent, of overvaluation was clear to the Central Bank by 2007. The tentative and cautious qualifications of the positive overall assessments in FSRs reflected a wish among Central Bank staff to avoid precipitating a loss of confidence, provoking public unpopularity, or "crying wolf". This cautious approach was fostered from those in positions of responsibility and created a climate of self-censorship in which staff were discouraged from investigating financial stability matters or voicing dissenting views (Nyberg 4.4.8).

Honohan states that these are not convincing excuses, particularly in respect of 2004 – 2006. A clearer assessment of the risks could have made it clear to the banks that balance sheets needed to be strengthened in advance of the inevitable downturn. Similarly, the absence of unequivocal evidence of overvaluation of property should not have prevented the CBFSAI from acting on the clear indications that it might be taking place, and taking steps to mitigate the risk it posed. Lastly, while there may have been little scope for remedial action by 2007, a clearer assessment of the situation by the Central Bank and a more forceful statement of the risks to financial stability would have forced markets and policy makers to confront the reality of the situation (Honohan 6.44 – 6.49).

1.3 Macro-prudential policy implementation

The macro-prudential tools available to the CBFSAI included:

- direct controls on types of lending (i.e. restrictions on particular types of products, such as equity-only or high-LTV loans);[2]
- increased capital requirements;

[2]See however Committee of Public Accounts Deb. 22 May 2008 p. 25: Mary O'Dea, Consumer Director of FR: "We do not have any authority to ban a product." While measures such as loan provisioning requirements could indirectly target particular types of products (e.g. high-LTV loans), there was no specific authority to ban particular products.

- sectoral limits (i.e. restrictions on lending to particular sectors);
- moral suasion.

Of these, moral suasion was most strongly favoured, while the only other tool used to any appreciable extent between 2003 and 2008 was increased capital requirements (Honohan 7.2). Sectoral limits were difficult to enforce and the existing sectoral rules (including restrictions on the aggregate amount that banks could lend for particular types of property) were not enforced (Honohan 7.18). Banning or restricting particular types of risky loans was seen as inconsistent with the principles-based approach to regulation.[3]

Moral Suasion

Moral suasion was, as previously noted, consistent with the principles-based approach favoured by the CBFSAI. It was exercised – however cautiously – through the reservations about the growth of banks' lending expressed in FSRs and in public speeches. The Central Bank also held roundtable discussions (i.e. annual exchanges with banks of views on FSRs) and private meetings with senior bank personnel. However, it is not clear that the Central Bank used these gatherings to express concerns forcefully or specifically, and these meetings did not result in action by banks to mitigate the accumulating risks (Honohan 7.6).

Prior to the establishment of the CBFSAI in 2003 it had been the practice of the Governor of the Central Bank to write directly to heads of banks expressing views on particular matters directly and forcefully. This practice was discontinued after 2003 (Honohan 7.7).

The CBFSAI Board wrote annual pre-Budget letters on fiscal matters to the Minister for Finance. These regularly highlighted house price inflation and the growth of the construction sector. The 2004 letter, for example, pointed out that house supply was nearly double the underlying demand. It recommended avoiding further extensions to property tax incentives as a way of limiting the more speculative aspects of the housing market (Honohan 7.8).

Increased capital requirements

In May 2006 the Financial Regulator increased the risk weighting that lenders should use for high-LTV mortgages. This followed protracted debate in the Financial Regulator over 12 months concerning high prices, the effect of a possible fall in the market, banks' relaxation of lending standards and the effects of IAS39 on their provisions for impaired loans. However, the housing market had peaked by the time this measure took effect. The resulting increase in

[3] *Ibid,* pp. 23 - 24

capital requirements was lower than that imposed in Australia, Canada and Germany, increasing Tier 1 capital requirement on 100% mortgages from 2% to 2.25%. Honohan adjudges this measure largely symbolic: both he and Regling & Watson term it too little too late (Honohan 7.9, 7.10, 7. 33; Regling & Watson p.38). Honohan also notes that the CBFSAI was anxious to avoid this measure being portrayed as a ban on 100% mortgages (Honohan 7.17).

In 2007 the Financial Regulator used its powers under the EU Capital Requirements Directive to increase banks' Tier 1 provision against speculative property loans from 4% to 6%. This increase was far too low given the overvaluation of the commercial property market and the consequent fall in prices (Honohan Box 7.2 p. 104). Few speculative loans were issued after mid-2007, and the increased requirement took effect only on 1 January 2008 (Honohan 7.11 – 7.14).

Honohan observes that this and the residential mortgage increase "show what could have been done, albeit much earlier." The measures were regarded in the Financial Regulator as "a shot across the bows" of the banks rather than as direct prudential measures that would prevent high-LTV or speculative loans. As such, he characterises them as more akin to moral suasion (Honohan 7.16).

Other possible measures

Nyberg maintains that further macro-prudential measures that the CBFSAI could have taken included a restriction on overly high-LTV mortgages.[4]

The Financial Regulator could have placed a ceiling on the growth of credit extended by one or more institutions. Similarly, it could have increased liquid reserve requirements or limited banks' loan-to-deposit ratios. These would have been a radical departure from the moral suasion approach but could have been very effective in stopping the bubble in its track (Honohan 7.19, 7.22).

The Financial Regulator could have increased the level of provisioning for impaired loans. While IAS39 restricted banks' ability to make such provisions, this measure could have been introduced when there was objective evidence of impairment when property markets entered a downturn (Honohan 7.21).

The CBFSAI could have privately expressed concerns about mounting risks to financial

[4]But see remarks to PAC of Ms Mary O'Dea, FR Consumer Director referred to above.

stability to the Department of Finance. There is no evidence that it did (Nyberg 4.4.9). The Secretary-General of the Department was an *ex officio* member of the board of the FSAI.

Part 2: Findings contained in published reports

2.7. There was a major domestic policy failure in respect of financial stability (Nyberg 4.1.1).

2.8. The international environment of trust in self-regulating financial markets had a major impact on the thinking of all Irish authorities and contributed to "bandwagon effects" (Nyberg 5.4.6).

2.9. There was pressure for groupthink both within and possibly between authorities including the Central Bank. This diverted attention from examining low-probability high-cost outcomes, and is evident from consensus views on soft landings and of the lack of support by senior officials for contrarian views or analyses (Nyberg 4.9.4 – 4.9.5).

2.10. Clear warning signals were available to the Central Bank by 2005 but it consistently took the view that risks would not materialise. While the CBFSAI was not completely inactive while the boom continued, it was hesitant and ineffective. The few concrete steps it took had little more than token effect (Honohan 7.37).

2.11. An independent Central Bank must ensure that it has an accurate picture of the market and be prepared to take unpopular actions. Financial stability should have been the overriding concern at the CBFSAI and it should have taken an active and suspicious stance and done whatever was reasonably necessary to maintain it (Nyberg 4.4.3, 4.4.11).

2.12. Financial Stability Reports (FSRs) were too reassuring in tone and tentative in their warnings (Honohan 1.15).

2.13. Too much confidence was placed in the reliability of stress tests (Honohan 1.17).

2.14. There should have been a closer interaction between staff dealing with financial stability and regulators. The lack of this may have been due to the institutional separation of the Financial Regulator from the rest of the organisation (Honohan 1.18, 1.19).

2.15. The Central Bank demonstrated deference and diffidence due in part to concerns

about competitive issues or undermining market confidence. These prevented it taking decisive action or issuing clear warnings. The concerns were overstated and the failure to act undermined the CBFSAI's core objective, which was the maintenance of financial stability (Honohan 1.20 – 1.21, Regling & Watson p. 38).

2.16. A hierarchical culture with elements of self-censorship prevented debate and analysis that ran counter to the views of senior staff (Nyberg 5.3.7).

2.17. There was no impediment to the Central Bank raising concerns about individual banks with the Financial Regulator. The Central Bank should not have accepted assurances about banks' individual health without analysing the aggregate position and its effect on financial stability (Nyberg 5.3.6 – 5.3.8). This is evidence of "silo thinking" (Nyberg 5.5.7 – 5.5.8).

Part 3: Recommendations contained in published reports

In this section the recommendations of the various reports are presented verbatim.

3.1. "Depending in part on the results of the parallel report by Governor Honohan, [regulatory supervision of banks] is an area for further investigation to determine what degree of censure is warranted for the failures of supervision." (Regling & Watson, p. 6)

3.2. "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 Department of Finance for it to be able to actively fulfil its part of the stability mandate, including cooperating closely and professionally with the CB and internationally." (Nyberg p. x)

3.3. "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." (Nyberg p. x)

3.4. "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.

3.5. In this regard, it is noteworthy that the Bank of Spain (BoS) had introduced a dynamic provisioning (DP) model for Spanish banks in 2000. BoS required the Spanish banks to continue using DP after 2005 notwithstanding the EU-mandated IFRS adoption." (Nyberg 2.8.13, 2.8.14)

3.6. "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." (Nyberg 3.5.6)

3.7. "[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. [...] 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." (Nyberg 4.4.2 - 4.4.3)

3.8. "The [Financial Stability Report] was, in theory, a cooperative effort by the CB and the FR but, in practice, it was almost entirely written by CB staff. [Footnote: The reassignment of FR staff from this process is particularly regrettable given their familiarity with individual institutions and relevant issues of a regulatory nature.]" (Nyberg 4.4.6)

3.9. "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 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." (Nyberg 4.4.11)

3.10. "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." (Nyberg 5.6.6)

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

The Central Bank is charged with ensuring the stability of the financial system and macro-prudential oversight. The Committee believes that two key strategic issues must be addressed in any investigation of the banking crisis:

Q127. How has the Central Bank responded to the findings and recommendations of the Regling & Watson, Honohan, Wright and Nyberg reports that are set out above?

Q128. How is the Central Bank managing the risk of the "pillar banks" being treated as "too big to fail" and the risks of moral hazard this creates?

The Committee is also of the view that a number of specific areas require further investigation, namely: understanding the crisis, the preparation of the Financial Stability Reports, the international dimension and governance and staff at the Central Bank. These are discussed below.

Understanding the crisis

Q129. Why did the Central Bank not appreciate the risks posed by the aggregate lending exposures of banks?

Q130. During the autumn of 2008 it was believed that there was a liquidity rather than a solvency issue; how was this conclusion reached?

Q131. Were the changing funding composition (interbank and wholesale vis-à-vis deposits) and the subsequent risks for liquidity adequacy fully appreciated by the Central Bank?

Q132. During the crisis, how did bank-to-bank lending contribute to exposure to market volatilities?

Q133. When did the Central Bank know about the irregular ILP deposits with Anglo?

Financial Stability Reports

Q134. Were the Financial Stability Reports purposefully drafted in a way to downplay risk?

Q135. Who drafted and who had final sign-off authority for the Financial Stability Reports?

Q136. Why did the 2007 Financial Stability Reports favour a "soft-landing" scenario, given that it does not appear to have been based on specific quantitative evidence or analysis? (Honohan 6.40, Nyberg 4.4.5) Why did the 2007 Financial Stability Report not include alternative house price models?

Q137. Why was commercial property not covered in Financial Stability Reports before 2007, and why was the danger of a crash in the commercial property market not perceived, given that the housing market was already falling? (Honohan 6.41, 6.19 - 6.20) Having highlighted commercial property vulnerabilities, why did the Central Bank not intervene more forcefully in 2007?

Q138. Why was the data that was presented in Central Bank roundtable discussions with banks in 2006, and which disclosed vulnerabilities and weaknesses of stress tests, not discussed in Financial Stability Reports? (Honohan 6.27)

Q139. Why did the Central Bank's pre-Budget letters note the oversupply of housing but deliver only qualified warnings on the consequent risk to financial stability? (Nyberg 4.5.17, Honohan 7.8)

Q140. Were Financial Stability Reports published in 2008, 2009 and 2010? If not, why

not and on whose decision?

Q141. Did the Central Bank consider Professor Morgan Kelly's analysis of the possible extent of falling Irish house prices? If so at what level? Was there any follow through on this?

The international dimension

The failure of international organisations such as the OECD and the IMF to provide strong external advice is highlighted throughout reports on the crisis.

Q142. To what extent were the IMF, OECD and other international organisations relying on data provided by the Central Bank to write up their reports?

Q143. To what extent has engagement taken place with these institutions to identify the lessons learned from that experience and promote a more rigorous reporting culture in future?

Q144. What cross-border arrangements has the Central Bank proposed or entered into relating to sharing information about bank borrowers and possible financial stability risks they may pose? (Honohan 7.31)

Q145. How will Basel III[5] prevent a reoccurrence of a similarly destructive crisis?

Q146. What can be done to sustain liquidity adequacy and prevent risk contagion from market fluctuation and disruptions in the interbank and asset markets?

Q147. Basel III requires sufficient capital adequacy to withstand both individual and systematic shocks. Which practices have been or will be implemented by the Central Bank to identify systemically important banks?

Q148. How are changes at EU-level to financial regulation and supervision affecting the Central Bank in pursuit of its mandate? Has due account been taken of the dramatic intensification of EU-level intervention in the aftermath of the financial crisis?

Q149. What are the effects on the Irish financial sector of new capital requirements under the Capital Requirements Directive and the impact of the Committee of European Banking Supervisors/European Banking Authority stress tests?

Q150. Do domestic organisational structures allow for the effective representation of Irish interests at EU level, on bodies such as the European Systemic Risk Board and the European Banking Authority?

[5] Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010-11. It will be implemented in the EU through the Capital Requirements Directive.

Q151. Are Irish interests in danger of being jeopardised by the setting of overly-rigid "maximum harmonisation" EU-wide capital requirements?

The board, governance and staff

Q152. What was the governance structure of the Central Bank in the lead up to and during the crisis? What was its composition and what qualifications did its members hold? How were members recruited?

Q153. Did this structure impair the Central Bank's ability to respond to the crisis?

Q154. Why did Central Bank board minutes not reflect dissenting opinions? (Honohan 3.17)

Q155. To what extent were there dissenting opinions among Central Bank staff? To whom were they communicated? To what degree were they explored?

Q156. Why were the opinions of dissenting external commentators rejected? (Honohan 6.12-6.13)

Q157. Up to 2003, the Governor would write to heads of banks to express his views. Has this practice been re-instated?

Q158. How has the Central Bank addressed questions as to the expertise of its board and staff?

Q159. To what extent have personnel and institutional changes aimed at creating a new dynamic at top levels at the centre of government regulatory and fiscal administration been successful in enhancing the challenge function and strengthen independent advice?

Q160. Can the Central Bank comment on the findings of the EU Commission (2010) on the lack of women in senior decision-making positions in the Central Bank and financial institutions[6]?

[6] EC 2010 More women in senior positions – Key to economic stability and growth European Commission Directorate-General for Employment, Social Affairs and Equal Opportunities, Unit G1 January 2010 http://ec.europa.eu/justice/gender-equality/gender-decision-making/database/public-administration/national-administrations/index_en.htm

5 The role of the Department of Finance in the crisis in the domestic banking sector

Introduction

The Department of Finance was a crucial player throughout the financial crisis. The Department was a key advisor to Government before and during the crisis, developed the legislative response to the crisis and senior officials liaised with the Financial Regulator and the Central Bank. Reports published to date on the crisis have found that in relation to the Department of Finance there were weaknesses in the budgetary process and in how the Department gave advice and warned of growing risks. It lacked specialist staff and while it gave advice on the negative effects of the Government's tax policies over the years leading up to the crisis, it did not perform quantitative analysis on the broader risk to the tax system.

Against this background the Committee believes it is critical to understand the role that the Department of Finance played, and its effectiveness in the lead up to and during the crisis.

Part 1 of this chapter details the issues relating to the Department of Finance that were addressed in the published reports, in particular its organisational background, advice on budgetary and policy matters, and the Department's interaction with the Central Bank and the Financial Regulator. Parts 2 and 3 recall the findings and recommendations contained in the published reports. Finally, Part 4 outlines issues identified by the Committee that require further examination, including: expertise within the Department; crisis management; the formulation and communication of advice; actions taken by officials of the Department before, during and after the crisis; the Department's role in oversight of the Financial Regulator, and coordination between the Department of Finance and the Department of Public Expenditure and Reform.

Part 1: Summary of issues addressed in the published reports

1.1 Organisational background

Between 2003 and the crisis of September 2008 the role of the Department of Finance included supporting and advising the Minister for Finance in Budget policy and preparation, advising the Minister generally on economic, taxation, sectoral and public service matters, and liaison with the CBFSAI, National Treasury Management Agency (NTMA) and other official bodies in Ireland and Europe.

During the period leading up to the financial crisis the Department included four principal divisions:

- Budget, Taxation and Economics;
- Financial Services;
- Sectoral Policy;
- Public Service Management and Development.

Wright found that the 542 staff of the Department in 2010 comprised 135 administrative and support staff, while of the balance only 39 had training in economics to Master's degree level or higher (Wright 4.11). Of the remaining staff, Secretary-General Kevin Cardiff observed that they were essentially generalists with a broad range of experience that gave the Department flexibility in their deployment. He conceded however that, even with recourse to outside legal, banking and economic advisors, this resulted in a lack of readily available expertise and specialist skills, particularly at times of crisis.[1] Similarly, he conceded that the Department's forecasting outcomes had been "dreadful" and that it required a stronger analysis of risk.[2] Wright points to the events of September 2008, which highlight the Department's shortage of skills and resources to perform in-depth investigation and analysis of the relevant issues (Wright 3.10).

1.2 Advice on budgetary and policy matters

Budget advice

The Department's main advisory input into the Budget was in its June Memoranda to Cabinet and (since 2006) a pre-Budget Outlook statement published in October. Each June Memorandum projects economic and fiscal circumstances and outlines appropriate tax and spending levels. The October Outlook statement is intended to guide public dialogue on the Budget prior to its announcement in December.

The June Memoranda clearly and consistently warned the Cabinet of the effects of pro-cyclical policies and high levels of spending. Wright states that in this they were more direct than other official observers, presumably referring to the Financial Stability Reports issued by the CBFSAI (Wright 3.23). However, the October statements were issued before publication of projected tax returns in November.

[1] Committee of Public Accounts Deb. 6 May 2010, pp. 22, 47
[2] *Ibid.,* pp. 11-12

In a period when returns were consistently higher than forecast, and when the economy continued to grow at record rates, the cautionary message in Department advices was undermined, while political pressure to meet public expectation of higher spending and lower taxation increased. Sources of pressure included the Social Partnership process and the Programmes for Government entered into by parties to the governing coalitions over this period, which, by operation of the Public Service Management Act 1997, defined the key objectives and use of resources by departments (Wright 3.2.7).

Programmes for Government represented core political commitments, and fiscal policies agreed in them had to be accommodated. When higher than forecast tax returns showed up before Budgets, they were appropriated to those policies.

The Social Partnership process also enjoyed political priority and consumed a considerable part of the Department's resources. The fundamental dynamic of Social Partnership had been an exchange of higher wages and lower tax rates in return for industrial stability, and the consistent growth of the economy and Budget surpluses seemed to validate it. However, the shift in the economy in 2000 from export-led growth to property-driven growth was matched by a strong decrease in Ireland's competitiveness as wage rates rose.

Commitments in the Programmes for Government and the Social Partnership process came to "overwhelm" the budgetary process (Wright 3.3.8).Government spending was consistently higher than recommended by the Department, especially in 2001 and 2007 (Wright Diagram p.22). Faced with politically-driven tax and spending priorities, the Department was not forceful in seeking changes in other areas that could compensate for inflationary, pro-cyclical, or tax base narrowing effects.

Wright concludes that these indicate a weakness in the budgetary process as well as in the Department's approach to giving advice. An independent fiscal council to give and publish advice on fiscal priorities and strategy would be less susceptible to political pressures. Further, the Department should have forecasted using alternative scenarios and been more direct and forceful in its warning of the mounting economic risks posed by Government policies (Wright 3.4.1, 3.6.1).

Where oral advice or warnings are given to Ministers, there should be some written record in order to increase consistency of and accountability for the advice. Where there are justifiable concerns about such advice becoming public under the Freedom of Information Act 1997, a suitable solution may be to create a statutory exception to the duty to disclose where budget

advice is concerned (Wright 3.5 – 3.6).

Construction policy

Despite mounting concerns about the fiscal and macroeconomic risks caused by over-reliance on construction and the tax incentives and credit that fuelled it, the Department did not present cautionary arguments forcefully enough to the Minister and Government. In the face of repeated Government rejection of the Department's advice for moderation and reduction of property-based incentives, the Department did not organise a strategic response or prepare alternative approaches for moderating construction activities. When the Government eventually moved to limit property incentives in 2006, the action was of limited scope and gradual effect. When the measures took effect, house prices had already peaked and commercial property would shortly do so, and the 2006 measures did little to mitigate the risks that led to the crisis in 2008 (Wright 3.8).

Tax policy

The Department provided clear warnings of the risk to revenue posed by a downturn in construction, and gave specific estimates of the fiscal risks. However, it did not perform quantitative analysis on the broader risk to the tax system posed by a general downturn in economic activity that had been stimulated in part by the Government's pro-cyclical fiscal policies. These policies caused current expenditure to grow faster than nominal GDP in every year after 2000, as well as a narrowing of the tax base and commitments to major tax expenditures as late as 2007 (Nyberg 4.5.3; Regling & Watson Chart 6). Had such analysis been expressed forcefully, it might have reduced the Government's willingness to enter into political commitments that added to the problem.

Macroeconomic risks

The June Memoranda were clear on the adverse effects of excessive spending and tax reliefs, but did not give sufficient focus to the broader macroeconomic risks. No single analysis integrated all risks, including those posed by the financial sector, and assessed their implications for the economy into the medium term (Nyberg 4.5.5). Wright observes that "the public and policy makers were insufficiently sensitive to the effects of extraordinarily expansive monetary conditions at the time, and to the fact that fiscal policy was the key potential counterbalance to this pressure" (Wright 3.2.6). Instead of analysing and stressing the nature of macroeconomic risks, the Department relied on the views of bodies such as the Central Bank, which was tasked with guarding financial stability. Wright also suggests that

the lack of trained economists and financial market experts in the Department may have contributed to this failure to appreciate mounting macroeconomic risks (Wright 3.7.1).

As events in September 2008 demonstrate, the Minister and the Department will be in the lead position when a crisis occurs. Accordingly, the Department must be able to provide, and be accountable for, reports on the broader risks to the economy, including the activities of NAMA. It must be able to advise and report on systemic risks and not leave those tasks to other bodies (Wright 3.7). In evidence before the Committee of Public Accounts in 2010, Secretary-General Cardiff agreed that expertise in risk analysis could be of value to the Department.[3]

Financial stability

The Department did not see itself as concretely involved in financial stability issues and was not staffed to be so involved (Nyberg 5.3.9).

The Department monitored growth in the housing market and of credit. In 2004 it noted that credit growth was unsustainable, house price inflation seemed to have overshot fundamental values, and that the construction sector was vulnerable to a downturn. However, it played down the systemic risks of the situation, arguing instead that a downturn would be a necessary correction albeit one that would impact revenue and GDP (Nyberg 4.5.7).

Some external analyses and commentaries – such as the ESRI Medium Term Review 2005-2012 and the widely publicised article by Professor Morgan Kelly in the ESRI's Quarterly Economic Commentary of Summer 2007 – highlighted the risks posed by the construction and credit bubbles and the impending sharp fall in property prices. The Department's briefing to the Minister on these noted the negative commentary, but no follow-up analysis appears to have been performed. When a 2007 ESRI commentary suggested that a housing bubble had formed, the Department's briefing note suggested that a soft landing was the likely outcome (Nyberg 4.5.8).

1.3 Interaction with the Financial Regulator and Central Bank

The Financial Regulator

The Department regarded the Financial Regulator as entirely independent of it and did not concern itself with prudential matters or the supervision of individual financial institutions (Nyberg 4.5.10). Its role was primarily to provide a legislative framework as the Financial

[3]Committee of Public Accounts Deb. 6 May 2010, pp. 20, 22

Regulator's needs or changing EU regulatory requirements demanded. This latter role led to close contact between officers of the Financial Regulator and Department officials.

A notable interaction of the Department with the Financial Regulator concerned the Financial Regulator's proposal in 2006 to require directors of financial institutions to sign compliance statements, as discussed in Chapter 1 of this Report. The Department's position aligned with that of the financial services industry, which opposed the measure on competitive grounds. After discussions with the Department, the Financial Regulator deferred the issue pending a general review of financial services legislation (Nyberg 4.5.13, Honohan 4.16 – 4.25).

Following concerns expressed by the Department of the Environment in 2005 on the effect of 100% mortgages on the indebtedness of households, the Department consulted the Financial Regulator (Nyberg 4.5.9). In its response to the Department of the Environment, the Department took the position that this was a consumer matter rather than a financial stability one, and that consumer caution and provision of appropriate information would prevent the matter causing extensive problems. Secretary-General Cardiff repeated this view in evidence to the Committee in 2010 (PAC 6/5/2010 at p. 59). Honohan notes however, that in 2005 an internal debate in the Financial Regulator centred on the risk weighting of high-LTV mortgages. In 2006 the Financial Regulator increased the capital requirement for 100% mortgages as a means of preventing them from having a destabilising effect and of discouraging further sales of them (Wright 3.8.3; Honohan 7.9; Nyberg 4.5.9).

Central Bank

The Secretary-General of the Department was *ex officio* a member of the Board of the Central Bank. In evidence to the Committee, Secretary-General Cardiff (who was Assistant Secretary-General with responsibility for banking in 2008) described his predecessor's approach to this role as "sort of personal" and that the Secretary-General acted in his personal capacity, rather than as the official voice of the Department, at the CBFSAI board. Nyberg states however that within CBFSAI "it was generally believed that the views of the Secretary-General reflected (or at least were consistent with) those of the Department". Board minutes of the Central Bank are confidential, and the board papers sent to the Secretary-General are covered by the Central Bank's exemption from the Freedom of Information Act 1997 (PAC 6/5/2010 at p. 39). However, Nyberg concludes that if the Department had major concerns about financial stability matters, these would have surfaced at Central Bank board meetings (Nyberg 4.5.16).

The CBFSAI Financial Stability Reports were central to the Department's understanding of

the situation concerning financial stability, and their generally positive message, with qualified concerns about house prices or credit risks and 'soft landing' scenarios, were not treated with scepticism or subjected to critical analysis. Similarly, the annual pre-Budget letters from the Governor of the Central Bank to the Minister did not express financial stability concerns, and mainly concerned questions of inflation and competitiveness. There was no discussion of the Government's pro-cyclical fiscal policy. While the letters made reference to rising house prices and growing credit, they did not refer to a risk of a crash (Honohan 7.8).

Part 2: Findings contained in published reports

2.1. There was a failure of prudent fiscal management (Wright 5.2).

2.2. The Department did not involve itself in financial stability issues and did not staff itself to be so involved. This may reflect "silo thinking" (Nyberg 5.3.9, 5.5.8).

2.3. There is no evidence that financial stability issues were raised either in the Department or the CBFSAI board arising from the Secretary-General's *ex officio* membership of that board (Nyberg 4.5.16).

2.4. Concerns about financial stability raised by outside commentators were reported to the Minister but not subjected to analysis and were downplayed (Nyberg 4.5.8).

2.5. There was a weakness in the Budgetary process and in how the Department gave advice, prepared forecasts and warned of growing risks (Wright 3.3).

2.6. A Fiscal Council may be able to advise on fiscal priorities and strategy with lower susceptibility to political pressures. Forecasts should be published and debated in public (Wright 3.4).

2.7. The Department gave clear advice on the pro-cyclical and base-narrowing effects of the Government's tax policies over the years leading up to the crisis, but did not perform quantitative analysis on the broader risk to the tax system (Wright 3.9).

2.8. Major reforms of the structure, staffing, organisation and processes of the Department are recommended. These include increasing the number of trained economists, banking specialists, risk analysts and other financially skilled personnel, removing the Public Service Management remit, and engaging in more public debate and discussion of forecasts (Wright, pp. 49 – 56).

Part 3: Recommendations contained in published reports

In this section the recommendations of the various reports are presented verbatim.

Wright recommendations

Budgetary and Other Processes:

3.11. After Cabinet review of Budget strategy in June, and consistent with its April submission to the European Commission, the Government should release for public and parliamentary review:

- the Department's economic and fiscal forecast,
- the Department's assessment of the economic and fiscal risks to this outlook,
- related sectoral analysis by the Department, and
- the Government's proposed quantum for fiscal action in new spending and tax expenditures.

3.12. The Minister and the Department should consult widely on this framework, particularly with the relevant Oireachtas Committee.

3.13. Departments would not seek spending enhancements beyond the spring consultations leading to the Budget review at Cabinet.

3.14. To the extent that November tax results surprised to the upside, such revenue should be used for debt reduction, not new spending or tax relief.

3.15. The Panel supports the establishment of a Fiscal Council to review and publish commentary on the Department's analysis and the Government's proposed quantum for fiscal action. The Panel believes that such a Fiscal Council must be independent of Government, have qualified membership, a straight forward role and the ability to report in a timely manner. For example, following a June release of the Government's fiscal plan, the Fiscal Council could review:

- the Department's economic and fiscal outlook,
- the Department's risk assessment,
- whether the proposed fiscal framework, including provision for new Government budgetary action, entails acceptable risks for the economy.

3.16. To the extent the December Budget exceeds the quantum of action identified in June, the Fiscal Council should reassess the risks of these further actions for the economy.

3.17. The Fiscal Council could also usefully assess the impact of future Social Partnership wage and fiscal provisions on Ireland's economic competitiveness.

Economic and Fiscal Forecasting:

3.18. Forecasts in Budget Memoranda to Cabinet and for public consultations should include well-articulated scenarios of alternative outcomes, consistent with the Department's risk analysis.

3.19. In addition, the Department should provide a public work-shop, with private sector and academic interests, once a year so that the assessment of the economic and fiscal challenges can be debated before the Department finalises its forecasts.

Advice over the Budget Cycle:

3.20. The Department of Finance should keep a written record of advice tendered and decisions taken as part of the budgetary process.

3.21. The Panel strongly supports the public release of substantially more economic analysis by the Department. However, policy advice to the Minister for Finance in the preparation of the Government's Budget should not be subject to release under Freedom of Information for at least five years.

Macro-economic Risks:

3.22. The Panel recommends that the Department prepare comprehensive macroeconomic risk assessment for Ireland as part of its annual advice to Cabinet.

3.23. The Department should establish sufficient formal arrangements with the Central Bank, including its Financial Regulation function, the NTMA and NAMA and establish sufficient technical capacity internally to manage this process.

3.24. The Government should introduce legislation to establish a coordinating committee of these financial agencies, chaired by the Secretary General of the Department of Finance, which would require the full exchange of any information that could entail fiscal or economic risks to the country, among the above agencies.

Construction Policy:

3.25. The Department should include sectoral assessments in its annual economic analysis and forecast that is released for public consultation.

Tax Policy Advice:

3.26. The Department should substantially increase its analytical capacity in the tax policy area.

3.27. The Department should organise itself to consult with tax and financial experts and prepare advice that is most appropriate to an efficient tax regime for Ireland.

Medium Term Analysis:

3.28. The Government should commit to the preparation of regular medium- term economic plans for Ireland at least every five years. Department's Interface with Other Departments:

3.29. The Department should integrate those sections of Public Service Management and Development Division dealing with administrative budgets into Sectoral Policy Division to create a "single window" interface with line Departments.

3.30. Activities could be organised immediately under the Assistant Secretary level in the Sectoral Policy Division. The longer-term objective should be to establish Principal positions responsible for the interface of all activities with outside Departments.

Public Service Management and Development:

3.31. Public Service Management and Development Division should be established as a separate entity, either as an entirely separate Department or reporting directly to the Minister of State for Public Service Modernisation.

3.32. The Secretary General of the Department of Finance and Minister for Finance should retain authority over the overall wage bill, negotiating mandates for new collective bargaining processes and manage a single window on departmental control functions.

Public Service Modernisation:

3.33. The Panel strongly supports the creation of a Private Sector Advisory Board which it understands is under consideration by the Departments of the Taoiseach and Finance.

3.34. A full-time Task Force should be established and assigned responsibility for driving forward the reforms under the Croke Park Agreement.

3.35. The Task Force would comprise existing staff from the Modernisation Unit of the Department. The Task Force would also include key individuals from the leading Departments along with expertise in the area of change management on secondment from the private sector.

3.36. The Task Force's Team leader should have direct access to the Minister of State responsible for Public Service Modernisation.

3.37. In addition, there is a need to recruit expertise in the areas of change management and business process re-engineering.

Core Finance Functions:

3.38. With the possible exception of the Public Service Management and Development Division, no other core functions should be moved out of the Department of Finance.

Structure:

3.39. Assistant Secretaries should report directly to the Secretary General of Finance.

3.40. Second Secretaries should cease to have divisional line management responsibilities, but should be able to call upon resources across the Department as and when necessary.

3.41. The Second Secretary currently responsible for Sectoral Policy Division should be designated as Chief Operating Officer for the Department. The function of this post would be to lead the coordination across the Department of major issues, for example, to lead the interaction between the Budget and expenditure sides of the Department, and otherwise to help ensure the entire Department is connected to key policy and management issues.

3.42. The Second Secretary post leading the Budget, Tax and Economic Division could focus primarily on the increasingly important role of interacting with the institutions of the European Union and other international institutions.

3.43. The Second Secretary responsible for Financial Services should retain responsibility for this function until such time as the banking crisis is considered to

have abated sufficiently. At that time the post should be abolished. That Second Secretary could draw on the support of the Assistant Secretaries currently in that Division as necessary, but they would report directly to the Secretary General.

Management Advisory Committee (MAC):

3.44. The remit of the MAC should be broadened to include discussion of major strategic challenges confronting the Department.

3.45. All those that report to the Secretary General should attend MAC meetings. Given the pace of change underway, MAC meetings could usefully include a brief report by Assistant Secretaries on key issues in their area, where appropriate, as well as Secretary General and Second Secretary reports on high level issues.

3.46. Attendees at MAC should, as a matter of course, brief their own direct reports on outcomes from these meetings.

3.47. The MAC should meet more often at Budget time and during periods of major change to enhance internal communication and connect all employees to emerging issues. It should schedule regular meetings on key policy issues.

Corporate Secretariat:

3.48. A Corporate Affairs Unit, which should be headed by a Principal who would report directly to the Secretary General, should be established. It would bring together and enhance a number of functions which are located in different areas of the Department. The functions of the Unit would be to:

- manage the interface with the Minister's Office;
- coordinate briefs and draft speeches for the Minister to ensure consistency and quality;
- help ensure effective internal communications;
- manage departmental outreach and the Department's profile;
- coordinate, on a regular basis, the preparation of a brief for MAC on all major live issues and an early warning on significant emerging issues;
- help coordinate major departmental initiatives;
- coordinate departmental strategy statements;

- manage the activities of the Department's Press Office; and
- manage the Freedom of Information function in the Department.

Structure at the Working Level:

3.49. The Department should examine working level structures and the devolution of responsibilities to ensure the delegation of more responsibilities to middle management levels and to create larger teams throughout the organisation.

Enhancing the Department's technical skills:

3.50. Even in this period of restraint, the Department must find a way to increase substantially the numbers of economists and other staff with relevant technical qualifications.

3.51. The Department should double the number of economists, appointed through open, public competition and trained to Masters level or higher, over the next two years. These appointees should comprise a mix of recent university graduates and experienced individuals and be assigned to positions throughout the organisation. The Department should organise itself to maintain a regular inflow of new university recruits.

3.52. The Department should work to establish a welcoming professional environment for new economists. Economists at Masters level and above should be identified and their numbers reported on annually; a champion for establishing and promoting this "community of interest" should be named.

3.53. The economic seminars by external economists, which were recently introduced by the Secretary General, should be made permanent; the Department should permit the publication of professional economic analyses, by staff in the Department, that are clearly identified as not the views of the Department.

3.54. The Department should expand its complement of skilled staff in other disciplines, especially accounting, analysis, banking and financial markets.

3.55. The Department should immediately seek the secondment of skilled personnel on a two-year rotation from the Central Bank, NTMA, ESRI and other relevant bodies.

3.56. The Department should also promote exchange agreements with other Finance Departments internationally.

Enhanced HR function:

3.57. A senior HR specialist should be appointed to the Department initially, at any rate, on a short-term contract. The post would be advertised and preference would be given to an individual who had managed a dynamic HR function in the private sector.

3.58. The Department should reinforce its performance review process and require the identification of under-performance and an individualised plan to deal with problems identified.

3.59. Once each year, the MAC should take a full day to review individual performance in the Department. It should identify, of all supervisors, the top 20% on people management – those who recognise high performance and deal with poor performance. This process should also identify the bottom 20% - those supervisors who are not performing well in this area and those who are not taking a proactive approach to this issue. Plans to address under-performance should be required. A supervisor's performance in "people management" should have a material impact on consideration for promotion.

Change Management:

3.60. The Secretary General should present a Change Management Plan to employees and report on progress in an annual accountability session to all staff.

3.61. He should be supported by all managers, by a champion for change management at Assistant Secretary level and by the newly recruited professional HR specialist." (Wright pages 49-56 note some omitted text).

3.62. "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 Department of Finance for it to be able to actively fulfil its part of the stability mandate, including cooperating closely and professionally with the CB and internationally." (Nyberg p.

x).

3.63. "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." (Nyberg p. x)

3.64. "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.

3.65. In this regard, it is noteworthy that the Bank of Spain (BoS) had introduced a dynamic provisioning (DP) model for Spanish banks in 2000. BoS required the Spanish banks to continue using DP after 2005 notwithstanding the EU-mandated IFRS adoption." (Nyberg 2.8.13, 2.8.14)

3.66. "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." (Nyberg 3.5.6)

3.67. "While the Department of Finance 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 Department of Finance of the need to take policy actions to counteract some of the factors contributing to these risks." (Nyberg 4.5.6)

3.68. "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." (Nyberg 4.6.7)

3.69. "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." (Nyberg 5.6.6)

3.70. "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." (Nyberg 5.6.9)

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

The Committee is of the opinion that there are five main areas that need further investigation in relation to the Department of Finance:

1. The expertise of officials in the Department of Finance;
2. The ability of Department of Finance officials to "speak truth to power" i.e. to confidently express legitimate contrarian views;
3. The actions that were taken by Department of Finance officials and the Minister for Finance, before, after and during the crisis;
4. The role of the Department of Finance in overseeing the Financial Regulator,
5. In the context of the Department of Public Expenditure and Reform in March 2011, the coordination mechanisms that have been put in place between the two departments.

Each issue is dealt with in turn.

Expertise within the Department of Finance

The Committee is of the opinion that compared with many other OECD countries, the Irish civil service has remained at the more conservative end of the spectrum with regard to human resources reform. In the context of the Wright Report's findings, which clearly identified a lack of expertise within the Department and poor Human Resource (HR) practices, the Committee believes that the following issues require investigation:

Q161. To what extent have HR practices been updated in the Department of Finance and the Department of Public Expenditure and Reform in the light of the Wright Report's findings?

Q162. How are the two departments' HR practices coordinated?

Q163. How have staffing and skill levels been improved to meet Wright's recommendations on risk analysis and financial stability?

Crisis management

The Committee believes that there is a need for a special crisis structure to be developed, which would include a clear division of tasks between the Cabinet, the Department of Finance, Department of Public Expenditure and Reform and the Financial Regulator when major economic crises take place. In this context the following questions arise:

Q164. Prior to the crisis did any exercises take place in the Department of Finance in which a financial crisis was simulated and alternative scenarios were worked out? If not, why not?

Q165. Is the Department of Finance in a position to carry out such exercises now?

Q166. Does it have any plans to do so?

Q167. How have the Department's risk models been revised?

Q168. What steps have been taken to improve crisis management skills within the Department of Finance, the Department of Public Expenditure and Reform, and the Department of the Taoiseach?

Q169. What has been the response of the Department of Finance and the Department of Public Expenditure and Reform to the findings and recommendations of the Regling & Watson, Honohan and Nyberg reports?

Formulation and communication of advice

The Committee believes that a key challenge ahead for the Department of Finance is to

combine objective economic analysis with effective communication on economic policy to Government. In this context the view of the Committee is that the following issues need to be examined:

Q170. Several of the reports highlighted a groupthink/silo mentality within the Department – what is being done to address this?

Q171. How is the challenge to "speak truth to power" and provide robust advice being addressed?

Q172. What procedures were or are in place to ensure that commercially sensitive issues are dealt with in a satisfactory manner when officials go on career breaks?

Q173. What procedures were or are in place to ensure that distance is maintained between officials who work in the department and retired officials?

Q174. Is a register of such contacts kept?

Q175. What is the Department doing to address the lack of women in the Department of Finance at the level of Assistant Principal and above?

Q176. How is the lack of analytical capacity for gender policy advice by the Department of Finance being addressed?

Q177. What actions have been taken to improve record keeping when advices are being given at senior level to support accountability and the decision-making process? In identifying the absence of a record of meetings between BoI, AIB, and the Minister for Finance and the Taoiseach on 29 September 2008, the Committee notes the Wright report finding that written records are an important aspect of the ministerial-administrative relationship.

Q178. The Committee notes the Wright Report's recommendation that budget advice be exempted from Freedom of Information requirements. Has budget advice been exempted along such lines? If not, what are the proposals in this regard?

Actions taken before, during and after the crisis by the Department of Finance officials

The Committee is concerned that there is no clear picture of what happened during and before the crisis.

Q179. What advice or analysis was prepared on the fiscal or monetary effects of property incentives in Budgets from 2000 to 2008? (Nyberg 4.5.2 – 4.5.5, Wright 3.8)

Q180. Given that the Department is understood to have consistently warned of over-

reliance on construction (Wright 3.8.1), why was no advice prepared on the risk posed by reliance on pro-cyclical taxes and narrowing of the tax base? (Wright 3.9.2)

Q181. What was the Department's objective when it intervened with the Financial Regulator in 2006 concerning Directors' Compliance Statements? What representations had it received from banks or other third parties concerning this matter? (Honohan 4.22 – 4.25)

Q182. During the period leading up the to the bank guarantee, what, if any, contact did the Department have with overseas bodies such as foreign governments, the European Central Bank or the EU Commission concerning Irish banks or monetary stability?

Q183. What, if any, views on the soundness of Irish banks were expressed to the Department or its staff by the NTMA between 2003 and 2009?

Q184. What, if any, views on the soundness of Irish banks were expressed to the Department or its staff by the NPRF between 2003 and 2009?

Q185. Did the Department of Finance receive any warning signs from supervisors (or financial institutions) that the institutions were having solvency problems?

Q186. When did the Central Bank give warning of illiquidity or insolvency to the Department of Finance?

Q187. Were these at such a stage that government intervention was unavoidable?

Q188. Given that Professor Morgan Kelly warned publicly in July 2007 on the likely extent of falls in Irish house prices and the effect of these losses on the Irish banks (Anglo/INBS in particular), what action was taken in the Department of Finance to check the analyses?

Q189. What follow through actions were taken?

Q190. During the winter 2008 what external advice from domestic non-bank analysts did the Department of Finance seek or was offered?

Q191. If so, were these warnings conveyed to Cabinet?

Q192. Did the Minister for Finance submit specific reports to the Government on the problems of the banks and their possible impact on the economy in 2007 or 2008?

Q193. What was the quality of information provided by the Department of Finance to the Government?

Q194. Given that concerns within the Financial Regulator and Central Bank about the banks' exposure to excessive lending were not sufficiently addressed or communicated to the Department or Minister for Finance, are there mechanisms in place for ensuring that the Department of Finance is aware of all viewpoints emerging from within the Financial Regulator?

Q195. What steps have been taken to improve the Department of Finance's ability to be assured of the quality of information it receives from agencies and regulators under its aegis?

Q196. What is now the Department's role in relation to banks and financial stability?

Q197. How does this mesh with the responsibilities of the Financial Regulator, Central Bank, Office of the Director of Corporate Enforcement and the Comptroller and Auditor General?

Role of Department of Finance in oversight of Financial Regulator

The Committee believes that there are questions to be raised on the appropriate relationship between the Department of Finance and Financial Regulator. While acknowledging the need for operational independence for the Financial Regulator, the Committee is of the opinion that a healthy relationship between political actors and financial regulators is desirable. The dynamics of the relationships between the Department of Finance, the Financial Regulator and the Central Bank merits closer study.

Q198. What is the appropriate relationship between the Department of Finance, the Financial Regulator and the Central Bank?

Q199. How is operational independence ensured?

Q200. How, at the same time, are flows of information ensured?

Coordination of the Department of Finance and Department of Public Expenditure and Reform

The Committee is of the opinion that there is a potential challenge ahead in coordinating actions and resolving disagreements between the two finance departments about expenditure for regulatory oversight. The Committee acknowledges that this challenge is compounded by the loss of senior personnel due in part to the early retirement scheme, which is part of government policy to reduce public service numbers.

Q201. How do the two departments aim to coordinate their activities and resolve any

disagreements that may arise in terms of priorities and actions?

6. Crisis management and the bank guarantee

Introduction

By 2007 the situation in domestic banking was becoming one of crisis and mechanisms for crisis management were prepared and implemented. This chapter focuses on how these mechanisms functioned and examines the events leading up to the bank guarantee, a decision that has had enormous long-term consequences for the financial stability of the State.

Part 1 summarises the issues relating to crisis management addressed by the published reports including the operation of the Domestic Standing Group, the events leading up to the bank guarantee and the guarantee itself. Parts 2 and 3 summarise the findings and recommendations relevant to crisis management contained in the published reports. Issues identified by the Committee that require further examination relating to crisis management before and since the guarantee are considered jointly in Part 4 of Chapter 7.

Part 1: Summary of issues addressed in the published reports

1.1 Domestic Standing Group

The Domestic Standing Group (DSG), comprising the Department of Finance, the Central Bank and the Financial Regulator, was established in 2006 in response to EU moves to strengthen inter-agency cooperation on crisis-related issues. Its purpose was to act as a framework for managing financial stability issues including potential crises. Meetings were attended by senior staff up to and including the Governor of the Central Bank and the Secretary-General of the Department. From 2008 the NTMA also participated.

The DSG exchanged information about financial markets and regulatory issues, developed procedures and legislation for managing financial stability crises, and participated in crisis simulation exercises. A note of a DSG meeting on 21 September 2007 includes an observation about the reliance of European banks on wholesale funding, adding "– need to do more research on that".

The DSG updated the Crisis Management Manual ("the Black Book"). This set out principles that would guide the Central Bank during a financial crisis, the terms under which it would

provide Emergency Liquidity Assistance[48] (ELA) to banks, and related legal and logistical matters. This task consumed considerable time and resources, but the Book's procedures were cumbersome and it was not relied on in September 2008 (Honohan 8.11).

Deteriorating liquidity

The US sub-prime difficulties began to emerge in August 2007, leading to UK bank Northern Rock seeking ELA from the Bank of England the following month. This prompted the Central Bank to establish a Liquidity Group to monitor liquidity flows.

In March 2008 Bear Sterns was rescued by US authorities. The sub-prime crisis heightened wariness of property-related lending, particularly in the US wholesale markets. While Irish banks had not invested heavily in US sub-prime securities, their exposure to property at a time of declining prices reduced their access to wholesale funds and the terms under which they could borrow. Bank share prices fell steadily, increasing the risk that wholesale depositors might withdraw their funds (Honohan 8.5). The Irish banks had increasing recourse to ECB liquidity facilities[49] as 2008 progressed (Honohan Chart 8.1).

DSG preparations

The DSG reviewed options for resolving potential financial crises in June 2008. The main options considered were the assisted acquisition of a distressed bank by a private (i.e. non-State) buyer and nationalisation. Other options included ELA, investment by the NTMA, and blanket guarantees. The review did not detail how these were to be implemented and recommended that legislation for nationalisation and bank resolution be investigated. If a bank were to be nationalised, it was considered likely that a State guarantee would also be required[50] (Honohan 8.14). Mr Kevin Cardiff, who in 2008 was Assistant Secretary-General with responsibility for banking, told the Committee in 2010 that the group's general view on these issues was informed by the Economic and Financial Affairs Council (ECOFIN), which had stated that no systemic bank should be allowed to fail (PAC 6 May 2010 at p. 57).

Bank resolution is a mechanism whereby authorities can assist distressed, but not necessarily insolvent, financial institutions by means of adjusting the rights and liabilities of investors

[48]ELA is the "lender of last resort" mechanism of Central Banks for distressed financial institutions. It is typically provided against defined classes of collateral provided by the borrowing bank, and at penal interest rates so as to discourage inappropriate or overly long reliance on it.
[49]ECB liquidity assistance is not a "last resort" in the way that ELA is, and recourse to it was relatively routine.
[50]Honohan notes (8.14, fn. 144) that this did not examine the question of guaranteeing senior or subordinated debt. However, a paper dated to September 2008 envisages that both should be covered.

such as bondholders and depositors. It is a more suitable instrument for banks than general insolvency legislation and has been used widely in the USA. The Department did not pursue bank resolution legislation because of the technical and constitutional difficulties it posed, as well as the destabilising effect that could be caused by a leak of the fact that it was being prepared (Nyberg 4.6.6, 4.6.7).

A General Scheme was prepared for draft legislation (known as the "Heads of a Bill") providing for nationalisation of a bank or building society and issuance of a guarantee by the Minister. The Heads refer only to a general guarantee of the borrowings and liabilities of the affected institution and do not distinguish between different classes of debts such as senior or subordinated bondholders. They do however refer to the possibility of a guarantee under another proposed Bill, which may have been intended to give greater definition to the terms on which the Minister's guarantee was to be given. A note on the draft Heads of Bill dated 6 June 2008 states that the Bill may need provisions for the amendment of, among other things, the obligations of lenders and bondholders. However, this seems to refer to consequential effects of nationalisation (such as triggering default clauses) rather than variation of rights under a bank resolution regime.[51]

Both Nyberg and Honohan note that much time was taken up by matters related to Anglo's share price and the effect of the Quinn/Anglo contracts for difference (CFD) situation. This prevented sufficient attention being paid to the mounting pressures on the banks, and actions – such as raising or conserving capital – that might have mitigated the risks they faced (Nyberg 4.6.9, Honohan 8.15). AIB, BoI and Anglo all paid dividends during 2008, and a DSG minute dated 8 July 2008 notes a report by the Financial Regulator that a "line-by-line" examination by a "major bank" of its loan book showed profitability even using a "worst-case" scenario.[52]

1.2 Events leading to the bank guarantee[53]

On 5 September 2008 Reuters alleged that INBS was in talks with lenders to avoid insolvency. Although retracted, pressure grew on banks as both share prices and access to funding declined. Prompted by these concerns, the Department commissioned Morgan Stanley to review ILP, Pricewaterhouse Cooper (PwC) to review Anglo and Goldman Sachs to

[51] Outline Heads of Bill, Department of Finance, 6 June 2008, Department of Finance Document 28
[52] Presentation by Anglo to Department of Finance, 18 September 2008, Department of Finance Document 15
[53] See the detailed timelines available in Honohan (Annex 5) and Nyberg (Appendix 3) for international developments during the period leading up to the Guarantee.

review INBS. The latter two institutions were regarded as most vulnerable to the liquidity squeeze, but their solvency was not considered to be in question (Honohan 8.19). Nyberg (4.6.2) states that the Financial Regulator showed an inadequate appreciation of the potential for a liquidity squeeze on a commercial property lender to result in the failure of its borrowers, forcing the bank either to seek external support or fall into insolvency.

On 15 September 2008 Lehman Brothers filed for protection from its creditors and the turmoil in financial markets grew intense. What little credit was available was for extremely short maturities. The DSG moved to establish the possibility of bilateral or European-wide action to help liquidity, and examined how the Central Bank or NTMA might ease the situation.[54]

On 18 September 2008 Anglo gave a presentation to Department officials, apparently to propose that Anglo acquire INBS. In evidence to the Committee,[55] Mr Cardiff stated that he suspected Anglo was seeking to manoeuvre itself into a position – similar to that of both AIB and BoI – of being "too big to fail", that is, of a size that would persuade the market that Anglo would be supported by the Government through any difficulties, and so improve its access to credit. Mr Cardiff said the Department treated this proposal with scepticism. Addressing the Committee on 21 October 2010, Mr Cardiff revisited the subject of this presentation and was in fact unable to state as a fact that Anglo had given the presentation to the Department, or, if they had, to whom it was given.[56]

Responding to public disquiet, on 20 September 2008 the Minister increased the limits under the Deposit Guarantee Scheme to the lesser of 100% of deposits or €100,000. This stabilised retail deposits in the banks, but wholesale deposits continued to be withdrawn. The NTMA retained Merrill Lynch to advise on how to manage the crisis.

Deterioration of Anglo's position

On 22 September 2008 Anglo requested liquidity assistance of €7 billion from the Central Bank. The DSG reviewed available liquid reserves, which came to approximately €18 billion.[57]

On the same day reports from the consultants' reviews of ILP, Anglo and INBS were received. ILP and INBS were reported to be vulnerable to loss of liquidity within weeks, but could

[54]DSG Minute 17 September 2008, Department of Finance Document 17.
[55]Committee of Public Accounts Deb. 22 July 2010, pp.7, 53.
[56]Committee of Public Accounts Deb. 21 October 2010, pp. 9-10
[57]Note of DSG meeting 22 September 2008, Department of Finance Document 9.

survive with assistance. Anglo was on the verge of running out of cash in days.[58]

Asked about the conclusions he drew from Anglo's up-beat presentation on 18 September and its state four days later, Mr Cardiff told the Committee of Public Accounts that, while solvency was always a consideration, the focus of concerns was on liquidity because PwC's report had indicated that Anglo's loan book, while not comprising assets that would give it quick access to liquidity, showed only 3% impairment.[59] This reflected accounting standards which prevented the bank from making provisions for impairment before the corresponding debts actually fell due: the fact that the commercial property market was falling was not grounds enough to record impairment.

Concerns continued to grow during the week. A number of individuals were given "listening briefs" on the Department's work to resolve the crisis. [60]

Merrill Lynch presentation

On Thursday 25 September 2008, Merrill Lynch reviewed options with the Taoiseach, Attorney General, the Minister for Finance, CBFSAI, NTMA, senior staff of the Department of Finance and external legal and accountancy advisors.[61] The Chief Executive of the Financial Regulator, Mr Pat Neary, stated that there was no evidence to suggest that Anglo was insolvent on a "going concern" basis.

On 26 September Merrill Lynch presented to the Minister on the options discussed the previous day.[62] The options outlined included nationalisation and a "Secured Lending Scheme" (SLS), under which the Central Bank would issue high-grade securities to the banks in return for collateral from their loan books; this would give the banks greater access to liquidity but would place the risk of the banks' loans on the Central Bank's balance sheet. Concerns about those risks, the Central Bank's relatively low cash buffer, and EU restrictions on State aids militated against this proposal (Honohan 8.22).

Another option was to use ELA to provide short-term liquidity. This too raised questions of the risk assumed by the Central Bank and the effect on its limited cash buffers. Given ELA's

[58]Department of Finance Documents 6, 8 and 11.
[59]Committee of Public Accounts 22 July 2010, pp. 9, 42, 51-52.
[60]Sunday Independent, "Ex-Anglo man 'briefed Cardiff on banks crisis'", 29 January 2012, available at http://www.independent.ie/business/irish/exanglo-man-briefed-cardiff-on-banks-crisis-3002988.html
[61]Minute of meeting in Department of Finance, 25 September 2008, Department of Finance Document 6.
[62]Merrill Lynch presentation to NTMA "Draft Preliminary Analysis", 26 September 2008, Department of Finance Document 4.

"last resort" nature, its use would cause reputational damage to Irish banks generally that could bring them all down (Honohan 8.23).

Other options presented to the meeting included guarantees, nationalisation, and the "bad bank approach". In relation to guarantees Merrill Lynch advised that depositors and senior bondholders should be covered, and possibly dated subordinated bondholders. A guarantee is described in the presentation as the "best/most decisive/most impactful" measure from the market perspective, but Merrill Lynch advised that a blanket guarantee for all banks could be a mistake and would affect Ireland's credit rating and prolong the survival of weak institutions. Minutes taken at the meeting emphasise the importance of credibility. The question of including dated subordinated debt was discussed. Undated subordinated debt holders are not mentioned in the Department's note of the meeting.[63]

1.3 The guarantee

An email from PwC to NTMA on Sunday 28 September makes it clear that Anglo would run out of cash the following day. INBS and ILP, while under pressure, had some liquidity assuming deposits were not withdrawn faster than expected.[64]

On Monday 29 September there was a dramatic fall in Anglo's share price and continuing deposit withdrawals. That afternoon, the Chairmen and CEOs of AIB and BoI requested a meeting with the Taoiseach and Minister for Finance to discuss the impending collapse of Anglo and how it might affect their banks. A series of meetings followed involving the Taoiseach, the Minister, Merrill Lynch, CBFSAI and the Department. According to Honohan, AIB and BoI sought a general guarantee (including subordinated debt) and the nationalisation of Anglo and possibly INBS so as to remove their negative reputations and reduce the other banks' borrowing difficulties (Honohan 8.30).

Lack of records

Mr Cardiff was unable to tell the Committee whether AIB and BoI had brought documents or financial statements, and he could not produce a minute of their meeting with the Taoiseach and Minister, even though officials were present.[65] Nyberg notes the lack of written records of those meetings, and the consequent difficulty in reconstructing the sequence of events or the

[63] Notes on Merrill Lynch presentation, 26 September 2008, Department of Finance Document 5.
[64] Email from J. McLoughlin (PwC) to B. McDonough (NTMA) 28 September 2008, sent to PAC 13 October 2010.
[65] Committee of Public Accounts Deb. 22 July 2010 pp. 21 – 23.

opinions of the Central Bank, Financial Regulator or NTMA. He allows that the pressure and rapid unfolding of events made it difficult to keep note of discussions. However, it makes it difficult to assess the participants' understanding of the banks' financial positions and hence the contingent liability assumed when the guarantee was announced (Nyberg 4.7.2 – 3). Addressing the Committee of Public Accounts in 2010 Mr Cardiff indicated that his main source of information on the state of the banks was the Financial Regulator.[66] He conceded that the fact that it had been found necessary to send in PwC to get an accurate picture suggested that the Financial Regulator did not have entirely accurate information.[67]

Options presented on 29 September 2008

The options outlined by Merrill Lynch appear to have formed the focus of discussion. There is a suggestion that nationalisation was the preferred option until 7:00pm.[68] However, at 6:37pm Mr Cardiff, while in a meeting with the Taoiseach, sent an email to Merrill Lynch requesting a note outlining the pros and cons of a guarantee, which was sent six minutes later.[69] This note discusses a number of options in terms consistent with Merrill Lynch's presentation on 26 September:

- Provision of immediate liquidity (by the Central Bank and possibly by the ECB);
- Nationalisation ("State protective custody") – this would be accompanied by a guarantee of the nationalised bank's depositors, senior creditors and holders of dated subordinated debt (as there is considerable "crossover" between these two), while shareholders and undated subordinated bondholders would get nothing;
- A Secured Lending Scheme (SLS) , which could be used in conjunction with nationalisation (for banks not taken into State custody) or as an interim measure while a more permanent solution – such as a sale of the distressed bank – is arranged;
- Consolidation of one or more banks – this option focused on ILP and EBS;
- A guarantee.

The guarantee option is proposed as an alternative to the SLS, as it would help to stem outflows, encourage deposits, and so provide liquidity without the cost or reputational damage

[66] *Ibid.* at p. 21.
[67] *Ibid.* at p. 16.
[68] *Ibid.* at p. 34.
[69] Merrill Lynch note attached to email to K. Cardiff, 29 September 2008.

of State-supported lending. The note emphasises the potential impact on the State's sovereign credit rating of contingent liabilities that it estimates could exceed €500 billion. That could in turn raise issues as to the guarantee's credibility. This section of the note is silent on the question of subordinated debt.[70]

As announced the following morning, the guarantee extended to all the deposits, covered bonds, senior debt and dated subordinate debt of AIB, BoI, Anglo, ILP, INBS and EBS. The covered banks were to fund the guarantee by a payment based on the estimated stress on the State's creditworthiness.

After the decision to issue the guarantee, AIB and BoI were asked to provide Anglo with immediate short-term liquidity. The two banks agreed to provide a total of €5 billion for a matter of days, subject to Government guarantee. The Central Bank also agreed to allow Anglo a €3 billion liquidity facility, which, following the inflow of funds consequent to the guarantee, Anglo did not draw upon (Honohan 8.31 – 8.32).

No contemporaneous records are available of the decision to recommend the adoption by the Government of the guarantee, and the Government's decision is subject to Cabinet confidentiality. However, Mr Cardiff stressed Merrill Lynch's observation that "the guarantee was the quickest means of making the greatest impact, although certain risks were associated with it".[71]

Scope of the guarantee

In September 2010 Minister Lenihan told the Joint Committee on Finance and the Public Service that in a small economy like Ireland's, the sovereign was inextricably linked to the banking system and that there was no alternative to the guarantee as issued.[72]

However, Honohan describes the guarantee's scope as "exceptionally broad", including as it did interbank deposits, covered bonds and senior and subordinated debt. Inclusion of long-term and subordinated bonds was not necessary to protect liquidity as these were "locked in". Furthermore, investors in these products are sophisticated and can be expected to understand the risks they face. If there was a fear that failure to include these bonds might have prejudiced future bank or Government bond sales, those future bonds could themselves have

[70]Merrill Lynch note attached to email to K. Cardiff, 29 September 2008, Department of Finance Document 3, pp. 3-7.
[71]Committee of Public Accounts Deb. 22 July 2010 at p. 45.
[72]Joint Committee on Finance and the Public Service Deb. 22 September 2010 at p. 19.

been guaranteed separately. While debt buy-backs have reduced the sums owed, inclusion of these bonds has added to the share of bank losses borne by the State (Honohan 8.39 - 40).

The flawed understanding behind the guarantee

Nyberg accepts that the broad, clear and decisive nature of the guarantee initially had the desired effect of restoring liquidity. However, the Government's limited insight into the large risks it was assuming cannot be excused. Had there been a proper understanding of the banks' situations in the years before the crisis, remedial action might have been taken, though given the depth of the crisis and the extent of the banks' exposure to property, even that is not certain (Nyberg 4.7.11 – 12). Similarly, Honohan observes that while the guarantee was appropriate in terms of the Government's state of perception of the banks and the liquidity pressures they faced, their information on the banks' true state of affairs was flawed, the likelihood of a major payout was misjudged, and no attempt was even made to quantify it (Honohan 8.44).

Was Anglo systemically important?

Honohan concludes that, given the international financial turmoil, heightened aversion to property risks and the widespread view that Lehman Brothers should not have been allowed to fail, any insolvency by an Irish bank would have had a catastrophic effect on the other Irish banks. Having particular regard to Anglo's interconnectedness with the Irish banking system, it must be regarded as having been of systemic importance to the Irish banking system and could not have been allowed to fail. A disorderly failure would have caused lenders to avoid all Irish banks and without Government support or ELA they would have had to close (Honohan 8.41 – 8.43, Box 8.4 p.131).

Part 2: Findings contained in published reports

The findings of the published reports in the area of crisis prevention and management were:

2.1. If the authorities had had better information about the underlying condition of the banks from August 2007, and had properly appreciated the macroeconomic imbalances, action could have been taken to put the banks in a more robust position in September 2008 (Honohan 1.24). However, both banks and the authorities were still convinced in September 2008 that the concern was principally one of liquidity (Nyberg 5.3.15)

2.2. Preparatory work led by the Department of Finance, particularly in 2008, increased the readiness of the authorities to deal with the crisis in September that year (Honohan 1.25).

2.3. A broad guarantee was appropriate in the conditions prevailing in September 2008. However, the extent of the guarantee – including long-term bonds – is subject to criticism even without the benefit of hindsight.

2.4. The authorities could have consulted overseas authorities earlier (Honohan 1.27). This, and use of short-term measures such as ELA, may have bought time for less pressurised consideration of options for dealing with the crisis (Honohan 8.46).

2.5. The positions of senior bank management should have been reviewed immediately following the guarantee.

Part 3: Recommendations contained in published reports

In this section the relevant recommendation is presented verbatim.

There is only one recommendation in the published reports that specifically focuses on the mechanisms for managing a crisis:

3.1. "Ultimately, recognising the nature of the crisis and the unprecedented level of State support to covered institutions there would be merit in a tripartite review by the Central Bank, the Regulator and the Department of Finance of the efficacy of the measures taken both individually and collectively and in order to record the knowledge gained in the course of the crisis and to identify any lessons learned for future policy formulation." (CAG Special Report 72, p. 10)

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

It is the view of the Committee that issues that remain outstanding and require examination in the area of crisis management before, during and since the guarantee (Chapter 7) are inter-linked. The evaluation of policies against policy alternatives available to the Government requires further examination. Questions also remain about the processes of governmental decision-making prior to, during and following the crisis. We present all of these outstanding issues together in Part 4 of Chapter 7.

7. Crisis management after the guarantee

This chapter concerns the Government's management of the crisis after the guarantee. A range of measures, including the recapitalisation and reconstruction of the banks, was undertaken and the process of transferring impaired assets to NAMA began.

Part 1 summarises the issues addressed in the published reports on this crisis management period (in particular the period from October 2008 to January 2009), the process of recapitalisation and reconstruction, the establishment of NAMA and developments in regulatory reform. Parts 2 and 3 outline the findings and recommendations contained in the published reports in relation to crisis management. Part 4 outlines issues identified by the Committee that require comprehensive examination including important policy decisions that were taken, and how such decisions were made both before, during and since the bank guarantee.

Part 1: Summary of issues addressed in published reports

1.1 October 2008 – January 2009

Following the Government's issue of the guarantee on 30 September 2008, it intensified its scrutiny of the covered banks to establish the extent of its contingent liability. PwC examined banks' loan books to get a clearer picture of their liquidity, while Merrill Lynch investigated the adequacy of capital. The preliminary results announced in November 2008 indicated that liquidity, rather than solvency, was the main issue of concern, though stress tests indicated that additional capital may be required to satisfy market expectations. Based on this, the Minister announced that the banks had sufficient capital to see them through until 2011 but that the State would be willing to back any market-led capital investments in the banks. Nyberg (4.8.4) finds the assumptions on which this analysis was based to be questionable.

In December 2008 Anglo issued preliminary results that were regarded by the market as disappointing. A Government announcement of a recapitalisation programme of up to €10 billion was undermined by media disclosure of the directors' loans issue at Anglo, resulting in the resignation of the Chairman and CEO. Shortly after, the Government announced a recapitalisation programme for Anglo (€1.5 billion), AIB (€2 billion) and BoI (€2 billion).

On 9 January 2009 the Chief Executive of the Financial Regulator announced his retirement

following the Financial Regulator's internal investigation into the Anglo directors' loans issue. That issue, combined with as-yet unpublicised information concerning back-to-back loans with ILP and loans relating to the Quinn Group's shareholding in Anglo, prompted the Government to announce the nationalisation of Anglo on 15 January 2009.

Nyberg remarks of this period that the Government's shifting positions, and the revelation of poor governance in and supervision of Anglo, contributed to a perception that the Government was unsure of the situation and lacked the ability to take decisive action. This undermined the credibility of the guarantee and hindered the banks' access to liquidity and capital funding (Nyberg 4.8.10).

1.2 Recapitalisation and reconstruction

This section describes the stages of the various recapitalisation efforts of the domestic banks and the forms these took, such as preference shares and issuing promissory notes. The following table sets out the State's direct support to the covered institutions as at the end of December 2010. The future capital needs of €24 billion as discovered by the March 2011 Prudential Capital Adequacy Requirement (PCAR) are shown in column 6.[73]

Table 1: Capitalisation of Credit Institutions, December 2010[74]

Credit nstitution	Cost of share acquisition [(a)]. €bn	Cost of Preference shares €bn	Value of Promissory note €bn	Total capital provided to 31/12/2010 €bn	Future capital needs €bn	Total capital requirement €bn
Anglo	4.00	0.00	25.30	29.30	-	29.30
AIB	4.10	3.50	-	7.60	13.30	20.90
BoI	1.91	1.84	-	3.75	5.20	8.95
INBS	0.10	-	5.30	5.40	-	5.40
EBS	0.63	-	0.25	0.88	1.50	2.38
ILP	-	-	-	-	4.00	4.00
Total	**10.74**	**5.34**	**30.85**	**46.93**	**24.00**	**70.93**

[73] The actual cost of the 2011 post PCAR recapitalisation was €16.5 billion due to private sector involvement in the recapitalisation of BOI.

[74] Taken from Comptroller and Auditor General, Annual Report 2010 p.36

Source: Department of Finance (a) Ordinary shares are acquired at cost. The investment in ordinary shares includes dividends received in the form of ordinary shares from AIB (€280m) in 2010.

Anglo

In February 2009 details of the back-to-back loan arrangement between Anglo and ILP became public and it was apparent that Anglo's balance sheet was overstated. This was confirmed in May 2009 when Anglo's losses for the six months to 31 March 2009 were announced at €4.1 billion after impairment charges of €4.9 billion.[75] Further losses of up to €7.5 billion were predicted to be incurred by September 2011.[76] The Minister immediately announced a capital injection to allow Anglo to continue to meet capital adequacy requirements. This was accomplished with EU State Aid approval on 29 June by means of a Government promissory note for €4 billion drawn on Exchequer funds, in return for which the State received equity capital in Anglo. Anglo applied the proceeds in part to buy back subordinated debt at large discounts.[77]

In March 2010 Anglo's losses for the 15 months to December 2009 were reported as €12.7 billion after impairment charges of €15.1 billion.[78] It was determined that Anglo would require approximately €8 billion immediately, and up to €10 billion more over time in order to meet regulatory requirements. The Minister issued a further promissory note to the value of €8.3 billion in March 2010, increased to €10.3 billion in May 2010. EU approval of a further injection of €10 billion was sought in June 2010. Further capital was required to provide for discounts of up to 100% on loans transferred to NAMA,[79] and by December 2010 the total State capital support to Anglo had come to €29.3 billion.[80]

Mr Alan Dukes, the State-appointed Chairman of Anglo stated in June 2010 that Anglo's post-nationalisation strategy was to realise its assets in the most cost-effective manner possible, "adding value" where it could, while running Anglo down over time.[81] Dukes argued that the cost of financing an immediate closure of Anglo would be considerably higher than the

[75] Comptroller and Auditor General, Annual Report 2008, para. 7.44
[76] Finfacts Ireland, "Anglo Irish Bank reports €4.1 billion loss for 6-months to March 31, 2009", retrieved 4 Feb 2012, available at http://www.finfacts.ie/irishfinancenews/article_1016805.shtml
[77] Comptroller and Auditor General, Annual Report 2008, para. 7.45
[78] Finfacts Ireland, "State-owned Anglo Irish Bank reports loss of €12.7 billion for the 15 months to end December 2009", retrieved 4 Feb 2012, available at http://www.finfacts.ie/irishfinancenews/article_1019371.shtml
[79] Joint Committee on Finance and the Public Service Deb. 16 June 2010 at p. 30
[80] Comptroller and Auditor General, Annual Report 2010, Para 4.7.
[81] *Ibid,* pp. 22 – 23.

strategy adopted following nationalisation, whereby the bank would avoid default and maintain its minimum required capital, allowing it to wind down its affairs over a 10-year period.[82] A contrary view was expressed by Mr Peter Matthews (then a private citizen) in evidence to the Finance Committee immediately following that of Mr Dukes. He said that the poor prospect of recovery on Anglo's loans, and the extraordinary nature of the errors and misjudgements that led to the banking crisis, were such that it should be shut down immediately, its losses shared by investors including bondholders, and State resources focused on supporting the "pillar" banks, AIB and BoI.[83]

The Government's position was elaborated by Minister Lenihan in September 2010 when he stated that, in light of the guarantee and of Anglo's systemic position in Ireland's financial system, there was no question of default on senior bonds or deposits as these had become effectively identified with Ireland's sovereign debt.[84]

AIB and BoI

Following reviews of loan assets by PwC and Jones Lang La Salle, the assessment of AIB's and BoI's capital requirements of €2 billion each in December 2008 was increased in March 2009 to €3.5 billion each. This was provided by means of an investment by the NPRF. On the direction of the Minister, the NPRF received advance allocations of its 2009 and 2010 payments from the Exchequer and these, together with funds from the NPRF's reserves, were used to buy preference shares in each of those banks to the value of €3.5 billion. The preference shares carry an 8% dividend payable in cash or ordinary shares, and entitle the State to appoint 25% of each bank's directors. In addition they entitle the State to 25% of voting rights in respect of board appointments and changes of control. As a condition of this investment, AIB was also required to strengthen its capital base by a further €1.5 billion from non-State sources.[85]

On 19 February 2010 BoI declared a dividend of €250 million on the preference shares. This was paid to the NPRF in ordinary shares equivalent to 15.7% of BoI's share capital. On 13 May 2010 AIB paid a dividend of €280 million in ordinary shares equivalent to 18.6% of the

[82] *Ibid,* pp. 41-42.
[83] Joint Committee on Finance and the Public Service Deb. 16 June 2010, pp.83 - 85
[84] Joint Committee on Finance and the Public Service Deb. 22 September 2010, p. 7.
[85] Comptroller and Auditor General Deb. Annual Report 2009, Paras. 6.51 – 6.52.

bank's share capital.[86]

In March 2010 both banks received further support. In the case of BoI, the NPRF supported a share placement and rights issue by converting preference shares to ordinary shares, increasing its equity stake to 36% and reducing the value of its preference shares to €1.8 billion. In the case of AIB, the NPRF converted preference shares to ordinary shares and bought further ordinary shares for cash. At the end of December 2010 a further €5.2 billion was projected to be required to fully recapitalise BoI.[87]

In December 2010 AIB required further capital investment to meet regulatory requirements. The NPRF purchased shares to the value of €3.7 billion giving it a stake of 92.8% of AIB's issued share capital, including 49.9% of its ordinary share capital.[88] At the end of December 2010 a further €13.3 billion was projected to be required to fully recapitalise AIB.[89]

INBS

The 2010 review of capital requirements identified a need to inject €2.6 billion into INBS to meet regulatory capital requirements. The State took control of INBS in March 2010 by means of a Special Investment Share for which it paid €200 million. Immediately after this the Minister issued it a promissory note to the value of €2.6 billion.[90] In July 2011 INBS was merged with Anglo to form the Irish Bank Resolution Corporation.

EBS

The 2010 review of capital requirements identified a need to inject €875 million into EBS to meet regulatory capital requirements. The State took control of EBS in June 2010 by means of a special investment share for which it paid €100 million. Immediately after this the Minister issued it a promissory note to the value of €250 million. This, together with the value received for the special investment share, and €88 million raised by EBS through a liability management exercise, contributed €438 million. Revised estimates of EBS's capital requirements resulted in a further €525 million being added by way of special investment shares in December 2010, with a projected future requirement of €1.5 billion.

[86]The NPRF had wished to receive the dividend in cash but this was vetoed by the EU Commission. See Committee of Public Accounts Deb. 22 April 2010 at p. 10.
[87]Comptroller and Auditor General, Annual Report 2010 Para 4.7, Fig. 7.
[88]NTMA Results and Business Review 2010
[89]Comptroller and Auditor General, Annual Report 2010, para. 4.7, Fig. 17
[90]Comptroller and Auditor General, Annual Report 2009

In February 2011 the deposits of Anglo and INBS were transferred to AIB and ILP respectively, together with NAMA and other bonds held by the two non-trading institutions.[91]

In March 2011 the Minister for Finance announced the twin-pillar strategy, whereby AIB would merge with EBS to form one full-service bank, with BoI remaining as the other. ILP was to be restructured also. In April 2011 the Government proposed legislation giving it power to require banks to maintain a loan-to-deposit ratio of 122.5%, as well as to dispose of assets.[92]

1.3 NAMA

As part of the Emergency Budget in April 2009, the Minister for Finance announced a "bad bank" programme of acquisition of impaired bank assets as a means of providing liquidity to banks and improving their ability to raise capital on the markets. This was to be affected through the National Assets Management Agency (NAMA) established under legislation passed later that year.

NAMA functions by buying impaired loans from banks at a discount that reflects the loans' "long-term economic value". NAMA pays for the loans by means of bonds that the receiving bank can either hold or use as a means of raising liquidity from the Central Bank or ECB. Mr Brendan McDonough, Chief Executive of NAMA, cited "huge systems failures" in the banks leading to unrealistic valuations of loans in 2009, and agreed that "false and misleading information" was given to NAMA about them. As a result, NAMA takes a very strict approach to loan valuation, resulting in discounts averaging 53%, in contrast to the average of 30% suggested by some banks in 2009.[93]

NAMA seeks to recover the full nominal value of the loan from the borrower. Where the underlying project for which the loan was granted appears unlikely to generate value, NAMA may move to realise the security (by way of receivership or sale of the secured property or other assets) or by calling in personal guarantees. Where the project for which the loan was granted appears to offer a prospect of a return within 3–5 years, NAMA is prepared to work with the borrower to achieve as much value as possible.[94]

[91] Comptroller and Auditor General, Annual Report 2010, para. 4.14
[92] *Ibid.* paras. 4.13, 4.15, 4.17
[93] Committee of Public Accounts Deb. 18 November 2010, pp. 48-49
[94] *Ibid,* pp. 3-7

Returns on loans are applied first to recoup the sum NAMA paid to the bank for them. Any net surplus will be remitted to the banks from which they were bought.

By December 2010 NAMA had purchased 11,000 loans involving approximately 850 borrowers and having a total nominal value of €71 billion. The price paid in bonds for these was approximately €41 billion, giving an average discount of nearly 58%.[95]

In 2010 Mr Peter Matthews criticised the NAMA strategy, arguing that experience in US bank crises indicated that direct investment in the banks while leaving the impaired loans in place generated up to 10-fold returns.[96]

1.4 Regulatory reform

Following the issue of the guarantee, the Financial Regulator intensified its regulatory approach to the covered banks. This included increased reporting requirements, on-site attendance (including at board and Committee meetings), reviews of management information and (after 2009) of individual transactions. A department dedicated to supervision of the covered institutions was created in the Financial Regulator.

The Financial Regulator's supervisory stance was widened to include more detailed analysis of banks' business models, strategies and risks, including directors' loans. It also increased resources available for, and the use of, investigations and penal measures such as administrative sanctions.

The Financial Regulator cooperated with external investigations conducted by An Garda Síochána, the Office of the Director of Corporate Enforcement, and the Director of Public Prosecutions. It also referred the conduct of certain external auditors to professional accountancy bodies.

The Financial Regulator explored with accountancy bodies the scope for an enhanced role for auditors in oversight and verification of regulatory returns.

Staffing levels were increased and a new IT investment and deployment strategy was developed.[97]

In 2010 the Oireachtas passed the Central Bank Reform Act, which created a unitary structure

[95] Comptroller and Auditor General, Annual Report 2010, para. 4.4
[96] Joint Committee on Finance and the Public Service Deb. 16 June 2010 at p.88
[97] See generally Comptroller and Auditor General, Special Report 72

for both the Central Bank and the Financial Regulator. It also created a statutory regime governing the fitness and probity of personnel in the financial services industry. The functions previously performed by the Consumer Division of the Financial Regulator were transferred to the National Consumer Agency, which was in turn merged with the Competition Authority.

The Credit Institutions (Stabilisation) Act 2010 gave the Minister for Finance power to direct the affairs and reorganise the assets and liabilities of banks as a means of resolving difficulties and preserving financial stability. This is a temporary Act, which is due to expire at the end of 2012. The Government has tabled the Central Bank and Credit Institutions (Resolution) (No. 2) Bill which is intended to provide the Central Bank and the Minister with a permanent set of tools and structures for bank resolutions.

The Government has also tabled the Central Bank (Supervision and Enforcement) Bill 2011 to provide enforcement measures relating to financial services legislation and to protect whistleblowers.

Addressing the Committee in 2010, the newly appointed Financial Regulator Mr Matthew Elderfield welcomed the new statutory fitness and probity regime under the Central Bank Reform Act, and looked forward to the introduction of statutory codes on corporate governance and loans to related parties. He reported that staffing in all areas of his office had increased and would continue to grow as he added personnel skilled in risk analysis, legal enforcement, investigations, policy, credit analysis and financial markets.[98]

Part 2: Findings contained in published reports

2.1 A decision to nationalise Anglo at the time of the guarantee rather than the following January would not have made a significant difference to the cost of the bank bailout (Honohan 8.52).

2.2 The Department of Finance, the Central Bank and the Financial Regulator should conduct a tripartite review of the efficacy of measures taken to support banks both individually and collectively, to record the knowledge gained in the course of the crisis, and to identify any lessons learned for future policy formulation (CAG Special Report 72, p.10).

[98]See generally Committee of Public Accounts Deb. 13 May 2010

Part 3: Recommendations contained in published reports

There are no relevant recommendations contained in the published reports beyond those mentioned in Chapter 6.

Part 4: Outstanding issues to be addressed in a parliamentary inquiry

The Committee is of the opinion that two key issues need to be fully addressed in the area of the management of the banking crisis both before and after the guarantee.

- The first is an evaluation of the policy decisions taken by Government to prevent and to manage the crisis in the context of alternative policy options available to it.
- The second is the question of how key policy decisions were made or not made.

4.1 The policy decisions taken

Some of the key decisions taken by the Government and authorities to uphold financial stability and to manage the crisis were examined in the Honohan and Nyberg reports.

The Committee, having assessed the evidence to date, is of the opinion that not all major policy decisions were explicitly evaluated against the alternative policies available to the Government. This is particularly the case for policy decisions made after the guarantee. A critical issue that requires examination is whether the decisions were optimal in achieving the objective of stabilising the financial system at the minimum cost to the taxpayer. In other words, was public money used wisely?

In this context the Committee believes that the following issues require detailed examination:

The guarantee

Q202. Was the decision to issue the guarantee optimal in achieving the objective of stabilising the financial system at the minimum cost to the taxpayer?

Q203. Was the scope of the guarantee the optimal policy decision given the alternatives available to the Government at the time?

In addressing these questions, the decision to issue a guarantee in September 2008 should be clearly evaluated against the policy options considered by the DSG earlier in 2008, namely:

- assisted acquisition (by a private buyer);
- nationalisation;

- Emergency Liquidity Assistance (ELA);
- investment by the National Treasury Management Agency (NTMA).

In addition, the decision should be evaluated against the policy outlined in the Merrill Lynch memorandum (26 September 2008):

- the provision of immediate liquidity by the Central Bank and possibly the European Central Bank;
- nationalisation along with a partial guarantee (guarantee of depositors, senior creditors and holders of dated subordinated debt);[99]
- a Secured Lending Scheme that could be used in conjunction with nationalisation (for banks not taken into State ownership) or as an interim measure while a more permanent solution is arranged;
- the consolidation of one or more banks;
- a "bad bank" option (investigated by the Honohan Report);
- the protective custody option.

Q204. Would earlier nationalisation have sped up the resolution of the crisis?

Q205. Was the decision not to accompany the guarantee with changes in senior management and remuneration policies an optimal decision given the ultimate goal to speed up the resolution of the crisis?

Q206. Did any of the banks incur liabilities between October 2008 and January 2009 that might have been avoided if their senior management had been changed following the introduction of the guarantee?

The recapitalisation programme

Q207. Was the re-capitalisation programme as rolled out for all banks the optimal policy option given alternative policies available to the Government?

Establishment of NAMA

Q208. Was the decision to establish NAMA and the timing of its establishment the optimal policy decision given alternatives available to the Government?

Legislative response

Q209. How effective has the legislative response been in tackling the causes of the

[99] With the partial guarantee, shareholders and undated subordinated bondholders would get nothing.

financial and banking crises? Included in the legislative response are: reforms to regulations affecting the Financial Regulator; the Central Bank Reform Act 2010; Credit Institutions (Stabilisation) Act 2010; and proposed legislation – the Central Bank (Supervision and Enforcement) Bill 2011 and the Central Bank and Credit Institutions (Resolution) (No.2) Bill.

4.2 How key decisions were made

It is the view of the Committee that there is a second dimension to an investigation of the management of the crisis prior to, during and after the guarantee. This concerns how and by whom policy decisions are taken, on the basis of what information, and by whom such information is supplied. Further it concerns how, and to what extent, policy makers are held to account for these decisions.

This is broader than an evaluation of the policy choices made. It relates to the more fundamental issue of how the political system functions and for whom it delivers. While an evaluation of the Government's policy choices might conclude that policies were optimal, sub-optimal or counter-productive, an investigation of the processes of decision-making would address the deeper and unacknowledged (as yet) question of how practices and policies, which were damaging to the financial stability of the country, were allowed to persist for years on end. The Committee is of the view that it is timely to question, with the requisite degree of hindsight, how the processes of decision-making contributed to the speculative mania and accompanying indebtedness that were the backdrop to the banking crisis, to sub-optimal decisions taken during the acute stage of the crisis, and to subsequent crisis management policies. This knowledge may help to prevent other crises of this magnitude in the future.

This question of how decisions were made was subject to far closer analysis in some of the reports published by parliamentary inquiries in other jurisdictions than is evident in the reports published to date on the banking crisis.

The Committee believes therefore that there is a need to probe the following issues: (a) the quality and sources of information and/or advice on which decisions were made by Ministers; and (b) the mechanisms and lines of communication in place between advisers and decision makers, and between the different responsible decision makers. In particular the following issues should be explored:

a) Information and/or advice on which decisions are based:

- the quality and independence of information/advice available to the Minister on the stability of the financial system from the Department of Finance, the Central Bank and the Financial Regulator;
- this is itself influenced by the internal functioning of these institutions – the extent to which senior civil servants in the Department of Finance, Central Bank, Financial Regulator or NTMA included diverging opinions from within their own organisations in the advice that they provided to the Minister explaining why they had discounted these views;
- the extent to which the Minister or Ministers was/were obliged to take the advice of the Department, Central Bank or Financial Regulator or to account for why they declined to do so;
- the opportunities available for private stakeholders and lobbyists to influence decisions taken by Government. This includes the extent to which private stakeholders – in this case the financial institutions themselves and their key debtors in the construction industry – had a role in influencing policy and the extent to which there were mechanisms in place to make this influence public knowledge at the time.

b) Mechanisms in place for informing decision makers and for holding them to account:

- the mechanisms in place to ensure that the Government, its Minister and Department of Finance, the Central Bank and Financial Regulator worked together to ensure the stability of the financial system on an ongoing basis;
- the lines of communication between these responsible actors;
- the clarity of their respective roles in the devising of policy and, more specifically, in devising crisis prevention and crisis management policy;
- the lines of communication between individual Ministers and Cabinet and the broader issue of the effectiveness of Cabinet decision-making and the accountability for decisions taken outside of Cabinet.

The Committee suggests that these processes be examined under the following headings:

Decision-making during the run up to the crisis

Q210. What mechanisms were in place, such as the DSG, to ensure that the Government, its Minister and Department of Finance, the Central Bank and Financial Regulator work together to ensure the stability of the financial system? How effective were the lines of communication between these responsible actors during the pre-crisis period?

Q211. Was there clarity as to their respective roles in the devising of policy and, more specifically, in devising crisis prevention and crisis management policy?

Q212. Are there mechanisms in place to ensure that the Department of Finance is aware of all viewpoints emerging from within the Financial Regulator? Equally, are there mechanisms in place in the Department to ensure that these viewpoints are relayed to the Minister for Finance?

Q213. What steps have been taken to improve the Department of Finance's ability to be assured of the quality of information it receives from agencies and regulators under its aegis?

Q214. Did Cabinet oversee major policy decisions taken, or not taken, in the years running up to the banking crisis? If decisions were not taken in Cabinet, where did that decision-making move to and how was it accountable?

Q215. Are decisions still taken in this way and is this the best way to deal with complex and fast-moving policy problems?

Q216. Concerns within the Financial Regulator and Central Bank about the banks' exposure to excessive lending were not sufficiently addressed or communicated to the Department or Minister for Finance. Why were these concerns discounted by the Government?

Q217. In what ways did lobbying by the construction industry influence the key policy decisions taken by the Government? In what ways did key Government decisions in the years running up to the crisis differ from the advice provided by the Department, the Central Bank and the Financial Regulator and instead appear to favour the construction industry? Was any information provided by the Department of the Taoiseach or the Department of Finance to justify such decisions, in particular where they differed from advice provided?

Q218. Were concerns expressed by the Financial Regulator in 2007 about the risks

inherent in proposed banking legislation considered by the Government? (The proposed legislation, which was subsequently passed as the Assets Covered Securities (Amendment) Act 2007, extended asset-covered securities to allow banks to issue bonds backed by commercial mortgages.) What were the responses of the relevant Ministers to any concerns raised by the Financial Regulator? How did they propose to address these concerns? Was the Government lobbied by the Irish Banking Federation in relation to this legislation? If so, how did such lobbying influence decisions taken by Government in relation to this legislation?

Q219. Has proposed legislation to regulate lobbying been drafted? Will the legislation address "revolving doors"? ("Revolving doors" is where people in positions close to Ministers, and even Ministers, subsequently take up employment with private stakeholders whose primary purpose is to lobby those same Ministers.) What effect would the draft legislation have, were this situation of revolving doors to arise in the future?

Q220. Has there been any consideration given to a system of legislative footprints? (Under this system, a full list of the stakeholders who have had access to Government or legislators in the preparation of legislation is publicly documented.)

Q221. How did the Government and regulators fail to appreciate the irrational positions increasingly adopted and the mounting risks they posed to financial and fiscal stability in the run up to the crisis?

Decision-making during the crisis period (the guarantee)

Q222. Why, and on whose authority, was the "black book"[100] not adhered to in 2008? What guidelines were contained in the black book in relation to crisis management? How did decisions taken and procedures followed differ from the black book guidelines?

Q223. Did the Crisis Management Plan identify lines of authority, roles and responsibilities and means of coordination, leaving individuals with a significant

[100] This is the Crisis Management Manual originally prepared in 2001 and updated by the DSG. It includes: the principles under which the Central Bank would operate during a financial crisis; operational procedures and terms and conditions for emergency liquidity assistance (ELA); and information and logistical issues such as arrangements for contacting responsible persons in the event of a crisis.

amount of autonomy to act?

Q224. Why was the NTMA asked to participate in DSG in 2008?

Q225. What steps have been taken to improve crisis management skills within the Department of Finance and Department of the Taoiseach?

The investigations to date found that the 'black book' was, in practice, found to be cumbersome and was not relied upon. Experts consulted by the Committee suggest that this is in line with international experience that the more elaborate a plan, the more likely it is to be ignored in an actual crisis. On the other hand, an effective integrated command system (ICS) has been proven to be particularly helpful where crises require a response from a network of organisations and where there is potential for confusion as to lines of command.

Given that the crisis-management structure envisaged by the DSG was not implemented, the Committee is of the opinion that there are outstanding questions about who ultimately made the decision to issue the guarantee, on the advice of whom and on the bases of what information.

Q226. When was the Department of the Taoiseach involved in discussions concerning the bank crisis? What papers were sent to, received from, or prepared by that Department for the Taoiseach's role in the crisis management meetings? How did its officials contribute?

Q227. What was the involvement of other Ministers in the decision-making process in September 2008 and why does Cabinet appear to have been side-lined? Was authority delegated by the other Ministers to the Taoiseach and the Minster for Finance?

Q228. More specifically, what role did Cabinet have on 28 September 2008?

Q229. What was the nature of the Central Bank's involvement in the decisions leading up to the guarantee on 29 September 2008? What advice did it give to Ministers? What, if any, contacts did it have with the European Central Bank or other central banks concerning the financial stability of Irish banks in the weeks before the guarantee?

Q230. Merrill Lynch included a "protective custody" option in their note of 26 September 2008, which suggested this as an interim step before a guarantee. Was this seriously discussed and, if so, why was it rejected?

Q231. On whose final say was it decided to include subordinated debt in the guarantee scheme? What role, if any, did non-elected external advisors play in the decision to go for a full guarantee? What advice did they give to the Minister for Finance or the Taoiseach? At what point was any such advice given?

Q232. What was the precise role of the banks – the key stakeholders - in this decision-making process in the run up to the guarantee and on the night during which the guarantee decision was made? In the run up to the guarantee, what contact or representations were made to the Department of Finance by Anglo? Were similar representations made by other banks?

Q233. On the night of the guarantee (29 September 2008), what information did AIB and Bank of Ireland provide to officials as part of their presentations? What were their exact proposals?

Q234. Did civil servants and any Cabinet Ministers discuss the various options being considered on 29 September with representatives of the banks? If so, what views were expressed and by whom?

Q235. Do written records of these discussions exist? If not, why not?

Q236. When were Government Ministers and senior advisers made aware of the directors' loans issue and the back-to-back loan arrangement between Anglo and ILP? Was this information known when Anglo was covered by the guarantee?

Q237. Who was given a listening brief on discussions on the liquidity crisis in September 2008? Why were such briefs given? What information was provided to these parties? What advice, if any, did they provide either formally or informally?

Q238. Who was present in Government buildings on the night of 29 September 2008?

Q239. Why was the decision to issue a guarantee taken as quickly as it was?

Q240. Why was there no written record of critically important meetings both in the run up to and over the course of crisis management?

> The Wright Report identified the absence of a record of meetings between Bank of Ireland, AIB, the Minister for Finance and the Taoiseach on 29 September in particular. The Wright Report clearly highlights the importance of a written record in the establishment of "clear accountability for advice not taken" (Wright, 2010, p. 29).

Q241. What actions have since been taken to improve record keeping at senior level in the Department of the Taoiseach and the Department of Finance?

Decision-making after the guarantee

Q242. What formal mechanisms were in place after the guarantee for decision-making on restoring financial stability? Were lines of authority, roles and responsibilities and means of coordination clear? Are there mechanisms in place designed to cope with a further financial crisis?

Q243. Why was there no alternative to the incremental approach to managing the crisis post-guarantee? Were plans drafted for alternative scenarios? How was this decision to handle policy after the guarantee in this incremental way made? On the basis of what information, and provided by whom, was it made?

Q244. How were decisions prior to the re-capitalisation programme in December 2008 made? On the basis of what information and advice did the Government decide in November 2008 that the crisis was fundamentally one of liquidity and not solvency? Was it on the basis of advice provided in reports commissioned from PwC and Merrill Lynch? How was this conclusion reached by the Government and/or by Ministers involved in crisis management?

Q245. What steps were taken to clarify and/or minimise the potential for conflicts of interest within Merrill Lynch, PwC and any other relevant advisors?

Q246. On the basis of what information, and provided by whom, was it decided to establish the "bad bank" programme? Why did it not become apparent to the Minister for Finance in the autumn of 2008 that the security and documentation underlying the future NAMA portfolio was weak?

Q247. Why were "individual loan concentrations" so poorly understood? Why were estimated haircuts so much less than the haircuts that were subsequently applied?

8. Effectiveness of Oireachtas oversight

There has been no investigation to date of the role of the Oireachtas in the context of the financial crisis in Ireland. The Committee is of the view that this is a glaring omission given the Oireachtas' duty to hold the Government to account for its policies and to legislate, largely by scrutinising the Government's legislative proposals. The Oireachtas is also responsible for holding regulators to account and, in this role, it faces many challenges.

The Committee recalls that the final report of the DIRT inquiry, conducted by a sub-committee of the Committee on Public Accounts, highlighted the role of the Oireachtas in what it described as "a breakdown over a sustained period of years of good government." It noted that a "breakdown in parliamentary scrutiny" was a significant part of this failure. It included in its final report a range of recommendations aimed at strengthening the separation of powers between the executive and the legislature and improving the resources at the disposal of the Oireachtas to scrutinise Government.[101]

The Committee notes that parliamentary inquiries into the financial crisis in other jurisdictions have critically examined the role of parliament. Reports published by the Dutch and the Icelandic inquiries include recommendations aimed at enhancing parliament's capacity and improving its performance in scrutinising government decisions.

Having regard to the above matters, the Committee is of the opinion that the following issues require investigation:

- The performance of the Oireachtas and its Committees in holding the Government to account and in scrutinising policy and legislation concerning the macro-economy and the financial system in the years running up to the crisis;
- The performance of the Oireachtas and its Committees in holding the Government to account and in scrutinising legislation aimed at stabilising the financial system during the management of the crisis and subsequently;
- The performance of the Oireachtas and its Committees in holding the relevant regulatory bodies to account prior to, during and following the management of the crisis;

[101] See Dáil Eireann, Committee of Public Accounts, (2001) Parliamentary Inquiry into D.I.R.T Final Report. P.88. http://vhlms-a01/Data/Library2/Library2/DL028621.pdf

- The incentives for Members of the Oireachtas to develop the level of expertise necessary to effectively scrutinise Government actions and to hold Government to account;
- The resources, capacity and oversight tools at the disposal of the Oireachtas to effectively hold the Government to account and scrutinise Government policy;
- The impact of the Government's control of the agenda on the capacity of the Oireachtas to effectively hold it to account and scrutinise its actions.

1.1 The performance of the Oireachtas in the years running up to the crisis

Q248. Was the Oireachtas proactive in foreseeing the possibility of a financial crisis?

Q249. Did the Oireachtas raise the issue of the instability of the financial system publicly with the Government? When and how frequently?

Q250. Did the relevant Oireachtas Committees raise questions about the stability of the financial system and the sustainability of the economy in the years leading up to the crisis? For example, what were the Committees' responses to high-profile public criticisms of Government policy such as the article published by Morgan Kelly in 2007?

Q251. What were the Committees' responses to the ESRI's 2007 report?

Q252. Did the Oireachtas, through its committees, raise concerns about legislation that allowed the Irish banks to increase their exposure to risk (e.g. the Assets Covered Securities (Amendment) Act 2007)? Did Oireachtas Committees discuss these concerns with the Financial Regulator and the Central Bank?

Q253. Other parliamentary inquiry reports criticised parliament's inattention to important initiatives at the international and European levels.[102] Did the Oireachtas, through its Committees, scrutinise legislation at the European level for their impact on financial stability and on the exposure of Irish banks to risks?

Q254. Were the relevant Committees cognisant of international developments and their impact on Ireland?

[102]See section on parliament in the next chapter of this report: international parliamentary inquiries into bank and financial crises.

1.2 The performance of the Oireachtas during crisis management and since

Q255. Following the Government's decision to issue the guarantee, was the scrutiny process undertaken by the Oireachtas and its relevant Committees adequate?

Q256. What has been the role of the Oireachtas and its relevant Committees in scrutinising key government decisions addressing the banking and financial crisis since September 2008 in the following areas?

- Banking recapitalisation and reconstruction
- Establishment of NAMA
- Legislative and regulatory reforms.

1.3 Government control of the agenda and its effect on the Oireachtas' role

Whether not the Oireachtas was provided with timely and adequate information to allow it to comprehensively scrutinise policy development and decisions is also a key issue, which requires further analysis.

Q257. How did the dominance of Parliament by Government in terms of setting the agenda affect Parliament's capacity to perform its oversight and accountability roles with respect to the stability of the financial system?

Q258. For example, was the time given to the Oireachtas to debate important legislation related to financial stability and the management of the financial crisis sufficient to allow for in-depth analysis?

Q259. Did the Government consult the Oireachtas and its Committees through a pre-legislative consultative process prior to any of the major policy decisions taken in the years running up to the crisis and during the financial crisis? Has it done so since September 2008?

Q260. How open to scrutiny were the governmental decision-making processes? Was Parliament sufficiently aware of the stakeholders with whom Government Ministers consulted in the pre-legislative stage? Was this information available to the Oireachtas?

Q261. Did the relevant Oireachtas Committees have sufficient opportunity to question Ministers about the influence of stakeholders and other advisers in the formulation of policies and legislation?

Q262. What was the extent of expert information available to Parliament that was

independent from information provided by Government?

1.4 Resources, capacity and oversight tools at the disposal of the Oireachtas

Academic studies consistently find that the Oireachtas is itself endowed with relatively weak tools and instruments compared with most European parliaments to perform its scrutiny and accountability roles.[103] A recent study points out that while Oireachtas Committees comprise one of the key mechanisms available to the Oireachtas to hold Government to account and to scrutinise its legislative proposals, they do not have specialised expertise available to them to advise on complex policy issues. Issues for investigation include:

Q263. Is the Oireachtas in a weaker position to perform its scrutiny and accountability roles compared to other European parliaments?

Q264. Are Oireachtas Committees – the key tool available to the Oireachtas to hold Government to account and scrutinise legislative proposals –resourced with specialised expertise and advice on complex policy issues?[104]

Q265. Does the practice of holding second stage debates, which conclude with a vote on the principles of a Bill before holding a committee stage debate, enhance the capacity of the Oireachtas to comprehensively scrutinise the Government's legislation?

Q266. What measures might enhance the capacity for the Oireachtas, primarily through its Committees, to scrutinise the Government's legislative and policy development and to hold it to account effectively?

[103] Gallagher, (2010) *Politics in the Republic of Ireland,* Routledge in association with PSAI Press. MccCartaigh Muiris,(2005) *Accountability in Irish Parliamentary Politics* Dublin, IPA. Hardiman Niamh, (2012), ed., *Irish Governance in Crisis* Manchester, Manchester University Press. pp. 9-11.

[104] The Oireachtas Joint Committee on Finance of the 30th Dáil (fourth report) recommended that an independent Budget Review Council be established to monitor and analyse the development of the economy, to prepare an annual fiscal monitoring report and to develop policy scenarios. It recommended that consideration be given to expanding the role of this Council to allow it to evaluate the fiscal scenarios proposed by opposition members of the Oireachtas. On the mechanics of its establishment it noted that some of the functions of such a Council could be performed by establishing a parliamentary budget office such as the Congressional Budget Office in the USA or the Dutch Bureau for Economic Analysis. See http://www.oireachtas.ie/documents/committees30thdail/j-financepublicservice/reports/20101111.pdf

1.5 Incentives for Members of the Oireachtas to develop levels of expertise

Recent academic work has identified features of the Irish party system that help to explain how the Oireachtas may have contributed to the financial crisis.[105] While parties have an excellent capacity to mobilise local support, they do so by diffusing conflict and grievances. Once in power, therefore, there is little incentive to developing coherent and consistent policy choices and much incentive to keep a variety of interests on board. Further, in keeping with this drive to diffuse conflict by keeping everybody happy, party recruiters value constituency service more than the development of specialised concerns with policy issues. This structure creates little incentive for elected members to develop high levels of expertise on national policy issues.

Q267. Does the nature of the Irish party system affect parliamentarians' ability and incentive to develop the level of expertise necessary to effectively scrutinise the Government's policies on the stability of the financial system?

Q268. Are members of the Oireachtas sufficiently incentivised to critically question Government policy generally and, more specifically, Government's macro-economic policy and its impact on financial stability?

Q269. What measures might increase the incentive for elected members to develop the level of expertise necessary to critically question government policy, in particular its macro-economic policy and its impact on the financial stability of the country?

1.6 Performance of the Oireachtas in holding regulatory bodies to account

Regulatory agencies have no political head and have a substantial amount of autonomy in relation to developing and executing policies. This raises concern as to "who holds the regulators to account?" Yet while a financial regulator must be properly accountable to the public through parliament, it is vital that they have operational independence so that they are shielded from short-term political influences that prevent them from taking unpopular decisions. Bearing in mind these concerns about operational independence, the question arises of how effectively the Oireachtas held the Financial Regulator to account and of the Oireachtas' capacity and incentive to perform this role.

Q270. What was Parliament's role in holding the Financial Regulator in particular to

[105] HardimanNiamh, (2012), ed., *Irish Governance in Crisis* Manchester, Manchester University Press. pp. 9-11.

account in the run up to the financial crisis?

Q271. What mechanisms were in place to enable it to perform this role? Were they adequate?

Q272. To what extent was the performance of the Financial Regulator challenged by the Oireachtas and, more specifically, by the Oireachtas Committees before which it appeared in the run up to and since the crisis?

Q273. Have Oireachtas Committees sufficient resources and expert and independent information available to them to hold regulatory bodies to account?

Q274. What resources were available to Oireachtas Committees to scrutinise and challenge the financial and performance accounts of the Financial Regulator?

Q275. Have Oireachtas Committees incentive to hold regulatory bodies to account?

Q276. What steps might be taken to enhance the scrutiny role of Parliament to raise questions in a timely manner, particularly concerning the operation of regulatory bodies?

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Appendix 1: Legal advice

PRELIMINARY ADVICES

Subject: Certain legal issues concerning a proposed parliamentary inquiry into the banking collapse and related matters

Introduction

1. I have been asked to provide written advices in relation to the "*legal framework*" and the "*appropriate legal form*" for an inquiry into matters connected with the banking crisis in Ireland. On the 25th November 2011, I appeared before a Sub-Committee of the Public Accounts Committee ("*PAC*") and offered certain advices on this issue. Since that time, PAC has commissioned two studies, one into the state of public knowledge already in existence in relation to the banking collapse and the other being a "*gap analysis*"; that is an analysis of issues not covered by reports already in the public domain. That "*gap*" analysis suggests a number of very diverse areas in which information is less than complete. Thus, it suggests that within the banks themselves, their auditors, the Financial Regulator, the Central Bank and the Department of Finance, there remain matters which are unknown and possibly worthy of further investigation. Separately, it is said that the events leading up to the giving of the bank guarantee on the 29th September 2008 are not known in full. I appeared again before the Sub-Committee on the 6th June 2012 and offered further advices in the light of the large amount of preparatory work described above.

Form of proposed inquiry

2. In my advices to the Committee, I have sought to emphasise that the decision of the Supreme Court in Maguire v. Ardagh[1] and the recent rejection of the Thirtieth Amendment of the Constitution (Houses of the Oireachtas Inquiries) Bill 2011 by the people of the State does not mean that all forms of Oireachtas inquiry are precluded. Maguire v. Ardagh is authority for the proposition that the Houses of the Oireachtas do not have an express or inherent power to hold an inquiry such as was at issue in that case, namely, an inquiry which is capable of leading to adverse findings of fact and conclusions as to the personal culpability of an individual who is not a member of the Oireachtas, thereby impugning his or her good name.

[1] [2002] 1 IR 385.

3. I attach as an Appendix[2] hereto a thematic analysis of certain aspects of the judgments of the Supreme Court in Maguire v. Ardagh[3] which merit particular note in the context of the issues on which I have been asked to advise. In Maguire the Supreme Court differentiated between an adjudicative inquiry of the type at issue in that case and inquiries traditionally carried out by Committees of the Houses in aid of their functions. This differentiation is evident in a number of the judgments including, by way of example: Hardiman J. when he, *inter alia*, stated of the Maguire ruling:

> *"The case…does not involve, directly or by implication, any attack upon the work of Oireachtas Committees in general, on the Public Accounts Committee in particular, on the Private Bill procedure, on the powers of scrutiny of the expenditure of public monies..."*[4]

And Murray J. when he stated:

> *"…the Houses of the Oireachtas have the right to inform themselves on matters relevant to their parliamentary functions and to conduct, or authorise committees of the Oireachtas to conduct, inquiries for that purpose."*[5]

An inquiry conducted for a direct and express legislative purpose which is stated in advance and which is not intended to result in findings of blameworthy conduct on the part of identifiable individuals, was stated in Maguire to be *"constitutionally and legally permissible"*.[6]

4. There are two forms on inquiry which appear to be permissible in the light of the Supreme Court decision in Maguire. The first is what may be described as the "inquire, record and report" type of inquiry. By that is meant an inquiry whereby evidence is called, recorded and reported to the Dáil. No findings or conclusions of any nature are made and no opinions of any nature are expressed. The second form of inquiry is one which envisages findings including findings leading to implied blame being attached to particular individuals. In Maguire, Geoghegan J. stated:

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[2] The Appendix was prepared by Douglas Clarke B.L.

[3] [2002] 1 IR 385.

[4] [2002] 1 IR 385 at 658. See section II of the Appendix hereto.

[5] [2002] 1 IR 385 at 584. See section III of the Appendix hereto.

[6] [2002] 2 IR 385 at 741. See generally section III of the Appendix hereto.

"A legitimate inquiry by a committee of the Oireachtas which was directed towards a perfectly proper legislative purpose might in some circumstances inevitably and unavoidably lead to implied blame being attached to an individual. That would not necessarily render the inquiry ultra vires…

…It is also true that a legitimate Oireachtas investigation may inevitably result in a finding of fault in a management system which in some circumstances could involve an implied attachment of blame to the relevant manager. That might also be legitimate. But the all important point is that the inquiry from the beginning would be merely for the purpose of considering whether new legislation was required and for no other purpose."[7]

It should be noted that not every judge in Maguire expressed an opinion on this issue and this aspect of the judgment of Geoghegan J. must be regarded as "obiter".

5. Although an "inquire, record and report" type of inquiry is not without risk or potential difficulties (including, for example a risk of prejudicing criminal proceedings), the second form of inquiry is much more difficult to operate. This is so because if the Committee has Terms of Reference which envisage findings and the possibility of implied blame being attached to individuals, then the various rules requiring the application of fair procedures, the rights to natural and constitutional justice and the rule against bias come into play. As explained later, those rules are of less concern in the context of an "inquire, record and report" form of inquiry. The balance of these advices are directed primarily to that form of inquiry. Some consideration might be given however to the possibility of having some aspects of the contemplated areas for inquiry subject to the second form of inquiry, in which case further and more detailed advices relating to the specifics of the issues arising can be offered.

6. Two forms of statutory inquiry should, however, also be noted. The first is an inquiry by a Tribunal established pursuant to the Tribunals of Inquiry (Evidence) Act, 1921, as amended. The second is an investigation by a Commission of Investigation established pursuant to the Commissions of Investigation Act, 2004. While there may be an understandable reluctance to establish a Tribunal of Inquiry, the establishment of a Commission of Investigation warrants careful consideration and, indeed, I note that one of the reports into the banking crisis was produced by a Commission of Investigation.[8] The possibility of new legislation should also be noted. However, it is clear from the

[7] [2002] 1 IR 385 at 717-718. See section 3, paragraph 32, of the Appendix hereto.

[8] Peter Nyberg "*Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland – Report of the Commission of Investigation into the Banking Sector in Ireland*" (published by the Minister for Finance in April 2011).

judgments in Maguire that any such legislation would have to be very carefully framed and, even then, the legislation or certain aspects of it may be constitutionally vulnerable.

Terms of Reference of proposed inquiry

7. Ultimately, the setting of the Terms of Reference is a policy matter for Dáil Éireann. It is important to recognise, however, that the terms set have both practical and legal implications. Practical experience suggests that the narrower the Terms of Reference the greater the prospect of conducting an efficient inquiry and the greater the prospect of generating a coherent body of evidence. An inquiry which sought to cover all of the areas identified in the gap analysis is most unlikely to be either efficient or productive of a coherent body of evidence.

8. There are also significant legal implications to setting of the Terms of Reference. First, it is very important that the Terms of Reference are clearly and rationally connected with the constitutional functions of the Houses of the Oireachtas. Thus, as Mc Guinness J. observed in Maguire, "*if an inquiry is to be in support of the legislative functions of both Dáil and Seanad, its investigative and legislative aims must be clearly set out in its terms of reference"*.[9] Mc Guinness J. explained that *"[t]he importance of clarity in the nature and purpose of the investigation is related to the terms of the 1997 Act"*:[10]

> *"Persons who are directed under the terms of the Act, as were the Gárda Applicants, to attend an inquiry into facts must answer questions as put to them and must produce documents as demanded. Refusal or failure to do so lays the witness open to suffering serious penalties."*[11]

9. It should also be noted that, while section 3 of the Committees of the Houses of the Oireachtas (Compellability, Privileges and Immunities of Witnesses) Act, 1997 (the "*1997 Act*") confers a general power of compellability upon certain committees, exemptions are provided for in sections 5 and 6 of the Act. Section 5 of the 1997 Act reflects the concept of cabinet confidentiality which is protected by Article 28 of the Constitution but it extends that concept further to include discussions at a meeting of a committee appointed by the Government whose membership consists of one or more members of the Government, together with *"any of the following, that is to say, one or more Ministers of State and the Attorney General"* if certain circumstances are satisfied. To the extent that the 1997 Act extends the constitutionally protected concept of cabinet confidentiality, it can be amended but any encroachment on cabinet confidentiality itself would require

[9] [2002] 1 IR 385 at 616. See generally section VI of the Appendix hereto.

[10] [2002] 1 IR 385 at 634.

[11] *Ibid.*

constitutional amendment. The important point for present purposes is that when setting the Terms of Reference of the proposed inquiry, the Committee should try to anticipate whether the proposed lines of inquiry are liable to meet the obstacles posed by sections 5 and 6 of the 1997 Act.

Standing Order 163 of Dáil Eireann Standing Orders Relative to Public Business

10. The existing Standing Orders, which provide for the establishment of PAC and the nature of its role, do not appear to provide for the holding of an inquiry of the type envisaged. They would therefore require amendment by the House.

Compellability powers

11. Once the Terms of Reference of the proposed inquiry have been set, it will be necessary to secure compellability powers pursuant to the 1997 Act referred to above. To secure such powers, the written consent of the sub-committee of the Committee on Procedure and Privileges of the House is required. The particular form of consent is prescribed by section 3(9) of the 1997 Act. A consent specific to the proposed banking inquiry and having regard to its proposed Terms of Reference will be required.

Natural / constitutional justice and fair procedures

12. An inquiry which takes the "*inquire, record and report*" form indicated above would significantly reduce the scope for issues concerning the rights to natural / constitutional justice and fair procedures that trouble many forms of inquiry.[12] While section 10 of the 1997 Act provides certain protections in the circumstances prescribed and issues concerning the rights to the rights to natural / constitutional justice and fair procedures may well arise during the course of the inquiry, the nature of the inquiry envisaged is such that, *in principle*, the full panoply of *In re* Haughey[13] rights is unlikely to arise. In that case, Ó Dálaigh C.J. identified certain constitutional rights to fair procedures of persons accused of conduct which reflected on their character or good name. The rights identified by Ó Dálaigh C.J. included the right "*to cross-examine, by counsel, his accuser or accusers*".[14] *In principle*, the nature of the inquiry envisaged does not involve any person being accused of conduct which reflects on his/her character or good name, or potential adverse findings or conclusions in respect of any individual. Thus, the inquiry envisaged is in sharp contrast to the inquiry at issue in Maguire.[15] As noted above, it involved potential adverse findings of fact and conclusions (including in that case a finding of unlawful killing) as to the personal culpability of an individual who is not a member of the

[12] In this context, see generally sections IV and V of the Appendix hereto.

[13] [1971] IR 217.

[14] Emphasis added.

[15] In this context, see generally section I of the Appendix hereto.

Oireachtas, thereby impugning his or her good name. The passages from the judgments concerning fair procedures which are set out in the attached Appendix should be read in that light. I note that the Wallace sub-committee inquiring into the fall of the Albert Reynolds Government did envisage certain limited natural justice rights but that appears to have been because it was envisaged that that Committee might report its opinion to the Dáil and in so doing could impinge upon the good name of witnesses who had given evidence before the sub-committee. In the form of inquiry which is envisaged, it should not be necessary for any witness to cross-examine another witness but it would be easy to accommodate a witness making a submission of his own (as opposed to merely being confined to answering questions by members of the Committee).

13. Furthermore, one aspect of the right to natural / constitutional justice – the rule against bias – merits particular note. As appears from section V of the attached Appendix, various issues concerning that rule were considered in Maguire. Although it is important to note the context in which the bias issues arose in that case – in particular as regards the fact-finding / adjudicatory nature of the inquiry the subject of those proceedings – the judgments underline the risk that the integrity and/or objectivity of a parliamentary inquiry can be compromised by purely political considerations and/or an appearance of bias. The judgments also raise the question as to whether certain matters are best addressed by an inquiry which is independent of the political process (such as, for example, a Commission of Investigation established under the Commissions of Investigation Act, 2004). Whilst the proposed bank inquiry, being non-adjudicatory in nature, is far removed from the nature of the inquiry at issue in Maguire, the members of an Inquiry Committee would be well-advised to *"accept a self denying ordinance which would, for example, prevent them from carrying out any media appearances or interviews dealing with the subject matter of the inquiry both before and during its currency"*[16] and care would be required to ensure that Committee members are not perceived as being unduly hostile in their questioning of a particular witness.

Michael Cush

13th June 2012

[16] *Per* McGuinness J. in Maguire v. Ardagh [2002] 1 IR 385 at 656.

Appendix 1a

ASPECTS OF THE JUDGMENTS IN MAGUIRE v. ARDAGH [2002] 1 IR 385

I INTRODUCTION

1. The case of Maguire v. Ardagh[1] involved a challenge to the conduct of an inquiry by a sub-committee purportedly established by a Joint Committee of both Houses of the Oireachtas to inquire into the shooting of a man by the Garda Síochana at Abbeylara in April 2000. The Divisional High Court granted, *inter alia*, a declaration that "*[t]he conduct of a Public Inquiry with the aid of the power of the State and conducted by members of the Oireachtas under the aegis of the Houses of the Oireachtas and with the authority thereof liable to result in finding of facts or expressions of opinion adverse to the good name and/or livelihoods of persons not members of such Houses is ultra vires the powers of such Houses."*

2. By a majority of 5 – 2, the Supreme Court dismissed the appeal but substituted the following declaration for the declaration granted by the High Court: "*the conducting by the Joint Oireachtas Sub-Committee of an inquiry into the fatal shooting at Abbeylara on the 20th day of April, 2000 capable of leading to adverse findings of fact and conclusions (including a finding of unlawful killing) as to the personal culpability of an individual not a member of the Oireachtas so as to impugn his or her good name is ultra vires in that the holding of such an inquiry is not within the inherent powers of the Houses of the Oireachtas*".

3. Certain aspects of the judgments merit particular note in the context of an analysis of the issues the subject of the attached advices. At the outset, it is necessary to identify the precise nature of the inquiry that was successfully challenged in Maguire. The passages from the judgments which are particularly material in that regard are highlighted in section II below.[2] In addition to analysing whether the Houses of the Oireachtas had power to hold an inquiry of the type impugned in Maguire, a number of the judgments also considered the powers of the Houses of the Oireachtas and committees thereof to undertake other types of inquiries. The most significant passages

[1] [2002] 1 IR 385.
[2] Paragraphs 4 – 18.

from those judgments are highlighted in section III below.[3] Sections IV,[4] V[5] and VI[6] highlight certain extracts from the judgments which address issues concerning fair procedures, the rule against bias and terms of reference in the context of inquiries undertaken by committees of the Houses of the Oireachtas.

II THE NATURE OF THE INQUIRY AT ISSUE IN MAGUIRE v. ARDAGH

4. As is apparent from the declaration granted by the Supreme Court, the overarching issue in Maguire was whether it was within the *inherent* powers of the Houses of the Oireachtas to hold the inquiry at issue in that case,[7] namely, an inquiry by a Joint Oireachtas Sub-Committee into a fatal shooting which was capable of leading to adverse findings of fact and conclusions (including a finding of unlawful killing) as to the personal culpability of an individual who was not a member of the Oireachtas, thereby impugning his or her good name.

5. In addressing the nature of the inquiry at issue in Maguire, Murray J. emphasised that the Court was "*only concerned with an inquiry which may make findings of personal culpability impugning the good name of an individual citizen.*"[8] Murray J. elaborated upon the features of the inquiry at issue as follows:

> *"What emerges from the foregoing is that a sub-committee of the Oireachtas has great and comprehensive powers to require citizens, who are not members of the Oireachtas, but whose actions or knowledge of*

[3] Paragraphs 19 – 34.
[4] Paragraphs 35 – 41.
[5] Paragraphs 42 – 59.
[6] Paragraph 60 – 64.
[7] It was accepted that the Constitution does not confer any *express* power in that regard. In this context, *cf* Article 35.4.1 of the Constitution and the judgment of the Supreme Court in Curtin v. Dáil Éireann [2006] 2 IR 566. In addressing the powers of a Joint Committee of the Houses of the Oireachtas established by virtue of Article 35.4.1 of the Constitution, the Supreme Court stated, *inter alia*, as follows:
> *"A committee empowered to hear evidence, rule on admissibility, resolve conflicts of evidence and report its findings to the Houses would have had obvious advantages. The committee would have been in a position to schedule hearings, hear and evaluate the evidence of witnesses, eliminate irrelevant material, concentrate on the principal points at issue and furnish a coherent and cogent report to the Houses. In the opinion of the court it would have been open to the Houses to have chosen such a committee, but they have not done so. It may well be that the Houses were concerned that such a committee could not validly be appointed, having regard to the decision of this court in* ***Maguire v.Ardagh*** *[2002] 1 I.R. 385. If so, it should be said that, so far as the power to appoint a committee was concerned, that case related to the question whether the Oireachtas had inherent implied power to appoint committees to investigate the behaviour of individuals. It has no application to a case where the Oireachtas is acting in the exercise of a power expressly conferred on it by the Constitution."*
[8] [2002] 1 IR 385 at 605. (Emphasis added).

facts are deemed by the committee to be relevant to the subject matter of their inquiry, to appear before it in public session, to answer to the sub-committee and to answer any allegations, however grave, made against them concerning their personal conduct. Persons called to attend are free to make such allegations of a grave nature against any other person with complete immunity, subject only to control by the sub-committee.

Moreover, the scope for an Oireachtas committee to make findings of fact or reached conclusions on any issue of fact or matter involving the culpability or reputation and good name of a citizen affected by the inquiry appears to be unlimited, and certainly appears to have been treated as so by the sub-committee in this case, once those matters fall within the ambit of the inquiry being conducted.

This is exemplified by the assertion of counsel for the sub-committee before the High Court and repeated before this Court that it would be entitled to make a finding of 'unlawful killing' on the part of an individual member of the Garda Síochána."[9]

6. In addressing the impact of such an inquiry, Murray J. stated as follows:

"In the light of the powers of the committee I do not think it can be gainsaid that <u>its findings, however they are characterised, can affect rights</u>.
[…]
An inquiry conducted by members of the Oireachtas on its behalf deploys a concentrated authority that derives from its role as one of the great organs of government established by the Constitution. A committee of the Oireachtas acting under the aegis of that authority and exercising extensive and magisterial, in a non-judicial sense, powers can make <u>an</u>

[9] [2002] 1 IR 385 at 587.

enormous impact on the name and reputation of citizens against whom it makes findings of wrongdoing which, in a court of law, would constitute civil or criminal wrongs. Should the sub-committee in this case proceed to find that an individual garda or gardaí had participated in an unlawful killing it could only have devastating impact on the professional and personal reputation of those concerned even in the absence of legal effect."[10]

7. Murray J. stated that "*any historical review of the role of parliamentary committees of inquiry in the United Kingdom, as those judgments demonstrate, leads to the conclusion that they had notoriously fallen into disrepute by 1921".*[11]Murray J. added that *[i]t is difficult to envisage then that the Constitution of 1922 or that of 1937 would, silently, ordain that the Oireachtas should have power to establish and conduct inquiries and make findings as to the personal culpability of individual citizens for serious wrongdoing".*[12]

8. In concluding, Murray J. stated that *"if the Oireachtas is to exercise the power to establish committees of inquiry so as to make findings of fact and reach conclusions involving personal culpability of individual citizens for alleged wrongdoing of the gravest kind and thereby impugning the good name of a citizen, that power must be found in the Constitution."*[13]Murray J. (and the other members of the majority) concluded that no such power existed.

9. In her judgment, McGuinness J. summarised the issue before the Court as follows:

"The issue before this Court, it seems to me, is whether this particular Sub-committee - the Abbeylara Sub-committee - carrying out the inquiry which the Sub-committee itself proposes by the means it proposes and with

[10] [2002] 1 IR 385 at 590 – 592. (Emphasis added).
[11] [2002] 1 IR 385 at 603.
[12] *Ibid*. (Emphasis added).
[13] [2002] 1 IR 385 at 607.

the end it proposes - falls within the ambit of the inherent power of the Oireachtas to acquire information in aid of its constitutional functions."[14]

10. The following passages from the judgment of McGuinness J. are also notable in this context:

"The Sub-committee could not and did not, of course, administer justice, but it clearly saw itself as having an inquisitorial and adjudicative role in relation to the culpability of individuals, in particular individual Gárdai. Its self-appointed task was to find the facts and to attribute blame by way of a public and deliberately publicised procedure.

In this context I have had the advantage of reading Hardiman J.'s careful analysis of the significance of the term 'findings of fact' and the adjudicative nature of the Sub-committee's role, and I agree with his reasoning and conclusions."[15]

11. McGuinness J. concluded that "*both the present remit of the Abbeylara Inquiry and the course of action taken by it go well beyond any constitutionally-related and proportionate inherent power of a committee of both Houses of the Oireachtas".*[16]

12. In his judgment, Hardiman J. stated that "*[t]he first and most fundamental issue raised by this case […] is whether the sub-Committee is empowered to carry out the sort of inquiry they propose - one which may potentially lead to a finding of unlawful killing - solely on the basis of the alleged unwritten but inherent power".*[17]Hardiman J. stated that "*itis important to be clear that certain issues do not arise":*[18]

"The case made by the Garda applicants, in my view, does not involve, directly or by implication, any attack upon the work of Oireachtas

[14] [2002] 1 IR 385 at 616.
[15] [2002] 1 IR 385 at 617. (Emphasis added).
[16] [2002] 1 IR 385 at 624.
[17] [2002] 1 IR 385 at 658.
[18] *Ibid*.

Committees in general, on the Public Accounts Committee in particular, on the Private Bill procedure, on the power of the Dáil to hold a government answerable to it or on its powers of scrutiny of the expenditure of public monies. Still less is the case 'an attack on parliamentary democracy' as Mr. Shatter saw fit to submit. It is a challenge to a novel assertion of a power to hold individual citizens directly accountable to a parliamentary committee."[19]

13. Hardiman J. stated that "*[t]he essential novelty of what is presently proposed is that the fact finding function, in a matter capable of grave repercussions for an individual, is proposed to be carried out by a committee of politicians rather than in a manner independent of the political process".*[20] Hardiman J. added that *"[t]he Garda applicants simply raise the question of whether this can be done without express authority".*[21]

14. Hardiman J. concluded as follows regarding the nature of the proposed inquiry:

"In light of the above, and for the purpose of the first issue, I regard the sub-Committee on the Abbeylara incident as one purporting to exercise a power of inquiry into a past event, the death of Mr.Carthy, with a view to arriving at findings of fact or conclusions. The Committee specifically envisages that these 'could aversely affect or impugn the good name of (some) person' and specifically the Garda applicants or some of them.The Committee says that the findings open to it may include a finding of unlawful killing."[22]

15. Hardiman J. stated that *"[i]t was not disputed, and was indisputable, that the consequences of the findings could be grave for an individual, in terms of his or her career and otherwise"*:[23]

[19] *Ibid*. (Emphasis added).
[20] [2002] 1 IR 385 at 659. (Emphasis added).
[21] *Ibid*.
[22] [2002] 1 IR 385 at 671. (Emphasis added).
[23] [2002] 1 IR 385 at 671.

"To be brought by compulsory process before a committee claiming those powers, and to be on risk of that Parliamentary Committee making a 'finding of fact' that a particular person shot the deceased man and that such shooting was an unlawful killing in my view can only be regarded as a form of accountability."[24]

16. Hardiman J. stated that *"the Garda applicants in this case are the persons whose 'conductis the very subject matter of the Committee's examination and is to be the subject matter of the Committee's report'."*[25]

17. In addressing the Acts upon which the appellants relied,[26]Hardiman J. stated that he agreed with the judgment of Geoghegan J. regarding those Acts and continued:

"There can be no doubt that Acts over a period of nearly eighty years have envisaged the attendances of witnesses before the Oireachtas or Oireachtas Committees: if this were not so it would, for example, be impossible to conduct the promotion and opposition to Private Bills which has gone on throughout that long period. But none of the pieces of legislation relied on either confers a power to make findings of fact of the kind in question here or necessarily implies the existence of such power."[27]

18. In his judgment, Geoghegan J. concluded that *"there is no inherent or implied power in the Oireachtas committees or subcommittees to make fact finding inquiries leading to formal expressions of findings or opinions as to culpability of named or identifiable individuals"*.[28]

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[24] *Ibid*.
[25] [2002] 1 IR 385 at 672.
[26] The Oireachtas Witnesses Oaths Act, 1924; the Committee of Public Accounts of Dáil Eireann (Privilege and Procedure) Act, 1970; the Committees of the Houses of the Oireachtas (Privilege and Procedure) Act, 1976; the Select Committee on Legislation and Security of Dáil Eireann (Privilege and Immunity) Act, 1994; the Committees of the Houses of the Oireachtas (Compellability, Privileges and Immunities of Witnesses) Act, 1997; and the Comptroller and Auditor General and Committees of the Houses of the Oireachtas (Special Provisions) Act, 1998.
[27] [2002] 1 IR 385 at 694. (Emphasis added).
[28] [2002] 1 IR 385 at 709. (Emphasis added). See also the dissenting judgment of Keane C.J., ([2002] 1 IR 385 at 496 – 498), noted below at paragraph 34.

III INQUIRY POWERS OF THE HOUSES OF THE OIREACHTAS AND COMMITTEES THEREOF

19. In addition to analysing whether the Houses of the Oireachtas had power to hold an inquiry of the type impugned in Maguire, a number of the judgments also considered the powers of the Houses of the Oireachtas and committees thereof to undertake other types of inquiries. This section highlights the most significant passages from those judgments.

20. In her judgment, Denham J. stated as follows in respect of the work of committees of the Houses of the Oireachtas:

> *"Members of the Oireachtas may function by way of committees. Such committees may differ in nature. The work of a committee may go to the essence of the role of the legislature in relation to legislation. In such work there may be references to individuals. Such references may be a necessary part of the work of the committee. A constitutional balance has to be obtained and fair procedures applied. However, if it is wished to hold an adjudicative inquiry of the type in issue in this case, there should be a legal basis for such an inquiry. None exists under the Constitution or the law."*[29]

21. In his judgment, Murray J. noted that it was "*not in issue"* in the Maguire case that "*the Houses of the Oireachtas have the right to inform themselves on matters relevant to their parliamentary functions and to conduct, or authorise committees of the Oireachtas to conduct, inquiries for that purpose"*.[30]Murray J. stated that the respondents had objected to the extent of the powers of the sub-committee the subject of the case and, specifically, it was contended that "*in so far as the sub-committee has considered itself entitled to make findings of fact or express opinions adverse to the good*

[29] [2002] 1 IR 385 at 571.
[30] [2002] 1 IR 385 at 584.

name, reputation and/or livelihood of persons not members of either House of the Oireachtas the establishment of the committee is ultra vires *the power of the Oireachtas to do so"*.[31]

22. In addressing the power of the Houses of the Oireachtas and committees thereof to conduct inquiries, Murray J. stated as follows:

> *"It does seem trite to say that members of the Houses have a right and indeed a duty to inform themselves of any matter which is relevant to their functions. Individual members may inform themselves by recourse to the views of constituents, expert reports, matters published in the media and the like. Collectively the Houses may keep themselves informed by recourse to similar sources of information and it is not uncommon for Ministers to place in the library of the Houses of the Oireachtas the reports of experts or inquiries relevant to legislation being introduced. It almost goes without saying that the Constitution should not be interpreted in a manner which is unduly restrictive of the functioning of either House of the Oireachtas. The Constitution is not only about rights but about liberties. There is nothing in the Constitution which would prohibit a local committee or indeed a committee of virtually any kind from conducting an inquiry into a matter which it considered worth inquiring into. The capacity of such committee to conduct an inquiry does not have to be derived from any express or inherent power conferred by the Constitution. It is simply something which they are not prohibited from doing. Of course, apart from any internal rules, such a committee would have to act within the law and would be liable for any defamatory statements which it made not enjoying the immunity which members of the Oireachtas enjoy under the Constitution. I think the Attorney General is correct when he submits that there is nothing in the Constitution to inhibit or prohibit the Oireachtas from conducting or initiating inquiries* ***as such***.[32] *The fact that*

[31] [2002] 1 IR 385 at 584 – 585. (Emphasis added).
[32] The words "*as such*" were emphasised by Murray J.

the Houses of the Oireachtas may conduct or initiate inquiries to obtain information or ascertain facts does not derive from an inherent power peculiar to its role and function as a representative democratic parliament although its desire to do so in any particular case would indeed be related to such functions. But once an inquiry is conducted within the law and the Constitution it seems to me it is axiomatic that the National Parliament, like many other even private bodies, may conduct an inquiry for their own purposes. It is not restricted from doing so.

The freedom to inquire and be informed on matters relevant to the exercise of their functions by members of the Oireachtas is in a sense neutral, once it does not impinge on the rights of third parties or the functions of other constitutional organs such as the courts.

But the Houses of the Oireachtas are creatures of the Constitution. That is their sole source of governmental authority which, according to Article 6 of the Constitution, is derived from the people. If it acts so as to affect the rights of citizens this cannot be compared to a simple search for knowledge. If an organ of State acts so as to affect the rights of citizens it can only be justified in doing so pursuant to a governmental power conferred on it by the Constitution. When the Oireachtas exercises its authority in a manner which may affect the rights of others it acts with the aura and authority of a constitutional organ of State. To adjudicate, in the sense that the term is used here, on the culpability of citizens in their conduct cannot in my view be equated with the everyday search for knowledge of facts or expert opinions. That is a governmental power which it seems to me can only be exercised by virtue of power conferred by the Constitution.

Accordingly, different considerations must arise when the Houses of the Oireachtas assert a constitutional power to embark upon an adjudicative

process, in the secondary sense, which has as one of its objects or functions to make findings of fact or reach conclusions which may impugn the good name of a citizen. As I have already pointed out earlier in this judgment this is a very great power capable of affecting the rights of citizens with potentially disastrous consequences. I would note in passing that the courts themselves do not have such an extensive power there being no investigatory role attributed to them."[33]

23. Murray J. emphasised that "*[i]n the circumstances of [the Maguire] case [the Court was] only concerned with an inquiry which may make findings of personal culpability impugning the good name of an individual citizen."*[34] Murray J. continued:

"I do not see any reason why the Oireachtas cannot conduct inquiries of the nature which they have, for practical purposes, traditionally done, including inquiries into matters concerning the competency and efficiency in departmental or public administration as well as such matters as those concerning the proper or effective implementation of policy, and to make findings accordingly. Also, in the case of a particular office holder, such as the chief executive of a semi-state body, who is by virtue of his appointment, whether by statute or contract, answerable to the Houses of the Oireachtas different considerations arise and I do not consider that the order proposed to be made by this Court affects such a situation."[35]

24. In addressing the type of inquiries which can be carried out by committees of the Houses of the Oireachtas, McGuinness J. stated, *inter alia*, as follows:

"In my view there is much to be said for the argument put forward by the Attorney General[36] *although, as I will point out later, I would further limit*

[33] [2002] 1 IR 385 at 594 – 595. (Emphasis added).
[34] [2002] 1 IR 385 at 605.
[35] [2002] 1 IR 385 at 605. (Emphasis added).
[36] In noting the arguments of the Attorney General, McGuinness J. stated, *inter alia*, as follows:
"*In our system of Government, he suggested, the Dáil and Senate have a legislative function, while the Dáil*

the type of inquiry to be carried out in aid of the functions of the Dáil and Seanad. It is clear that general inquiries have in fact been carried out over the years both by Committees of the individual Houses and by Joint Committees of the Oireachtas. These inquires have in general been directed towards future legislation or possible future amendment of the Constitution. A few examples demonstrate: the Committee on the Constitution 1967, the Joint Oireachtas Committee on Marriage Breakdown 1987, the Sub-committee on Health and Smoking and the All-Party Oireachtas Committee on the Constitution. These Committees have relied on voluntary submissions and willing witnesses but there is in fact no reason why such enquiries should not use the powers of the 1997 Compellability Act to obtain necessary evidence and information. As far as the Dáil's functions in relation to financial matters are concerned the Public Accounts Committee maintains this function and was, of course, the Committee who carried out the Inquiry into Deposit Interest Detention Tax (DIRT). It would, however, be a mistake to make too direct a comparison between the DIRT Inquiry and the Inquiry under consideration in the instant case. Firstly the Public Accounts Committee is a Standing Committee of Dáil Eireann with a long established and continuing role. Under its terms of reference it is appointed to examine a report to the Dáil on 'the accounts showing the appropriation of the sums granted by the Dáil to meet the public expenditure and such other accounts as they see fit...which are audited by the Comptroller and Auditor General and presented to the Dáil, together with any reports by the Comptroller and Auditor General thereon; the Comptroller and Auditor General's reports on his or her examinations of economy, efficiency, effectiveness evaluation systems, procedures and practices; and other reports carried out by the

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alone has the additional function of scrutinising the Government and holding it to account and also has a number of functions in relation to financial matters - the passing of estimates, the budget etc. The Attorney General argued that a power of inquiry should be implied in aid of any or all of these functions, but accepted that such a power would have to be proportionate both to the actual requirements of the Oireachtas and to the rights of those who are not members of the Oireachtas."

Comptroller and Auditor General' under the Comptroller and Auditor General (Amendment) Act 1993.

Secondly, in the case of the DIRT Inquiry the Public Accounts Committee was reliant on specially enacted legislation and on the specific and detailed investigative work of the Comptroller and Auditor General which was carried out under that legislation before the Committee itself began its inquiry. (Comptroller and Auditor General and Committees of the Houses of the Oireachtas (Special Provisions) Act 1998)."[37]

25. McGuinness J. "*accept[ed] that the Oireachtas must clearly have such powers as are relevant to and necessary for the carrying out of its constitutional functions"*.[38] However, McGuinness J. stated that "*these powers must be proportionate to the need for them and must be balanced against the rights of individual citizens who are not members of the Oireachtas"*.[39]

26. With reference to the fact-finding inquiry which the sub-committee purported to undertake, McGuinness J. stated, *inter alia*, as follows:

"By way of comment I would also ask, with due deference to the Sub-committee, <u>why</u> the present style of fact finding inquiry is thought to be necessary for any purpose of the Houses of the Oireachtas? The members of the Sub-committee and Mr Shatter argue that they must know the facts of what happened before they can comment or make recommendations. But in outline, insofar as is necessary for their purposes, they know what happened - Mr Carthy was tragically shot dead by a member of the GárdaSiochana. This was an undesired and more than undesirable outcome - an event which should not be permitted to occur again. The Sub-committee already has before it the report of Superintendent Culligan which deals with many of the relevant factual matters including the identity of the Gárdai involved.

[37] [2002] 1 IR 385 at 615 – 616. (Emphasis added).
[38] [2002] 1 IR 385 at 619.
[39] *Ibid*.

In the circumstances it would be relevant for the Sub-committee to have regard to such matters as the policy of the Gárda on the use of firearms, the licensing of firearms held by members of the public, the care of persons suffering from psychiatric illness, and perhaps the need for an independent Ombudsman or other public official to deal with complaints concerning Gárda matters. All of these matters would, in my view, come within the normal inherent power to enquire of at least a Committee of the Dail, if not a Joint Committee. They would form part of the Dáil's powers to hold the Government to account. In what way would the making of recommendations for future policy or legislation in these matters be assisted by making findings of individual culpability as to which shot actually killed Mr Carthy and as to which Gárda actually fired that shot? The Sub-committee claims, inter alia, to include in its powers the power to make a finding of unlawful killing. Leaving aside the legal or other merits of such a claim, in what possible way would such a finding assist in any of the constitutional functions of a Joint Committee of the Oireachtas?"[40]

27. In concluding, McGuinness J. stated, *inter alia*, as follows:

"In conclusion, I would accept that the Dáil and Senate, and the Houses of the Oireachtas jointly, have an important power to enquire. This power is inherent in the Constitution but is a limited one. It may be implied solely and directly in aid of the functions of each House of the Oireachtas as delineated in the Constitution itself. The power however does not extend to the making of 'findings of fact' concerning the individual culpability of non-members of the Oireachtas which involve damage to the good name of such individuals. It does not, for the various reasons set out above, extend to the present inquiry as it is proposed to be carried out by the Abbeylara

[40] [2002] 1 IR 385 at 624 – 625.

Sub-committee. To that extent I would uphold the decision of the Divisional Court at Declaration 1 of their Order."[41]

28. Certain observations made by McGuinness J. in the course of addressing "*the bias issue*" are also material in the present context:

"For this purpose it is in my view again necessary to distinguish the type of fact finding inquiry envisaged by the Sub-committee in this case from the work of what might be described as the ordinary run of Parliamentary Committees such as those that deal with the committee stage of Bills before the House. Where such work is closely connected with the framing of legislation or involves the gathering of generalised information relevant to the framing of legislation, it is clear that the Attorney General is correct in his contention that the rule against bias is not relevant. When approaching such a task it is probably desirable rather than otherwise that members of the Oireachtas have already formed strongly held opinions, and in addition that they put forward the views both of their constituents and of their Party. It is out of this open interchange of such views and opinions (which in another context might be described as biased) that policies are formed and eventually legislation is framed. In this context it is not damaging, or certainly not seriously damaging, that politicians court publicity for their views and for their representational work.

The situation is somewhat different when, as in the Abbeylara Sub-committee, the committee sees itself as having an inquisitorial role leading to findings of fact which may damage the good name of persons who are not members of the Oireachtas."[42]

29. Hardiman J. also made a number of observations regarding committees of the Houses of the Oireachtas which should be noted:

[41] [2002] 1 IR 385 at 625. (Emphasis added).
[42] [2002] 1 IR 385 at 653 – 654. (Emphasis added).

"[The] content [of the challenge] does not seek to challenge the established practices of the Oireachtas.

The Oireachtas Committee, of course, has a major role in aid of the legislative function which has been acknowledged since 1922. The practice of the Oireachtas to date is correctly stated in the judgment of Hamilton C.J. in Haughey v. Moriarty where he says:-

> *'There are various models which may be availed of by the Oireachtas and the Executive in the form of commissions or committees, in the latter case either within the Oireachtas or external to it for the purpose of advising them as to the desirability of legislation on particular topics. The essential purpose, however, for which a tribunal is established under the Act of 1921 is to ascertain the facts as to matters of urgent public importance which it is to inquire into and report those findings to Parliament or to the relevant Minister.'*

There is clearly a major distinction in principle between the exercise required to advise on the desirability of legislation on the one hand and that required to establish the truth of controverted facts about a past event, and perhaps to make so grave a finding as that of unlawful killing, on the other. Advising on the desirability of legislation requires no legal mandate: it can be done by any person but is plainly particularly appropriate to members of the Oireachtas, who have special powers to assist them in doing so. It relates to the future, not to the past and will not in itself affect the rights of any person in respect of past activities. It does not require an unbiased approach: on the contrary, legislation may quite properly arise out of the strong opinions and preconceptions of those elected to office. And it is an intrinsically political function since legislation is a political product. Adjudication on the propriety or

otherwise of past behaviour, on the other hand, is not intrinsically a political function.

[…]

There may be cases where it is difficult to draw a precise line of distinction between the two functions described in the citation from Chief Justice Hamilton above. Advice on the desirability of legislation on a particular topic may of course reflect the adviser's view of past events or transactions. So long as this is genuinely incidental and not a mere device, this incidental overlap certainly does not, in my view, even potentially invalidate an exercise of the first kind. But what is proposed here is not a consideration of legislation, or possible legislation, which might incidentally involve an expression of some general view about the Abbeylara incident."[43]

30. Hardiman J. referred to the Select Committee on Legislation and Security of Dáil Eireann (Privilege and Immunity) Act, 1994 which he observed was "*of considerable interest*":

"It conferred a privilege and immunity on witnesses, as opposed to members, but only those who appeared before the particular Committee named in the title of the measure. This was the well remembered Committee appointed, as the schedule to the Act states 'For the particular purpose of hearing statements and the answering of members questions ... upon circumstances surrounding...' five particular events in November, 1994, which led to the fall of the Government then in power.

The Attorney General, in the course of his submissions, said that:- 'The reference to "evidence"... clearly implies that the members can form a view about the evidence before them. It would be meaningless for them to

[43] [2002] 1 IR 385 at 658 – 660. (Emphasis added).

be given a power to take evidence but to have no power to form an opinion about the evidence taken.'

The Act of 1994 demonstrates the fallacy in this argument. The relevant Select Committee made no findings of fact at all but simply transmitted the transcript of its proceedings to Dáil Eireann. But the examination of the various matters set out in the schedule to the Act, and the hearing of the witnesses in connection with this examination was thought to be a useful exercise notwithstanding that the Committee, from its inception, intended to find no facts and to express no opinions. Against this background it can be seen that the Act nor merely does not give rise to the implication contended for but affirmatively demonstrates as a matter of Oireachtas history that the power to summon witnesses, the conferring of privileges on these witnesses and the conferring of privilege on members of a committee do not imply that such committee will make any findings, or express any opinions whatsoever, let alone findings or conclusions of the kind in question here. In the Rules and Guidelines document referred to above, committees are required by Rule 1 to 'identify, from the start of their consideration of any matter the nature and purpose of any investigation or proceeding to be conducted by them and, in particular, whether it is proposed to arrive at findings of fact or to express opinions'. (Emphasis added)

This provision, and the specific example of the Committee to which the 1994 Act relates, in my view invalidate the submission of the Attorney. That submission would be perfectly correct if applied to a court: there could be no conceivable purpose or justification in a court's receiving evidence unless for the purpose of forming a view about it. But that, as recent history demonstrates, is a point of divergence between the Courts and the Oireachtas: the latter may hear evidence for the purpose of putting it on the record or for some other purpose without making any attempt to,

or having intention of, forming a view about it. There is no question, as a matter of history, of the 1994 Select Committee having originally intended to report, but being unable to do so because it could not arrive at a consensus. There is in fact no obligation on a parliamentary committee in the ordinary course of its business to arrive at a consensus: it can act by a majority. A consideration of the Dáil resolution related to the 1994 Committee positively demonstrates that the work envisaged was the hearing of statements and the answering of members questions by 'all persons the Committee deems appropriate'. There was no provision for findings or for a determination of any sort, and it was clearly not thought that the authority to 'report to Dáil Eireann' implied any necessity to make findings of fact. It involved merely the transmission of the transcript.

Even apart from this, however, there is a distinction between the hearing of evidence and acting on it, and the making of adverse findings of fact. A committee hearing evidence, for example, in support of or opposition to a Private Bill will reach a conclusion. Typically it will at least reach a conclusion on whether the title to the Bill has been proved or not. Similarly, a committee may be greatly assisted by hearing the evidence of a particular person on a specific issue, as the recent D.I.R.T. Committee was. But nothing of this nature is, or approximates to, the makings of findings of fact or conclusions adverse to a person or likely to impugn his good name, or indeed to lead to damage in connection with his 'dealings or associations with others, or injury in his trade office or financial credit' to quote Standing Order 58. The ability to make findings of fact or conclusions of this sort can only arise, I believe, if it is expressly and validly conferred by statute."[44]

31. In the introductory section of his judgment, Geoghegan J. "*note[d] that at no stage in the Judicial Review proceedings was it suggested that the Houses of*

[44] [2002] 1 IR 385 at 695 – 696. (Emphasis added).

the Oireachtas had no 'inherent' power to inquire into anything at all in any circumstances nor has the Divisional Court made any such suggestion in its findings and orders".[45]

32. In addressing the power of the Oireachtas to conduct an inquiry for legislative purposes, Geoghegan J. stated, *inter alia*, as follows:

"But if it is suggested that there is an inherent power limited to legislative purposes (a form of language which may be inappropriate as I will elaborate on later) then in my view if the inquiry is to be intra vires, the exact legislative purposes must be stated in advance. I see no reason why that should not be done. I do not accept or agree with the theory that provided an inquiry was vaguely connected with matters of public interest it could be regarded as being for legislative purposes. I would not follow the wide definition of legislative purposes emerging in the later American case law particularly having regard to the difference in legislative process as already adverted to and having regard also to its genesis which was in the main the committee for investigating un-American activities, a body of dubious repute. Furthermore even if one is to postulate a legitimate exercise of a supposed inherent power to conduct an inquiry for legislative purposes, the committee or subcommittee conducting the investigation would be obliged to avoid, as far as possible, the attribution of blame and especially apparent criminal misconduct to a named individual. In this case there is nothing to suggest that the subcommittee was confining itself to considering the need for new legislation.Such an inquiry would have to so confine itself and its report should primarily relate to whether there is or is not such a need. A legitimate inquiry by a committee of the Oireachtas which was directed towards a perfectly proper legislative purpose might in some circumstances inevitably and unavoidably lead to implied blame being attached to an individual. That would not necessarily render the inquiry ultra vires and, therefore, I consider that the wording of

[45] [2002] 1 IR 385 at 709.

the declaration made by the Divisional Court is too wide, particularly having regard to the use of the words 'liable to'. It is also true that a legitimate Oireachtas investigation may inevitably result in a finding of fault in a management system which in some circumstances could involve an implied attachment of blame to the relevant manager. That might also be legitimate.But the all important point is that the inquiry from the beginning would be merely for the purpose of considering whether new legislation was required and for no other purpose. That was emphatically not the case here."[46]

33. The following passages from the judgment of Geoghegan J. are also instructive:

"I have no doubt that a joint Oireachtas committee or a subcommittee thereof has power to gather information up to a point for its legislative purposes. In a sense they can do this because there can be no legal objection to it rather than pursuant to the somewhat grandiose title of 'inherent power'. Order 79 of the Dáil Standing Orders provided that a select committee empowered 'to send for persons, papers and records, may report its opinions and observations, together with the minutes of evidence taken before it, to the Dáil, and also make a special report of any matters which it may think fit to bring to the notice of the Dáil.' But in so far as there is any element of compellability it can only be under the 1997 Act. Before that Act the evidence had to be obtained on a voluntary basis. There were analogous provisions in the Seanad Standing Orders. With or without compellability powers it may well be that an Oireachtas committee or subcommittee carrying out an inquiry for a legitimate legislative purpose, that is to say, to obtain necessary information for the purposes of a particular type of legislation if proved appropriate, may necessarily have to probe into management structures and there may consequentially be read into the report implied criticism of persons in existing management

[46] [2002] 1 IR 385 at 717 – 718. (Emphasis added).

roles. I do not think that would necessarily be objectionable and that is why I consider the declaration made by the Divisional Court to be too wide. In the context for instance of Abbeylara I see a very big difference between a view being expressed by an Oireachtas subcommittee that muddled orders were given and defective systems devised at some particular level in the gardaí and an opinion on the other hand that an individual garda on the spot had effectively committed what the public would interpret as an unlawful killing.

[…]

Any kind of inquiry by an Oireachtas committee or subcommittee for a direct and express legislative purpose and which would not be intended to result in findings of blameworthy conduct on the part of identifiable individuals is constitutionally and legally permissible. In some instances such an inquiry would be constitutionally and legally permissible even if as a necessary fallout some blame became attached by the committee to higher levels of management who could be identified. Again there is a very big difference between a conclusion that command structures at some high level of the gardaí were defective on the one hand and blame being placed on a particular garda on the other. The former may not be constitutionally or legally objectionable depending on the circumstances but the latter will be."[47]

34. The following observations in the dissenting judgment of Keane C.J. also merit note:

"Consideration of this issue must start with a proposition which is so self evident as to be almost banal. The Oireachtas, like any other body or person in the country, is entitled to keep itself informed and, for that purpose, to initiate inquiries, provided that, in so doing, it does not infringe the law. That is not in any way in dispute in this case.Nor was it

[47] [2002] 1 IR 385 at 740 – 742. (Emphasis added).

seriously contended on behalf of the respondents that the Oireachtas was precluded from establishing a fact-finding committee to investigate and reach conclusions on particular matters which might be relevant to the exercise by them of their legislative function. Thus, it was conceded that there could be no legal inhibition on their establishing a committee to investigate and report to them on a particular topic of scientific controversy in order that they might consider the possibility of, and, if thought appropriate, enact, legislation dealing with the topic. The challenge in these proceedings is to the establishment of a body, such as the Committee, charged with what the divisional court and the written submissions on behalf of the respondents describe as 'adjudicative functions', the conclusions of which may affect the good name and reputation of persons, such as the respondents, who are not members of either House of the Oireachtas."[48]

IV FAIR PROCEDURES

35. The requirements of fair procedures and natural / constitutional justice are inter-related.[49] This section, however, focuses on the significant *dicta* in Maguire concerning fair procedures. Section V below focuses on the *dicta* concerning a core principle of natural / constitutional justice – the rule against bias.

36. In addressing the work of committees of the Houses of the Oireachtas, Denham J. stated, *inter alia*, as follows in respect of fair procedures:

"Members of the Oireachtas may function by way of committees. Such committees may differ in nature. The work of a committee may go to the essence of the role of the legislature in relation to legislation. In such work there may be references to individuals. Such references may be a

[48] [2002] 1 IR 385 at 496 – 498. (Emphasis added).
[49] The circumstances in which these rights can be invoked were considered *in extenso* by the Supreme Court in Dellway Investments v. NAMA [2011] IESC 14.

necessary part of the work of the committee. A constitutional balance has to be obtained and fair procedures applied. ”[50]

37. In addressing the importance and purpose of fair procedures, Murray J. stated as follows:

“[T]he whole raison d'etre for specific measures designed to ensure fair procedures, such as the right to be represented and to cross-examine witnesses, is to enable persons, whose conduct or actions are the subject of such an inquiry, to defend themselves where their rights, such as a right to a good name, may be affected

[…]

Ó Dálaigh C.J. in In re Haughey (at 264) stated:-

> *‘... in proceedings before any tribunal where a party to the proceedings is on risk of having his good name, or his person or property, or any of his personal rights jeopardised, the proceedings may be correctly classed as proceedings which may affect his rights, and in compliance with the Constitution of the State, either by its enactments or through the Courts, must outlaw any procedures which will restrict or prevent the party concerned from vindicating these rights’.* ”[51]

38. In addressing the issue of fair procedures, McGuinness J. stated, *inter alia*, as follows in respect of the submission regarding the procedures adopted:

“Counsel for the applicants also informed this Court that during the actual proceedings of the Sub-committee the senior Gárda witnesses were called to give evidence in groups of four or five and were permitted to refer questions and answers to each other. While such a procedure might on

[50] [2002] 1 IR 385 at 571. (Emphasis added).
[51] [2002] 1 IR 385 at 590 – 591.

occasion be suitable for what I might describe as the traditional information-gathering inquiry carried out by Parliamentary Committees, it is, I consider, open to objection in any inquiry which is seeking to make serious and damaging 'findings of fact'.

What appears to have happened as far as can be gathered from the materials provided to this Court, is that a pattern of procedure which had been established - and apparently agreed - for the DIRT Inquiry carried out by the Public Accounts Committee was transferred more or less holus bolus to the Abbeylara Sub-committee's inquiry. Clearly, insufficient thought was given as to whether it was a suitable procedural framework for such an entirely different type of inquiry."[52]

39. In addressing the fair procedures issues, Hardiman J. stated, *inter alia*, as follows:

"Where a person is accused on the basis of false statements of fact, or denied his civil or constitutional rights on the same basis, cross-examination of the perpetrators of these falsehoods is the great weapon available to him for his own vindication.

[…]

Accordingly, the right to cross-examine one's accusers is a constitutional right and not a concession. It applies, as Haughey's case affirmatively demonstrates, in an Oireachtas Committee or sub-Committee as well as in any other forum in which a citizen may be accused. It is an essential, constitutionally guaranteed, aspect of fair procedures.

It follows from the foregoing that the right of cross-examination may not be unreasonably confined or hampered in terms of the time allowed or

[52] [2002] 1 IR 385 at 545 – 646. (Emphasis added).

otherwise. A person is, of course, entitled to cross-examine himself but equally entitled to do so by counsel.

[…]

Cross-examination adds considerably to the length of time which proceedings will take. But it is an essential, constitutionally guaranteed, right which has been the means of the vindication of innocent people.

[…]

It must be firmly understood that, when a body decides to deal with matters as serious as those in question here, it cannot (apart from anything else) deny to persons whose reputations and livelihoods are thus brought into issue the full power to cross examine fully, as a matter of right, and without unreasonable hindrances. This, of course, is not to deny to any tribunal the right to control prolixity or incompetence if that is manifested.

[…]

A person cannot be put on risk of a grave finding of fact against him without a full opportunity of defending himself or herself, including by cross-examination."[53]

40. In addressing the procedural complaints, Geoghegan J. stated, *inter alia*, as follows:

"It is well established by decided cases that in respect of any kind of tribunal or inquiry body, as to what is or is not fair procedures may vary depending on the nature of the matters being investigated. There is, for instance, no absolute right to cross-examine. As to whether there should be a right to cross-examine or not in any given instance depends on the circumstances. There was nothing wrong in principle with a ruling that permission had to be obtained to cross-examine. But such permission would have to be based on the significance of the witness to be cross-examined and the nature of the evidence of that witness which might be

[53] [2002] 1 IR 385 at 704 – 707. (Emphasis added).

adverse to the interests of the cross-examiner's client. The granting or withholding of the permission could not normally be based on any kind of detailed inquiry as to the nature of the cross-examination itself because surprise can often be the essence of cross-examination. It is also true that in courts of law cross-examination of a friendly witness can often be extremely helpful. But while there can be no hard and fast rule, in most circumstances it would be my view that a committee of this kind would be entitled to confine cross-examination to witnesses who are giving definite evidence or making allegations inimical to the party who wants to cross-examine. If the subject matter is serious as the events of the Abbeylara Inquiry certainly are, cross-examination in those circumstances would have to be allowed but not necessarily of every witness.

The confining of the cross-examinations to one day if that was implemented would be wholly objectionable and a grossly unfair procedure. But declaratory relief in this regard is all that the respondents on the appeal would require. If the majority of the court takes the same view, as I do, in relation to the absence of inherent power the question does not arise."[54]

41. In addressing the fair procedures issue, Keane C.J. concluded as follows:

"In In re Haughey Ó Dálaigh C.J. identified certain constitutional rights to fair procedures of persons accused of conduct which reflected on their character or good name. These included the right to 'cross-examine, by counsel, his accuser or accusers....'. In a frequently quoted passage, the learned Chief Justice said

> *'Article 40.3 of the Constitution is a guarantee to the citizen of basic fairness of procedures. The Constitution guarantees such fairness,*

[54] [2002] 1 IR 385 at 740. (Emphasis added). See also O'Callaghan v. Mahon [2006] 2 IR 32.

and it is the duty of the court to underline that the words of Article 40.3 are not political shibboleths but provide a positive protection of the citizen of his good name. [The Committee's procedures] while valid in respect of witnesses in general, in this instance, would, if applied in the circumstances of this case, violate the rights guaranteed to Mr.Haughey by the provisions of Article 40.3 of the Constitution.'

[…] However, in my view, no citizen whose good name may be affected by the proceedings of a committee of this nature and who is required by legal process to attend and give evidence before it can be constitutionally denied in advance the right to cross-examine those whose evidence might so affect his rights. The Committee, in this case, have not expressly denied to the respondents or their counsel the right to cross-examine witnesses, but they have undoubtedly reserved the right to subject it to drastic constraints which, in my view, are seriously at variance with the nature of the right as identified in re Haughey.

I would accept that it is reasonable for a committee such as this to adopt a certain flexibility in this area and that it may be reasonable not to afford a right of cross examination to a person whose good name or reputation would not appear to be affected by any conclusion the committee might reach on a particular issue. It was, however, in my view, not permissible for the committee to adopt a procedure which meant that cross-examination in respect of crucial matters would be deferred until after other witnesses had given evidence, a practice which would serious erode the value of cross-examination as it has been traditionally understood. Moreover, while the committee might have found themselves, in practice, unable to adhere to the remarkably limited time they were affording counsel for both the next of kin and the respondent to cross-examine and make submissions, the adoption by them of so apparently rigid a time

schedule was, again, inconsistent with the constitutional protection which should have been afforded in accordance with In Re Haughey.

I would, accordingly, uphold the finding of the divisional court insofar as it found that the right to fair procedures had not been upheld by the committee."[55]

V NATURAL / CONSTITUTIONAL JUSTICE AND THE RULE AGAINST BIAS

42. One of the core principles of natural / constitutional justice – the rule against bias – was considered from a number of perspectives in the judgments in Maguire v. Ardagh and the relevant passages in that regard merit particular note.

43. In addressing the issue of "*bias*", Denham J. stated, *inter alia*, as follows:

"In this case the inquiry was not the administration of justice but an inquiry of the nature described. However, fair procedures are required. While there was some discussion of 'structural' bias I am satisfied that the issue of bias relates to two aspects - subjective and objective. Subjective bias means actual bias and clearly no committee member who has subjective bias may participate in such an inquiry. Objective bias is a matter which also is a component of fair procedures. Thus a committee member in such an inquiry as is in issue may not sit if in all the circumstances a reasonable person would have a reasonable apprehension of bias, an apprehension that the committee member might not bring an impartial and unprejudiced mind to the hearing. This would refer to considerations relating to matters prior to the establishment of the committee and during the hearings of the committee. Thus, indications of a

[55] [2002] 1 IR 385 at 549 – 550.

view being held by a committee member whilst the hearing is proceeding would be contrary to the concept of fairness."[56]

44. In addressing the question of whether the Houses of the Oireachtas have an inherent power to conduct an inquiry of the type at issue, Murray J. explained that there were "*further considerations which lead [him] to conclude that the Constitution of Ireland does not permit let alone mandate that there is to be found in its provisions an unexpressed inherent power of the Oireachtas to conduct inquiries of this nature concerning the personal culpability of individuals leading to findings which may impugn their good name"*:[57]

> *"Committees of inquiry are, by virtue of their role and function, part of the political process. Evidently, they are composed of public representatives answerable to their constituents, public opinion and with a day to day interest in the cut and trust of everyday politics. I do not say that a public representative by virtue of his or her political role is incapable of acting fairly and objectively. Nonetheless there is the underlying fact that they each have an ever present interest, from one perspective or another, in the political issues of the day including the ever present one of the standing or otherwise of the Government in office and its Ministers. Constitutionally the Government is answerable to members of the Dáil and in a different, but substantive way, may be the subject of support or opposition by members of the Senate. Unlike other forms of enquiry Oireachtas Committees are not independent of the political process. The question arises whether the Constitution, although silent on the matter, intended that personal culpability of citizens for serious wrongdoing with consequential implications for their good name should be decided in the course of an enquiry which was part of the political process."*[58]

45. Murray J. noted that *"[s]omewhat similar concerns, although from a*

[56] [2002] 1 IR 385 at 572 – 573.
[57] [2002] 1 IR 385 at 598.
[58] [2002] 1 IR 385 at 598 – 599. (Emphasis added).

different perspective, were echoed in the Affidavit of Mr. Sean Cromienfiled in these proceedings".[59] Murray J. observed that "*Mr.Cromien is a person of great experience in the functioning of Government and the Oireachtasand has a distinguished reputation as a former Secretary of the Department of Finance"*.[60] Murray J. quoted the following extracts from the Affidavit of Mr.Cromien:

> *"As illustrated in this case I have, however concerns abut the way in which the developing activities of these committees may lead to the good name, reputation, privacy and livelihood of citizens being damaged. The very political effectiveness of politicians, which is based on their closeness to public opinion as expressed both directly and through the media, and the ability to respond quickly and effectively to it, is likely to be a drawback where politicians are expected to operate in a quasi-judicial manner, as in this inquiry by the sub-committee.*
>
> *My experience reinforces these concerns. It is difficult for politicians to cease, even temporarily, to be politicians. For example, the Public Accounts Committee, in questioning accounting officers, generally acts in an all party manner and members avoid making party political points. However, it is the experience of accounting officers that occasionally on an issue of major political controversy, they are asked questions by opposition deputies on the committee which are meant to elicit an answer which can be used to criticise the Government of the day. The Government Deputies then ask other questions which are meant to support government policy. "*[61]

46. Murray J. stated that "*Mr.Cromien's observations […]underline[d] the necessity of taking into account potential and inherent frailties in such a parliamentary system of inquiries when considering whether it is likely that*

[59] [2002] 1 IR 385 at 600.
[60] *Ibid*.
[61] *Ibid*. (Emphasis added).

the Constitution contemplated such a system". However, Murray J. emphasised that he was not in this context addressing any question of objective or structural bias which would exclude the possibility of such powers of inquiry being attributed to members of the Oireachtas but rather whether, in the absence of an express provision, such a far reaching interpretation could be implied as being inherent in the Constitution. Murray J. continued:

> *"However, the foregoing extracts demonstrate that there is at least a real risk that the integrity or objectivity of parliamentary inquiries could be compromised by purely political considerations. It was the reality of such frailties that brought the parliamentary committee system in Britain into disrepute. It is difficult to imagine that the framers of the 1922 Constitution would not have been aware of this factor. Nor could one suppose that it was not considered by the drafters of the 1937 Constitution. The views expressed in the document of the Office of the Attorney General appears to envisage that in certain circumstances, particularly where there is the risk of bias or of a parliamentary committee being perceived as being open to political bias, that the Oireachtas, in the exercise of its own discretion, would resort to the option of an independent statutory tribunal in lieu of an inquiry conducted by a committee of the Oireachtas. I find it highly improbable that the Constitution was intended to confer an inherent power of this nature on the Oireachtas without expressly doing so or that, in the face of potential frailties to which the two texts which I have just cited refer, it would have been impliedly left to the Oireachtas to exercise its own exclusive discretion as to whether an inquiry which may result in findings of fact impugning the good name of a citizen should be conducted by an Oireachtas Committee or an Independent Statutory Tribunal."*[62]

47. McGuinness J. also referred to the Affidavit of Mr.Cromien in the context of "*highlight[ing] the weaknesses of a political system of inquiry"* and expressed her agreement with the comments of Geoghegan J. regarding that

[62] [2002] 1 IR 385 at 601.

Affidavit.[63]

48. In addressing the applicability of the rule against bias, McGuinness J. stated as follows:

> *"While it is of course accepted that the members of the Sub-committee were not judges and were not administering justice, they themselves accept that in carrying out the type of inquiry they envisaged it was necessary for them to behave in a judicial manner. The matter which is at issue between the parties is not the nature of the test, but the extent of its application to the Sub-committee, or if it applies at all.*
>
> *For this purpose it is in my view again necessary to distinguish the type of fact finding inquiry envisaged by the Sub-committee in this case from the work of what might be described as the ordinary run of Parliamentary Committees such as those that deal with the committee stage of Bills before the House. Where such work is closely connected with the framing of legislation or involves the gathering of generalised information relevant to the framing of legislation, it is clear that the Attorney General is correct in his contention that the rule against bias is not relevant. When approaching such a task it is probably desirable rather than otherwise that members of the Oireachtas have already formed strongly held opinions, and in addition that they put forward the views both of their constituents and of their Party. It is out of this open interchange of such views and opinions (which in another context might be described as biased) that policies are formed and eventually legislation is framed. In this context it is not damaging, or certainly not seriously damaging, that politicians court publicity for their views and for their representational work.*

[63] [2002] 1 IR 385 at 624.

The situation is somewhat different when, as in the Abbeylara Sub-committee, the committee sees itself as having an inquisitorial role leading to findings of fact which may damage the good name of persons who are not members of the Oireachtas. The Houses themselves have provided a special set of Rules and Guidelines under the 1997 Compellability Act which are to govern 'the conduct of proceedings which may give rise to findings of fact or to conclusions which could adversely affect or impugn the good name of any person'. These Rules and Guidelines deal, inter alia, with the matter of actual, or subjective bias. At Rule 5 it is stated:-

> *'Members of the committee shall, before participating in particular proceedings, declare any financial, personal or other material interest or material obligation they have in*
> *(a) a matter under consideration by the committee or*
> *(b) the outcome of a matter under consideration by the committeeand shall make such declaration in private to the Chairman of the main committee and shall, subject to Rule 7 abide by such rulings as the chairman may make arising from declarations so made.*
>
> *Provided that such rulings shall be given privately or at a meeting of the committee (or part thereof) held other than in public; and such further proceedings as may directly relate thereto shall similarly be held other than in public.'*

Rule 7 refers to an appeal from the ruling of the Chairman. This, of course, reflects the general rule of the Oireachtas that members 'should declare their interests'. It is perhaps a little surprising that the Sub-committee members should under the Rules and Guidelines make these declarations of interest out of the public eye; one must, I think, assume that the "ruling" by the Chairman of the main committee would, in a case where the member in question continued in membership of the Sub-

committee, include a direction that the interests in question be declared publicly.

The Rules and Guidelines therefore recognise the need to guard against a risk of subjective bias. The matter of objective bias is more subtle, and would be difficult to provide for in a set of rules. In my view, however, where a committee deals in an inquisitorial fashion with persons who are not members of the Oireachtas and whose good name may be impugned, the normal rules of objective bias must apply.This follows directly from the admission of the Appellants that in these circumstances the members of the Sub-committee must act 'judicially'.

The test for objective bias has been set out above. Neither in a court nor in a committee should the test be applied in an over-strict or exaggerated way. (See Bula v. Tara (No. 6). It is a 'reasonable person' test. But on any such test it must in my view be unacceptable for members of an inquisitorial committee such as this to make public comments on the subject matter of the inquiry both in the run up to the inquiry and during its actual currency. The Gárda Applicants have exhibited documentary material in the pleadings containing scripts of television programmes (Questions and Answers, Prime Time) and press reports which include comments and discussion by members of the Sub-committee directly referring to the subject matter of the inquiry. In at least some cases members expressed strongly held views which would undoubtedly give rise to a reasonable apprehension of bias. In many of their submissions the Appellants compare the inquiry to be undertaken by the Abbeylara Sub-committee to inquiries carried out by tribunals under the 1921 Act. What would be the public view of a judicial, or indeed any other, Member of a 1921 Act tribunal if he or she were to appear regularly on television or give briefings and interviews to the Press expressing personal views on the subject matter of the tribunal? A moment's consideration of such a

scenario would show how grossly inappropriate it would be. The same standard must apply to an inquisitorial committee of the Oireachtas.

The Gárda Applicants say that given the nature of the work and life of members of the Oireachtas this must mean that they are automatically incapable of carrying out an inquiry such as that on Abbeylara. I would not go so far. Members of the Oireachtas have been given highly important constitutional duties; they have been elected by their constituents to fulfil these duties. If whether under Statute or otherwise they have been properly mandated to carry out an inquiry, I consider that they cannot be disabled from so doing by an automatic assumption of objective bias.If, however, they are to carry out such a proper inquiry, the members of such an inquiry committee would have to accept a self denying ordinance which would, for example, prevent them from carrying out any media appearances or interviews dealing with the subject matter of the inquiry both before and during its currency. This, of course, does not mean that the inquiry proceedings themselves should not be held in public; in most cases this would be desirable rather than otherwise."[64]

49. McGuinness J. also considered the references to bias in the Comparative Study into Tribunals of Inquiry and Parliamentary Inquiries (including Costs Comparison Report) published by the Committee of Public Accounts of Dáil Éireann following the DIRT Inquiry. McGuinness J. referred to, *inter alia*, the following extract from that Study:

"However, this is probably the critical point insofar as the decision might be made in certain circumstances to convene a tribunal of inquiry, rather than investigation by a select committee. There are some situations in which members of the Oireachtas cannot provide an impartial and unbiased hearing, and in which therefore as a matter of law, it is difficult

[64] [2002] 1 IR 385 at 653 – 656. (Emphasis added).

to see how a parliamentary inquiry can take place. This difficulty is not as present in relation to tribunals established under the 1921 Act."[65]

50. McGuinness J. observed that this was a "*clear and succinct statement of the problem".*[66]McGuinness J. stated that *"[t]t is not an insoluble problem but it is one which must be recognised, faced and properly dealt with".* McGuinness J. added that *"it was neither recognised nor properly dealt with in the Sub-committee on Abbeylara and thus that Sub-committee is tainted with objective bias".*[67]McGuinness J. concluded as follows:

"[…] I have suggested that the Respondents' complaints concerning objective bias were closely connected with the overall concept of fair procedures and natural and constitutional justice. If fair procedures are to be maintained and if the taint of objective bias is to be avoided, the members of the Abbeylara Sub-committee, and any similar Committee, should not participate in media appearances and interviews, nor make statements to the media, during the period immediately prior to the Inquiry or during its currency."[68]

51. Hardiman J. referred to extracts from the report of the DIRT inquiry and, in particular, the following views expressed by the Attorney General regarding different types of inquiries:

"Different subject matters [to the subject matter of the DIRT inquiry], however, call for a demonstrably impartialand neutral person to act as chairman of an inquiry and as author of any report.... It seems that a process of compulsory inquiry leading to findings of fact which could seriously affect the personal representation of those subject to inquire ought to be conducted in a manner calculated to uphold their rights. Thus if people who are not members of the Oireachtas are to be compelled to come before Committees of either House to have their probity and truthfulness tested and reported on in public they might, depending on the

[65] [2002] 1 IR 385 at 656 – 657.
[66] [2002] 1 IR 385 at 657.
[67] *Ibid*.
[68] *Ibid*.

subject matter, be justified in asking whether the persons summoning them compulsorily were doing so in a genuine spirit of inquiry or with a view to advancing their own political interest or confirming their own well known prejudices. Another practical consideration is whether members of the Oireachtas could be reasonably expected, in addition to their other duties, to apply sustained detailed and scrupulous examinations of the subject matter of an inquiry, especially having regard to the limited lifespan of the Dáil, the limited resources available to a committee and other public and parliamentary commitments. Could a Dáil Committee, for instance, realistically attempt a fair detailed inquiry into, say, the Whiddy Island disaster or the Kerry babies tragedy and would any members of a Dáil Committee want to carry out such an inquiry.

[Having referred to the specific inquiry undertaken, the Attorney General continued:] But it would be very different, I think, if the allegation had been that someone in the Bank had taken five million pounds, as a bribe, say, and that was the issue you were trying to determine. Then I think you might pause and hesitate and say 'Am I the correct person to judge this or am I.....' I mean, I think any deputy, any conscientious deputy would ask themselves 'Am I concerned about acquitting this person of a charge against them of impropriety, or am I concerned about the public reaction to my doing so?' That is the kind of circumstance in which it is appropriate to get an independent Tribunal of Inquiry, I'd imagine, to make the decision that somebody who is free from personal interest or even political interest in the very vaguest meaning of that term".[69]

52. Hardiman J. continued:

"The foregoing, both questions and answers, obviously has significance in relation to the question of bias and impeachability. But more generally, it

[69] [2002] 1 IR 385 at 698 – 699.

shows a realisation that there are issues which a parliamentary committee should not approach, in part because it may lack the time or resources to do so but principally because practising politicians may not be in a position to provide the appearance of impartiality necessary when dealing with very grave allegations. This real and honestly expressed inhibition does not suggest that the Oireachtas has a general power to inquire in an adjudicatory manner about the doings of individual in grave matters with potentially serious consequences."[70]

53. Hardiman J. observed that, having regard to his conclusion on the first issue, it was not necessary for him to rule on the allegations either of structural or of objective bias. Nevertheless, he made the following general observations which he stated were *"so obvious that they might be considered trite"*:

"A person who sits in judgment on the actions of another must act in a quasi judicial fashion. He must clearly avoid bias; what is less well understood is that he must also avoid the appearance of bias. One obvious course of conduct which risks giving rise to an appearance of bias is to discuss either the issues being inquired into, or the procedures adopted for the inquiry, outside the context of the inquiry itself. It is therefore undesirable for persons sitting in a quasi judicial capacity to make themselves available for interview, discussion programmes, or comment of any sort on either substantive or procedural issues during the hearing. Members of the Oireachtas would, I imagine, be amazed to see a judge or a juror behaving in this fashion: for precisely the same reasons restraint in this area is required of persons who agree to act in a quasi judicial capacity."[71]

54. In addressing the issue of bias, Geoghegan J. stated as follows:

[70] [2002] 1 IR 385 at 699. (Emphasis added).
[71] [2002] 1 IR 385 at 704. (Emphasis added).

"Even in cases where in the eyes of a reasonable observer bias might not exist merely from the composition of the body, the conduct of an inquiry by such committee or subcommittee is fraught with great practical difficulties if bias in the legal sense is to be avoided.

[…]

Having regard therefore to the combination of the inherent likelihood of structural bias or at the very least the obvious difficulties in avoiding objective bias in any given case, I see no reason to infer that the framers of the Constitution and the people in enacting it intended that such powers should inhere in the Oireachtas."[72]

55. In addressing the argument that the Oireachtas could enact a law which would confer on a sub-committee such as the Abbeylara sub-committee the power asserted, Geoghegan J. stated:

"But the short answer to this response is that it is irrelevant. There is obviously no issue before this court nor was there before the Divisional Court as to whether the Oireachtas could constitutionally enact such a law. Indeed once such a law was enacted it would immediately attract the presumption of constitutionality. It would be improper for this court in any way to speculate as to the constitutionality of such an Act. The question simply does not arise. It might well be for instance that there would be considerable opposition to such a Bill if introduced or more to the point that even if it was thought to be perfectly constitutional, it might be perceived in practice to be very difficult to operate in any controversial circumstances such as the Abbeylara incident because of the problems of bias to which I will now be returning.

A key question that has to be answered is this. If in the public interest it is necessary that there be an inquiry potentially resulting in findings

[72] [2002] 1 IR 385 at 721 – 722. (Emphasis added).

(whether they be of fact or opinion) which are damaging to the good name of the citizen (otherwise protected by the Constitution) is it not essential that such inquiry be independent and be perceived to be independent?"[73]

56. Geoghegan J. further addressed potential legislation conferring power on the Houses of the Oireachtas to hold inquiries such as those at issue in Maguire as follows:

"[a]lthough in theory, if this appeal is dismissed, the Oireachtas could legislate to give itself the powers which it now claims to be inherent, the exercise of those powers might prove legally difficult because I am quite satisfied that all the normal rules of natural and constitutional justice involving fair procedures and absence of bias whether subjective or objective would apply no differently than in the case of an extra parliamentary inquiry. Any member of the Dáil or Seanad who was on such committee or sub-committee would be precluded from commenting on the matters the subject matter of the inquiry whether to the press or on radio or television or in any other public forum other than the Houses of the Oireachtas themselves but there they would be subject to their own restraining Standing Orders. One can imagine all kinds of practical difficulties because as was pointed out at the hearing T.D.s are in constant communication with their constituents and quite properly are lobbied by their constituents and have to take into account the views of their constituents."[74]

57. In this context, Geoghegan J. also referred to the comments in the Affidavit of Sean Cromien. Geoghegan J. stated that they *"underline[d] the obvious problems about an Oireachtas subcommittee conducting an extensive inquiry in the nature of the Abbeylara Inquiry even if it was given a statutory power to do so".*[75]Geoghegan J. also stated that he was in complete agreement with the analysis and observations of McGuinness J. in respect of

[73] [2002] 1 IR 385 at 733 – 734. (Emphasis added).
[74] [2002] 1 IR 385 at 734. (Emphasis added).
[75] [2002] 1 IR 385 at 735 – 736. (Emphasis added).

the bias issue.

58. The following observations in the judgment of Keane C.J. should also be noted:

> *"It has already been pointed out that the chairman and two members of the Committee, Deputy Marian McGuinness and Deputy Alan Shatter appeared on television or radio to discuss the inquiry: the chairman, indeed took part in a television discussion on the day the Committee began its hearings. In addition, members of the Committee gave regular briefings to the media.*
>
> *It is in the nature of politics that its practitioners will participate constantly in discussions in the print or electronic media on the issues of the day. However, even when one makes every allowance for that indisputable fact, one would also expect them to refrain from commenting on sensitive matters upon which they may subsequently, as members of an Oireachtas committee, find themselves reaching opinions and conclusions which may seriously affect the reputations of citizens who are not in any way engaged in the political process. It is unfortunate that, in the case of the present inquiry, some at least of the Committee failed to observe that obvious precaution."*[76]

59. In addressing the issue of bias, Murphy J. (who ultimately dissented) stated as follows:

> *"In recent years there have been numerous and repeated applications to the Courts for the judicial review of the decisions of tribunals set up under the 1921 Act - what are usually called the 'Judicial Inquiries'. It is constantly alleged that these inquiries do not afford to witnesses the requisite degree of fair procedures to protect their constitutional rights.*

[76] [2002] 1 IR 385 at 546. (Emphasis added).

Indeed very real problems do exist in extending fair procedures, which were developed under the adversarial judicial system, to an inquisitorial system. Evolving jurisprudence may have assisted in resolving some of these problems but the difficulties faced by a judge, whose profession and career gives him both security of tenure and a particular expertise, would be multiplied several fold for a committee consisting of elected politicians who do not have that security and may not have that expertise. The tradition of the judiciary is properly one of reticence: the business of the politician is one of communication. The very nature of the duties performed by a politician involve discussion on matters which are of interest to them and their constituents. Such discussion must give rise - as it has already done in the present case - to difficult questions of perceived bias. It would seem to me that fair procedures would virtually preclude a politician from discussing any aspect of an inquiry in which it was involved until the matter had been concluded. Whether the television interviews granted by some members of the subcommittee in the present case would disqualify them from further participation is a matter on which the divisional court has not expressed any view and accordingly is not before this court for determination. It is, however, obviously one of many matters which is likely to give rise to problems in the conduct of an inquiry by a committee consisting of elected politicians."[77]

VI TERMS OF REFERENCE

60. The importance of clarity in the terms of reference of the inquiry was emphasised by McGuinness J.:

"I would also reject his submission that the inquiry was in fact in aid of possible legislation concerning the organisation and management of the GárdaSiochana. In my view, if an inquiry is to be in support of the

[77] [2002] 1 IR 385 at 579 – 580. (Emphasis added).

legislative functions of both Dáil and Seanad, its investigative and legislative aims must be clearly set out in its terms of reference.

The terms of reference of the Abbeylara Sub-committee on the other hand at no stage contained any reference to either the amendment of existing legislation or the promotion of new legislation.

[…]

By no stretch of the imagination could the type of inquiry which the Abbeylara Sub-committee actually intended to carry out be described as primarily, or indeed even peripherally, directed towards producing proposals for legislation."[78]

61. In addressing the terms of reference of the sub-committee,[79] McGuinness J. referred to the submissions on behalf of the applicant and stated, *inter alia*, that *"[c]larity is of great importance in an inquiry such as that proposed by the Sub-committee"*.[80] McGuinness J. noted that the first rule under the heading *"Committee Procedures"* in the Oireachtas' own Rules and Guidelines for Committees reads as follows:

"Committees shall identify, from the start of their consideration of any matter, the nature and purpose of any investigation or proceedings to be conducted by them and, in particular, whether it is proposed to arrive at findings of fact or to express opinion."[81]

62. McGuinness J. stated that *"[t]he importance of clarity in the nature and purpose of the investigation is related to the terms of the 1997 Act"*:[82]

"Persons who are directed under the terms of the Act, as were the Gárda Applicants, to attend an inquiry into facts must answer questions as put to

[78] [2002] 1 IR 385 at 616 – 617. (Emphasis added).
[79] Hardiman J. agreed with the observations of McGuinness J. in this regard. ([2002] 1 IR 385 at 702).
[80] [2002] 1 IR 385 at 634.
[81] *Ibid*.
[82] *Ibid*.

them and must produce documents as demanded. Refusal or failure to do so lays the witness open to suffering serious penalties."[83]

63. McGuinness J. concluded in respect of the terms of reference issue as follows:

"In my view, the information provided by the Sub-committee, while it gave a general indication of the nature of the inquiry, did not measure up to the 'luminous' clarity required, given the possible penalties faced by the Gárda Applicants. In the Watkins case,[84] *the United States Supreme Court approached the Committee's lack of clarity from the point of view of the 'due process' rights of the petitioner. It seems to me that this approach is of assistance in the instant case. It is not so much that the procedural flaws in the establishment of the Abbeylara Inquiry are so serious as in themselves to render the Committee's proceedings ultra vires. It is rather that the confusion and complexity that beset the procedures in question, and the failure clearly to convey the nature and powers of the Sub-committee to the Gárda Applicants, resulted in a lack of fair procedures or due process on the part of the Sub-committee.*

This issue on the appeal, therefore, is related to the other complaints of the Gárda Applicants which I will deal with under the heading of Fair Procedures."[85]

64. In addressing the power of the Oireachtas to conduct an inquiry for legislative purposes, Geoghegan J. stated, *inter alia*, as follows:

"But if it is suggested that there is an inherent power limited to legislative purposes (a form of language which may be inappropriate as I will

[83] *Ibid*.
[84] 354 US 178 (1957).
[85] [2002] 1 IR 385 at 638.

elaborate on later) then in my view if the inquiry is to be intra vires, the exact legislative purposes must be stated in advance. I see no reason why that should not be done. I do not accept or agree with the theory that provided an inquiry was vaguely connected with matters of public interest it could be regarded as being for legislative purposes. I would not follow the wide definition of legislative purposes emerging in the later American case law particularly having regard to the difference in legislative process as already adverted to and having regard also to its genesis which was in the main the committee for investigating un-American activities, a body of dubious repute.''[86]

[86] [2002] 1 IR 385 at 717. (Emphasis added).

Appendix 2: List of documents reviewed by the Committee

This review covered the following:

1. The CAG Report 57 (the Financial Regulator) and the debate of the Committee dated 22 May 2008;
2. The CAG Special Report 72 on Financial Regulation and the debate of the Committee dated 13 May 2010;
3. The Chapters in the Annual Reports of the CAG for 2008 and 2009 into banking stabilisation and the debates of the Committee on these chapters [6 May 2010, 22 July 2010, 21 October 2010 and 21 July 2011];
4. The Report of Regling &Watson entitled "A preliminary report on sources of Irelands Banking Crisis";
5. The Report of the Nyberg Commission of Investigation into the Banking Sector;
6. The Report by the Governor of the Central Bank entitled "The Irish banking crisis: regulatory and financial stability policy 2003-2008";
7. The Independent Review of the Department of Finance [the Wright Report];
8. The papers of the Department of Finance released to the Committee dealing with the decision to issue the bank guarantee in September 2008;

Number	Date	Title/Description
Documents sent to the Committee		
Documents sent to the Committee by Department of Finance 8 July 2010[87]		
1	30/09/08	Government statement re guarantee
2	30/09/08	Speaking points for Taoiseach re guarantee
3	29/09/08	Email from Merrill Lynch (ML) to Department of Finance (DoF) outlining options for dealing with crisis.
4	26/09/08	Presentation by ML prepared for NTMA re strategic options
5	26/09/08	Transcript of handwritten note of meeting with ML, Minister for Finance (MoF), DoF, Central Bank (CB), Financial Regulator (FR)
6	25/09/08? (date not certain)	Transcript of handwritten note of meeting: FR, ML, Central Bank, PwC, Arthur Cox, Attorney General (AG), Taoiseach, Dept. of Taoiseach, MoF, DoF, NTMA, Goldman Sachs (for part)
7	23/08/08	Results of DoF brainstorming session

[87] These documents are available on the Committee's website at http://www.oireachtas.ie/viewdoc.asp?fn=/documents/Committees30thDail/PAC/Reports/document1.htm

Number	Date	Title/Description
8	22/09/08	Paper outlining INBS options, prepared by Chairman INBS, submitted to Sec-Gen DoF.
9	22/09/08	Transcript of handwritten note of meeting DoF, CB, NTMA re liquidity.
10	22/09/08	Transcript of note of DoF, CB, FR meeting w/ Goldman Sachs re INBS
11	20/09/08	Morgan Stanley Discussion materials re ILP
12	20/09/08	Briefing for Taoiseach on increase in deposit guarantee scheme.
13	20/09/08	Government press statement on increase in deposit guarantee scheme
14	18/09/09	Transcript of meeting, MoF, DoF, CB, FR, NTMA
15	18/09/08	Presentation by Anglo to DoF
16	16/09/08	Note for MoF on developments in financial markets
17	16/09/08	Internal DoF email outlining plans for drafting and passing nationalisation Bill
18	14/09/08	Output from Contingency Planning session held over weekend of 13-14/09/08.
19	13/09/08	Papers circulated at Contingency Planning session

Number	Date	Title/Description
20	10/09/08	Letter and paper on liquidity, from FR to DoF
21	05/09/08	Note to MoF re Moody's downgrade of INBS
22	02/09/08	Note for MoF on developments in financial markets
23	26/08/08	Heads of Bill for nationalising/guaranteeing an Irish credit institution
24	01/07/08	Email from DoF to AG Office re competition
25	26/06/08	Note to MoF re performance of Irish banks on stock markets
26	19/06/08	Email from DoF to AG Office re nationalisation Bill.
27	12/06/08	Internal DoF email re power of CB to acquire shares in banks
28	06/06/08	Draft Heads of Bill giving MoF power to take ownership of, guarantee, Irish bank
29	21/05/08	Briefing for MoF before meeting with Head of NTMA re financial stability issues
30	16/05/08	Internal DoF note re EU state aid rules
31	08/05/08	MoF briefing on financial stability issues

Number	Date	Title/Description
32	29/04/08	DoF consultation note to AG Office re options for bank nationalisation Bill.
33	24/04/08	Internal DoF email re State Guarantee Act 1954
34	10/04/08	Note of meeting, DoF, and NTMA
35	08/04/08	DoF presentation for DSG meeting 17/4/08 on contingency planning.
36	08/02/08	DoF presentation for DSG meeting 17/04/08 re financial stability resolution issues
37	08/01/24	DoF Scoping paper on financial stability issues
Documents sent to the Committee 13 October 2010		
1	13/10/10	Letter Sec-Gen DoF to Clerk of PAC
2	29/09/08	Email from PwC to K. Cardiff DoF re liquidity
3	28/09/08	Email from PwC to K Cardiff DoF, B. McDonough NTMA, B. Halpin CB re credit positions
4	28/09/08	Email from NTMA to DoI forwarding email from PwC to NTMA
5	27/09/08	PwC Credit Overview of Anglo
6	18/09/08	Email from Goldman Sachs to CB re INBS review

Number	Date	Title/Description
7	26/09/08	Email, Goldman Sachs to K Cardiff DoF re INBS
8	19/09/08	Letter, M. Fingleton INBS to D. Doyle DoF
Documents sent to the Committee 29 October 2010		
1	21/10/10	List: Anglo Senior & Subordinated Debt
2	27/10/10	List: Anglo dated & undated subordinated debt
3	[no date]	AIB bond issues
Document sent to the Committee 5 November 2010		
1	05/11/10	Cover letter Sec-Gen DoF to Clerk of PAC
Documents sent to the Committee 8 December 2010		
1	08/12/10	Cover letter, Sec-Gen DoF to Clerk of PAC
2	21/09/07	Transcription of note of DSG meeting
3	16/11/07	Transcription of note of DSG meeting
4	08/02/08	Transcription of note of DSG/NTMA meeting
5	22/04/08	Transcription of note of DSG meeting
6	2009 – 2010	Invoices from Arthur Cox & PwC
7	2010	Reports on legal, accountancy etc consultancy fees

Number	Date	Title/Description
		paid by BoI, AIB, ILP, EBS, Anglo, INBS
8	[undated]	Report on pension arrangements of M. Fingleton, CEO, INBS
Document sent to the Committee 12 December 2010		
1	12/12/20	Email from K. Nolan DoI to Clerk of PAC

9. The minutes/notes of the Domestic Standing Group which were released by the Department of Finance to the Committee for its meeting of 22 July 2010;

DSG Documents[88]		
1	03/07/07	DSG meeting
2	31/08/07	CBFSAI views on financial market developments
3	21/09/07	CBFSAI views on financial market developments
4	08/10/07	Update on financial sector for Tánaiste
5	06/11/07	Note to Tánaiste with CBFSAI views on financial market developments from DSG 02/11/07
6	28/11/07	Note to Tánaiste with CBFSAI views on financial market developments from DSG 16/11/07

[88] These documents are available on the Committee's website at http://www.oireachtas.ie/viewdoc.asp?fn=/documents/Committees30thDail/PAC/Reports/document2.htm

DSG Documents[88]		
7	10/12/07	Note to Tánaiste with CBFSAI views on financial market developments from DSG 01/12/07
8	15/01/08	Note to Tánaiste with CBFSAI views on financial market developments from DSG 11/01/08
9	08/02/08	Note with CBFSAI views on financial market developments from DSG 08/02/08
10	10/03/08	Note to Tánaiste with CBFSAI views on financial market developments from DSG 06/03/08
11	21/04/08	Note to Tánaiste with CBFSAI views on financial market developments from DSG 060/03/08
12	22/04/08	Meeting
13	03/06/08	Note to Tánaiste with CBFSAI views on financial market developments from DSG 26/05/08
14	23/06/08	Note to Tánaiste with CBFSAI views on financial market developments from DSG 18/06/08
15	08/07/08	Meeting
16	23/07/08	Transcript of DSG meeting notes (part illegible)
17	17/09/08	Action points from meeting

10. Evidence given to the Joint Committee on Economic and Regulatory Affairs on 3 February 2009 and 21 May 2009;

11. Evidence given to the Joint Committee on Finance and the Public Service on 2

July 2008, 23 September 2009, 25 November 2009, 16 June 2010, 22 September 2010;

12. Other evidence given to the Committee as follows:

- National Treasury Management Agency on 14 May 2009, 22 April 2010 and 6 October 2011;
- National Asset Management Agency on18 November 2010 and 26 October 2011.

Appendix 3: Inquiries in other jurisdictions

1 Introduction

This paper concerns parliamentary inquiries into financial and banking crises undertaken in other jurisdictions. We examined the reports issued by parliamentary inquiries and considered whether or not the inquiries identified any further issues, either not considered at all or not considered at great length, in the Irish reports. This paper does not discuss the legal powers of inquiry which are available / can be granted to inquiry committees in these jurisdictions.

Appendix 3a is an extract from an earlier paper (Library & Research Service, Paper 1), which outlined the terms of reference, mechanisms and powers of the committees conducting parliamentary inquiries into financial and banking crises in six parliamentary democracies.

For a number of reasons, mainly practical ones related to language and the costs of translation, we have confined this analysis to four cases, three of which are concerned with the recent banking and financial crisis (2008). Inquiries conducted by the UK House of Commons, the Icelandic Althingi, the Dutch TwedeKamer (House of Representatives) and the Norwegian Sorting were considered. In the cases of the Netherlands, Iceland and Norway, we consulted translated summaries of the reports as full copies of the report were not available in English.

We first provide some background to the parliamentary inquiries in all four countries. Following this, Section 2 summarises key issues investigated and identified in the reports, noting where possible how these differed from the issues identified and investigated by the Irish reports. Section 3 elaborates on points 1-8 of Section 2.

1.1 UK, House of Commons, Treasury Committee (2008-2009)

An inquiry into the banking crisis was undertaken by the House of Commons Treasury Committee in 2008-2009. The inquiry had wide-ranging terms of reference concerning

how to secure stability in the financial system while protecting the tax payer, consumers and shareholders. Five reports were published on foot of its inquiry:

- Banking crisis: the impact of the failure of the Icelandic banks (April 2009)
- Banking crisis: dealing with the failure of the UK banks (April 2009)
- Banking crisis: reforming corporate governance and pay in the City (May 2009)
- Banking crisis: regulation and supervision (July 2009)
- Banking crisis: international dimensions (July 2009).

1.2 Netherlands, Parliamentary Inquiry, Financial System (2009-2012)

A temporary committee, including eight members representative of all parties and chaired by Jan de Wit, was established by the Parliament in June 2009. It has conducted its inquiry into the financial system in two parts. Part 1 of the inquiry focused on charting the causes of the financial crisis, including the structural problems in the financial system, with a view to making recommendations on how to improve the financial system so as to avoid such crises in the future (reported in June 2010). The second part of the inquiry documented the implementation of government measures during the crisis, focusing on the use of government funds since the Cabinet first intervened in September 2008. For Part two of the inquiry, the committee was granted full powers of inquiry by the Dutch parliament. All hearings were held first in private and then in public. The report of Part 2 was published in April 2012.

1.3 Iceland, Special Investigative Commission (2009-2010) and Parliamentary Review Committee (2010)

The special investigative committee (SIC) into the collapse of the Icelandic banks was established in Iceland by an Act of Parliament (no. 142, 2008). Independent specialists were appointed as Members and SIC published its final report on 12 April 2010. The Icelandic parliament established a special Parliamentary Review Committee (PRC) in 2009 to present its opinion on the general conclusions in the SIC report, to make

recommendations on legislative and regulatory change and to make an assessment of responsibility on the actions of Cabinet ministers during events leading up to the economic collapse. This position was to be followed by an assessment of whether there were grounds for impeachment proceedings before the Court of Impeachment (Landsdormer) for violation of the Act on Ministers' accountability under Article 13 of the Act on a Court of Impeachment no. 3/1963. The PRC delivered its report to Parliament in September 2010. **The SIC and PRC hearings were held in private.**

1.4 Norway, Commission of Inquiry (1997-1998)

A Commission of Inquiry into the banking crisis of the late 1980s/early 1990s, to which the *Sorting* appointed five external experts, was established by the *Sorting* in May 1997. The Commission was established because two inquiries undertaken in the immediate aftermath of the crisis, one commissioned by the Department of Finance and the other by the Banking Insurance and Securities Commission, were judged to have been too close to key relevant policy makers and too early to gain a broad perspective on the banking crisis. The Commission was to examine, analyse and evaluate the circumstances leading to the banking crisis, evaluate the decisions taken by the different public authorities, the banks and the banks' guarantee funds before and during the crisis, study how similar banking crises have been dealt with in other countries and discuss how the experiences may be of use if similar situations are to be avoided in the future. The Commission reported to the *Sorting* in 1998.

2 Summary of issues identified in the reports of the parliamentary inquiries

This section summarises the key themes from the reports of the four inquiry committees. We point out whether or not the issue was examined, or received less attention, in the Irish reports. We also include an observation about the approaches taken to the inquiries in other jurisdictions (point 10). Section 3 elaborates on each of the themes identified in the first eight points below.

2.1 Government policy

More focus on evaluating the key decisions made by the Government both in the run up to, and in response to, the crisis is evident in the reports from other inquiries. The policy decisions taken by the Government when faced with the financial crisis are examined against alternative policy options available to the Government at the time. The Icelandic report (SIC) was very critical of the authorities' decision to commit almost one quarter of the Central Bank's foreign currency reserves to one financial institution in the absence of any information to estimate whether or not the action was rational. The Dutch Report (Part 2) found that the authorities made major mistakes in the billion euro interventions involving certain financial institutions. In particular, the valuations used by Dutch delegations were criticised as incomplete and inaccurate. Other reports were highly critical of aspects of the rescue package. Criticism is made of the governments' failures to impose sufficiently stringent conditions on rescued banks, such as the failure to insist that banks tackle the causes of balance sheet problems (Dutch Report), or the failure to insist that top management and non-executive boards in rescued banks should go (UK inquiry). The Dutch inquiry judged this to have unnecessarily increased the burdens and risks incurred by the Government. The UK inquiry highlighted a contradiction in the Government's approach to bank re-capitalisation: it aimed to protect the taxpayer by imposing a high rate (12%) on the level of dividend payments the banks were required to make on the Government's preference shares while at the

same time wanting the banks to increase lending levels (UK House of Commons Report 2, p. 63).

2.2 Governmental decision-making processes

An analysis of governmental decision-making processes as contributing to the quality of decision making, both prior to and during crisis management, is evident in all the reports of other inquiries. Governmental decision-making processes include the mechanisms in place to ensure that the Government, Department of Finance, the Central Bank and the Regulator work together to ensure the stability of the financial system. It includes the lines of communication between the responsible actors, the clarity of their respective roles in the crisis prevention and management process, the quality of information available to decision makers, and whether or not a crisis management strategy had been agreed by responsible parties in advance.

The ad hoc manner in which decisions which had major financial implications for tax payers were made is criticised. Ethically questionable decision-making processes were identified in the Icelandic report (SIC) such as decisions that were made in consultation with the Chair of the boards of banks, which were to be affected by the decisions taken (see Sections 3.1 and 3.2 below). Other issues highlighted included the apparent lack of collective decision making in Cabinet and the sometimes inexplicable omission of certain key individuals from decision-making processes, which had enormous implications for the future of the countries in question. The Dutch authorities were heavily criticised for, amongst other things, having no clear agreements regarding how to report in advance (and thus manage) solvability (as opposed to liquidity) problems in financial institutions. To address these problems inquiries called for special crisis management structures to be devised and approved by Cabinet; contingency plans for how solvability aid or other possible crisis measures should be designed; clear divisions of tasks within Cabinet; and clarity with regard to the division of legal and political responsibility between the Minister of Finance, the Regulators and Central Banks.

2.3 Role of Parliament and its Committees

The reports examined the role of parliament in the financial crisis. Inquiries were concerned with whether or not parliament, as the body elected to scrutinise legislation and government policy and to hold the Government, its departments and regulatory authorities, to account, was sufficiently assertive during the run up to and the management of the crisis. An enhanced role for, and improved performance by, parliament were identified as important components of a crisis prevention framework in the future (by the Icelandic and Dutch reports in particular). Shortcomings identified were parliament's failure to develop knowledge and expertise on the financial system, which left it ill-equipped to scrutinise the Government and regulatory authorities and vulnerable to influence by interest groups. Parliament's inattention to important initiatives at the international and European level was also criticised.

However, it was generally concluded that parliaments received incomplete and untimely information, which impeded them in holding governments to account. The significance of parliament having the capacity to gather its own information, and to consider this information alongside information provided by the Government, was recognised in the Icelandic and Dutch reports (see Section 3.3 below). Both the Dutch and Icelandic reports recommended a greater supervisory role for parliament in particular via its Finance Committee and in particular of the reforms to the financial sector. The Finance Committee of the Dutch Parliament has had its research budget increased as a result (Dutch Report 2, 37).

The Dutch report recommended that the transparency of stakeholder influence on the content of legislation be increased via a system of legislative footprints (see Section 3.3). This system might also be appropriate for government departments especially in parliaments (like Ireland's) where much of the pre-legislative scrutiny takes place before parliament debates a bill. The Dutch Report (2012) also proposed an information protocol between Cabinet and Parliament via which the House can be informed quickly and confidentially in advance of crisis measures. It also recommended that where the budgetary authority of the House is infringed, as it was in the case of the crisis, the

Cabinet be obliged to compose a retrospective memo of justification containing full information regarding the measures taken, as well as the arguments upon which these measures were based.

2.4 Model of corporate governance (banks) including external auditors, rating agencies and remuneration policy in financial institutions

Weaknesses in the model of corporate governance are identified by all of the inquiries as largely responsible for allowing banks to behave in ways that caused the crisis: promoting a culture of easy reward; taking excessive risk for short-term gains; cross-financing (between banks); blurring boundaries between the interests of all shareholders and the largest ones by allowing managers to also be the bank's largest shareholders; and (in some cases) breaching company law. The model of corporate governance in place is designed to create a "complex web of assurances about liquidity and solvency through shareholders, bondholders, non-executive directors, auditors, credit rating agencies and the media" (UK House of Commons, Report 3). However, the model is judged to have largely failed and recommendations about how to reform it are included in the inquiry reports. Issues raised in other inquiries include the qualifications of board members to perform their oversight role; the optimal amount of time board members may need to dedicate to undertake their role properly; the independence of board members from senior management; inter-relationships between members of the boards of different banks; the quality and type of information made available to board members about risk; and the role of **external auditors** (if any) in recognising and reporting risk.

Rating agencies and the methods they used to rate financial institutions are also investigated and both the Dutch and the UK inquiries recommended that rating agencies be regulated.

The reform of **remuneration practices** by banks to mitigate risk, including possible ways to regulate to ensure remuneration practices that reward stable consistent profitability in contrast to one-off gains based on more risky strategies, is identified as desirable. Progress by the banks since the crisis in reforming corporate governance and

remuneration is addressed in the inquiry reports. The design of **codes of practice** for bankers, and how to ensure compliance with such codes, is discussed in the Dutch report (Part 1) and the inquiry committee recommends that the code include a requirement that banks compile a plan as to **how they will fulfil their social responsibility**.

2.5 Inadequate capital and risk analysis

The reports are long and many different actors are examined as part of the quest to understand the causes of the crisis and to evaluate the authorities' crisis management policies. In spite of this, the immediate reason for the crisis can be distilled from all reports to be the **inadequate capital** held by financial institutions. All inquiries recommend that a reinforced capital position among banks is a priority (see Dutch Report 2, 2012, Recommendation 4; Norwegian Commission, 1998**;** UK House of Commons, Report 4**;** Icelandic SIC, 5). How this might be achieved – through the business practices of private banks, actions by national and international regulators, including the European Commission, and policy makers – is subject to analysis in the UK inquiry (Report 4) in particular. The Norwegian inquiry recommended that regulators be empowered to set capital adequacy differently for different institutions depending on the level of risk (1998, p. 222).

The models used to set adequate levels of capital, and the risk models used prior to the crisis and currently by the banks and by the regulators, were addressed in the inquiries. The UK House of Commons (Report 4) found during its hearing with regulators and experts that the **issue of how to set the optimal capital is surprisingly under-researched**.

With regards to **risk management**, two core issues are identified.

One is, how (or if) risk analysis was communicated from in-house risk-management managers to non-executive boards, shareholders, bondholders, the public at large and regulators. The UK report includes a recommendation that the proposal that internal risk

management report to the non-executive board rather than to senior management be considered.

Two, the adequacy of the actual risk models employed is questioned. The UK House of Commons Report heard evidence that the 'originate and distribute' model of issuing loans which replaced the 'originate and hold' model at the end of the 1990s has failed to deliver the promised diffusion of risk (Report 2, 32). While the UK House of Commons Report 2 concluded that there were major failures in the modelling procedures and strategies of risk management, it pointed out that some banks managed risk better than others.

2.6 Complex banks and banks that are "too big to fail"

The particular problem for the stability of the financial system posed by large, complex banks which are "too big to fail" is identified in the inquiry reports. Measures were proposed that aim to reduce the incentives for bigger banks to engage in risky behaviour for private gain on the implicit assumption that they will be bailed out if the risks do not pay off. These included:

- a tax on size;
- a bank levy that is related to risk;
- that capital requirements are calculated not only using the probability of a bank's failure but also the potential costs of such a failure;
- that retail and commercial banking be separated from the investment banking functions in the same institution;
- that large banks be forced to "write a will" (outlining a resolution plan) which would be regularly evaluated by the Central Bank; and
- that the provision of capital injections by the State be framed in stringent conditions for the institutions (and be prepared in advance of a crisis).

2.7 Financial Regulators

Criticisms of financial regulators found in the other inquiry reports are not dissimilar to those made in the Irish reports. Regulators:

- were found to have relied too much on "moral suasion";
- were not assertive and did not use the powers and sanctions that they did have at their disposal;
- focused too narrowly on micro-prudential appraisal;
- showed a lack of critical thinking in failing to identify macro-prudential risks; and
- were under-resourced vis-à-vis the private banks and were deferential towards them.

An issue identified in the other reports, not identified by the Irish reports in so far as we can deduce, was the proposal to empower regulators with rules-based counter-cyclical supervisory tools that would enable them to "lean against the wind" (i.e. take unpopular decisions) during economic booms.

In order to address in part the regulators' lack of assertion and deferential attitude towards the financial institutions, the Dutch inquiry report recommended that the liability of financial regulators be restricted (Dutch Inquiry, Report 1). The second Dutch report suggested that the concept of supervisory confidentiality be defined in a more material sense to increase opportunities for regulators to raise concerns which arise (see Section 3.7 below).

The regulation of insurance and other types of financial institution, including pension funds, was also recommended in the Dutch and Icelandic inquiry reports.

2.8 The international context

The deeper international macro-economic causes of the crisis stemming from trade and monetary policy, globalisation and the liberalisation of financial markets, are raised in all reports.

Firstly, at the highest level, challenges to the future regulation of the global trade and monetary system were discussed in the report of the UK House of Commons fifth report, in particular the instability caused by global imbalances.

Secondly, specific regulations at a global or European level are identified as creating incentives to engage in risky behaviour and allowing complex financial transactions that obscure risks. Most of the reports recommended that the solutions to capital inadequacy, risk management practices and banks that are seen as "too big to fail" lie in international and/or European-wide regulations and policies (see Section 3.8).

Thirdly, the Dutch reports identified inadequacies in cross-border transnational supervision of financial institutions as a problem requiring solution. It suggested that cross-border supervision be based on transparency rather than on trust (which is currently the case) and should include agreements on burden sharing between states in the event of interventions to guarantee deposits.

Fourthly, the European crisis management architecture provided by the European Commission was identified as problematic and as needing reform. In particular, questions were raised about the compatibility of the European Commission's dual role as supervisor of competition and prudential matters.

Finally, the manner in which national authorities – Government Ministers, senior officials and governors of Central Banks – engage and represent their interest in the quest to secure financial stability at the national and international level was investigated by the inquiries.

2.9 Explaining the "herding mentality" and stifling of countervailing views

A "herding mentality" and the suppression of dissenting opinion within senior and non-executive management in all institutions – the regulators, the Government and its ministries and the private banks – was identified in all inquiry reports as it was in the Irish reports. There are some examples in the material that was available to us from the inquiries where the herding mentality, if not the reasons behind it, was thoroughly investigated.

The Icelandic SIC examined internal communications within the regulatory bodies. On the herding mentality within regulatory bodies, its report (SIC, 2010, p. 5) found that within the Central Bank, opinions frequently diverged on what should be the desirable level for interest rates, with the Board of Governors of the CBI more often in favour of less restraint than the Chief Economist of the Bank. It notes that meetings of the board do not shed light on the data or information on which the board based its decisions when deciding on a policy that differed from that suggested by the chief economists.

The herding mentality within the senior management and non-executive boards of the banks was investigated by the UK House of Commons inquiry. It heard a risk manager at one financial institution (HBOS) who reported being ignored and silenced by senior management when he gave his opinion about the extent to which the bank was exposing itself to risk (UK House of Commons, Report 2, p. 25). A recommendation aiming to, in part, address this herding mentality at senior management level i**s to have the risk management function report to non-executive directors instead of to senior management.**

In general, it appears from the reports that the herding mentality and the silencing of countervailing views within banks and the regulators can be best explained by the fear that negative public commentary about the stability of a financial institution would precipitate a reaction by the markets and would have catastrophic effects on the key stakeholders and unknown knock-on effects on the economy as a whole. This fear was exacerbated in the cases where the owners of the banks were their biggest debtors (e.g.

in Iceland), that is they had the most to gain from the status quo and a lot to lose if the "house of cards" collapsed.

2.10 Approach to inquiries

We outline the approach taken by the Icelandic Parliament believing that there may be some lessons for Ireland. The **inquiry model adopted in Iceland combined a specialist, independent committee with a follow-on inquiry by a committee of parliament.** The Specialist Investigative Commission (to which external experts were appointed by parliament) was established by parliament. Its report was considered by Parliament to be an "independent achievement".

The parliamentary committee – the Parliamentary Review Committee (PRC) on the Special Investigation Commission (SIC) Report – was elected by the Parliament in December 2009 (before the SIC published its full report). It was an ad hoc committee established specifically to address the SIC report. It consisted of nine MPs nominated by the parliamentary parties and elected by the parliament: five members of opposition parties, four from the two government parties, the Chairman being a member of the smaller governmental party.

Iceland's Parliament does not afford particularly strong investigative powers to its parliamentary committees. For example, they do not have the right to summon witnesses nor do they have the right to demand access to all relevant documentation.[1] However, the role of the Parliamentary Review Committee was very clearly linked to SIC's report, which had already thoroughly investigated the causes of the financial crisis and the adequacy of crisis management and which had made a large number of findings that assigned blame to the Government, the banks and the regulators. The

[1] The Icelandic parliament does possess one rather unusual power, which is particular to Nordic parliaments. It empowers parliament to bring Ministers before a Court of Impeachment **(Landsdormer)** for breaches of the Ministerial Accountability Act. The PRC was asked to make an assessment of the responsibility of the senior Ministers in power in the run up to and during the crisis on the basis of the information provided in the SIC report and to make a recommendation on whether they should be brought before the Court of Impeachment. It was parliament, and not the committee, that made the final decision about who should be referred to the Court of Impeachment. Further, the PRC was "not to take a stance relating to matters that the SIC sends to the State Prosecutor regarding alleged criminal conduct of individual persons, nor to matters notified to executives or ministries concerning alleged offences by civil servants". http://www.althingi.is/vefur/prc.html

PRC's role was to see what could be learnt from SIC's findings and **to propose the means of reform** by:

- outlining the legislation and regulations that need to be changed;
- highlighting ethical aspects that arise from SIC's findings; and
- outlining changes to the standing orders of Althingi to strengthen the parliament's capacity and role in supervising the financial system.

It also reviewed ministerial responsibility in the run up to the collapse of the banks (see footnote 2 above).

Hearings were held in private (as is the practice for all Icelandic parliamentary committees). The PRC's recommendations were approved by a motion of parliament. A special standing committee in Althingi was established (on PRC's recommendation) to survey the implementation of legislation proposed by PRC. The resolution stated that the changes of legislation should be completed by 1 October 2012.

Finally, in terms of approach, **the future of banking and the financial system** was to the fore in all of the inquiries. As well as identifying the causes of the banking crisis, and examining responses to it, the reports are quite **forward-looking and prescriptive** in identifying a variety of measures all aimed at enhancing the security of the financial system in the future.

For example, the Icelandic PRC recommended that a public policy on the financial market (presumably like a white paper) be developed that includes a clear goal as to how the financial market should operate in Iceland. The policy would define the appropriate financial system so that it is compatible with the size and requirements of the national economy, set out the future role of the State in the affairs of financial corporations and the arrangements of deposit guarantees. In the UK, the Treasury Department published a white paper entitled "Reforming Financial Markets" in 2009 on which the Treasury Committee commented in its inquiry reports.

3 Elaboration on the identified issues

3.1 Evaluation of key decisions made by the Government (prior to and during crisis management)

All of the inquiries place more focus than the Irish reports do on examining the actions of Government Ministers and Departments both in the run up to and especially in response to the crisis.

The **first part of the Dutch inquiry** critically examined government policy and the decisions made by the Government in the run up to the crisis (in 2007). It focused in particular on the Government's reaction to business decisions made by two of the banks (Landsbanki and ABN-AMRO), which ultimately required intervention. It was highly critical of the Minister for Finance's decision to issue a "no objection", which effectively allowed the takeover of ABN AMRO in 2007 as a sub-optimal choice at the time.

The **second report of the Dutch parliamentary inquiry** focused almost exclusively on the actions of the Government (and Central Bank) in response to the crisis since 2008, with a particular emphasis on whether or not the Government has used public funds wisely. Former ministers and senior government officials and senior regulators were heard by the committee. The committee examined the authorities' handling of all banks that required government intervention (Fortis/ABN AMRO; ING; Icesave (Landsbanki). It examined the decisions behind the establishment and the adequacy, in terms of a policy response, of the Government's:

- Deposit Guarantee Scheme;
- the capital provision facility (recapitalisation); and
- the Guarantee Scheme for bank loans.

For example, the committee examined in detail the authorities' actions in respect of Fortis/ABN AMRO.[2] This included the Government and Central Bank's decision to

[2] The Dutch government has transferred a total of €66.8 billion to Fortis. A week after the Belgian-Dutch financial

allow Fortis Bank Nederland to acquire ABN AMRO in September 2007, the Central Bank's supervision of the bank following this acquisition, the decision to intervene on 27-28 September 2008 to save Fortis from bankruptcy, and the acquisition of Dutch parts of Fortis by the State. It found, amongst other findings, that in authorising the consortium, the Minister and the Central Bank took a decision that has had severe negative consequences for the Dutch economy and taxpayers and that a different decision could and should have been taken. It found that the valuations used by Dutch delegations were incomplete and inaccurate and assumed that the subsidiaries had liquidity and capital which was not always the case. It found that a heavy price was paid for financial stability, which was out of proportion to the economic value (Dutch Report, 2, pp. 1-6).

It similarly examined the authorities' actions in respect of ING.[3] It examined the supervision of ING as it tried to deal with its exposure to the US sub-prime mortgage market in 2007, the decision to give a capital injection of €10 billion in October 2008, the setting up of the Illiquid Assets Back-Up Facility, which allowed the State to assume economic risks on ING's US-Alt-A mortgage-backed securities in January 2009 and the development of emergency legislation regarding the nationalisation of ING (as a worst case scenario). The inquiry report found that the choice for capital injection in October 2008 allowed the core problem (the risk to ING's solvency from the US Alt-A portfolio) to persist. It found that the decision to develop emergency legislation was wise.

An issue identified in the investigation of the capital provision facility was that **it failed to include agreements on tackling the causes of balance sheet problems**: no form of

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conglomerate's (Fortis) banking subsidiary had run into an acute crisis, the Dutch government purchased the Dutch subsidiaries off Fortis after negotiations with the Belgian government. It paid €16.8 billion for 97.8% of the shares in Fortis Bank Nederland Holding, including the entire stake Fortis held in the ABN AMRO subsidiaries. The government assumed €34 billion in short-term debt from Fortis Bank Nederland and its subsidiaries and it agreed that Fortis Bank Nederland would replay some long-term and subordinated loans to a maximum of €16 billion to Fortis on an accelerated schedule. Since that time, Fortis Corporate Insurance has been sold and the banking subsidiaries have been merged to form a new ABN MRO Bank. Dutch Inquiry Report, 2, (2012) p. 4. (English translation).

[3] On 19 October 2008, ING received a capital injection of €10 billion and a new intervention followed on 26 January 2008. This involved the Illiquid Assets Back-up Facility which the State created for ING. This is a special arrangement in which the State assumed the economic risks for 80% of a portfolio worth €30 billion in US-Alt-A mortgage-backed securities.

agreement was made with institutions to "put their houses in order" in any of the capital injection cases examined, not even with reference to the future (Dutch Report, 2012, p. 22). This was judged to have unnecessarily increased the burdens and risks incurred by the Government.

The **UK inquiry** investigated the Government's response to the banking crisis in detail and it dedicates one of its reports to evaluating the decisions taken in response to the crisis against alternative policy options. The Chancellor of the Exchequer (at the time of the crisis and who was still in office at the time of the inquiry) and heads of the Central Bank and the Financial Regulator were called as witnesses. While the report covers the causes of the crisis, it places significantly more focus on **examining government policy in 2008 and 2009 and the pros and cons of the decisions that it made when faced with the banking crisis.**

The report examined the Government's support package for the banks (October 2008), the January 2009 package, as well as discussing alternative policies. For example, the benefits of the asset-protection scheme (which was adopted) were assessed versus a bad-bank scheme to deal with toxic assets. There is also a section discussing the Government's decision in October 2008 to establish UKFI to manage the Government's shareholdings in UK banks.

The inquiry report was highly critical of the Government's failure to impose the condition on the rescued banks that the top management and all non-executive boards should go as part of the rescue package. The Committee argued that this meant that a moral hazard continued into the future (Report 7, 2009, p. 63).

The **Icelandic** SIC investigated, and was highly critical of the Government. It placed a large part of the blame for the collapse of the financial system on ministers. It concluded, amongst other findings, that:

- The Government needed to respond no later than 2006 – when the size of the banking system was obviously too big compared to the Icelandic economy. However, instead the Government pursued a policy that ensured continued

growth of the financial institutions, domestically and internationally, and encouraged them to maintain their headquarters in Iceland. This was evidenced in the coalition agreement of May 2007.

- The Government lowered taxes during an economic expansion in spite of expert advice to the contrary. It made legislative changes that affected lending practices and fuelled the property bubble – "one of the biggest mistakes in monetary and fiscal management made … with full knowledge of the likely consequences."

The actions of the Government and the Central Bank in response to the crisis is also examined and equally criticised:

- The SIC report is critical of the authorities' immediate response to the crash in the decision to announce that the Government would supply Glitnir (bank) with €600 million in exchange for a 75% share in the bank. It says that the CBI's board (Central Bank of Iceland) did not have the necessary information to be able to estimate whether the action it proposed to the Government was rational.
- The decision was made following a meeting between CBI Board Director and the Chairman of the board of Glitnir. The amount proposed was nearly one quarter of CBI's foreign currency reserves. To foreign investors and credit-rating agencies, the report says "it must have seemed evident that the Icelandic state did not have access to financing markets either."

The **Norwegian Commission** closely investigated the behaviour of the Government and of the supervisory bodies under the Ministry for Finance, prior to and in response to, the crisis. It criticised the Government's failure, in some cases for political reasons, to implement a number of possible measures to prevent a crisis from emerging:

- It found that the Government's primary contribution to the crisis was its failure to address the conditions which created the strong demand for credit during the mid-1980s.

- It also held the Government responsible, in particular the Department of Finance, which is primarily responsible for the failure of the banking

supervisory system. The Ministry of Finance was, it wrote, the governing body of the Banking, Insurance and Securities Commission (i.e. the Norwegian Financial Regulator) and the legislative and administrative apparatus does not allow the responsibility for the stability of the financial system to be passed onto it. The report found that there was no reason to claim that the Government and the Minster lacked the information necessary to fulfil this responsibility (Chapter 5).

- Chapter 8 examines whether or not the policy options taken by the Government in response to the crisis, for example to use a royal decree to write down share capital to zero to recover recorded losses in some banks, were sound and optimal in the given circumstances.

- Chapter 9 focuses specifically on how the crisis was handled by the authorities for the two commercial banks – Christiania Bank and Fokus Bank – in which the share capital was written down to zero. It investigated the banks' liquidation value, net asset value and discounted future profit value, as well as reversals of earlier loan-loss provisions in the period following the crisis. It simulated what the banks' situation would have been had they adhered to another practice for recording losses. The Commission concluded that the decision was handled responsibly by the authorities but criticised their omission of an independent procedure to determine the value of shares.

- Chapter 10 focused on the authorities' handling of Den norske Bank and examined the financial basis for writing down the ordinary share capital.

3.2 Evaluation of the processes of governmental decision making

Some inquiries, in particular in the Icelandic and Dutch inquiries, identified the **processes of governmental decision making** (i.e. the way in which decisions were taken) as contributing to generating the crisis and as affecting how well the authorities handled the crisis. Issues central to the decision-making process include:

- the mechanisms in place to enable the Government and its Department of

Finance, which together have responsibility for macro-economic policy, and the Central Bank, which is responsible for ensuring the stability of the financial system, to work together effectively to ensure the stability of the financial system;

- the issue of "who was in charge" when it came to crisis prevention and management in the financial system;
- whether or not there was a contingency plan in place;
- the quality of information available to the Government;
- the transparency of decision-making; and
- the accountability of government and the authorities for these decisions.

Iceland

The Special Investigative Committee (Iceland) was critical about the working relationship between the Government and the Central Bank and this was the central structure for crisis management. For example, it found that:

- The Board of Governors of CBI (Central Bank of Iceland) described concerns to the Prime Minister or group of ministers in November 2007 but there was no evidence that the Board of Governors of CBI made available to the Government formal propositions for necessary measures. It understood that it lacked the means to react to the problem alone. On 7 February 2008, the Board of Governors of CBI and the Prime Minister, Minister for Foreign Affairs and Minister for Finance met and CBI painted a very bleak picture of the imminent danger for the economy. CBI Board met ministers again (without the Minister for Finance) on 1 April and informed them that huge funds were withdrawn from Icesave accounts and that Landsbanki could withstand such an outflow for six days. Yet no active or credible measures were taken.
- It found that there was mistrust between the Chair of CBI Board and ministers of the Social Democratic Alliance. It appeared that these ministers did not trust the information that he provided to them.

- The Report found as a cause for wonder that at meetings of the Board of Governors of CBI with ministers, the bank would not hand out documents with summarised information, the bank's review of that information and proposals for action where applicable. Ministers no doubt had difficulties assessing the right course of action. Also, minsters did not seem to call for such proposals and documents from the CBI in spite of having ample reason to do so.
- Nothing suggests that the ministers responsible for economic affairs (Prime Minister), banking affairs (Minister of Business Affairs) or the State's finances (Minister for Finance) submitted a specific report to the Government on the problems of the banks and their possible impact on the economy in 2007 or 2008.
- At least five meetings took place between the Prime Minister, and the Ministers of Finance and Foreign Affairs in 2008 without the Minister for Business Affairs, even though the banks' problems were being discussed there.
- Ministers' only actions appear to have been partaking in public discussions, mainly abroad, to talk up the image of Icelandic banks without making any assessment of the financial capability of the State to come to the banks' assistance.
- The report said that it was a valid to ask the question, "Who was in charge?" A Consultative Group on Financial Stability and Contingency Planning was established on 21 February 2006 and it included the Prime Minister's Office, the Ministry of Finance, Ministry of Business Affairs, the FME (Iceland's Financial Regulator) and the CBI. While it was consultative, it was clear to the SIC that the Central Bank and Financial Regulator looked to the group for initiatives towards a joint contingency plan. Yet, the Commission concluded that uncertainty regarding the powers and responsibilities of the group seems to have led to a lack of clarity as to who was in charge and responsible for contingency preparations. The result was that when the banks collapsed there was no joint governmental contingency plan available.

- Further on this topic, the report says that three different groups had discussed contingency plans between February 2006 and 3 October 2008. But the last of these three groups (which was summoned by the CBI and met between 30 September and 3 October 2008) was not given access to the material from the other two groups. It describes this as unacceptable and "not in keeping with the manner in which nations with developed financial markets and administration operate in general."
- The Emergency Act (6 October 2008) was drafted in two days in spite of its complexity and the wide-ranging nature of it. It was drafted without the assistance of experts in fields of insolvency law, for example.

While contingency preparations were very poor, the report did acknowledge that more thorough contingency planning in 2007 and 2008 would not have prevented the collapse but could have lessened the damage caused by the collapse.

In sum, the report (SIC) criticised the **seemingly ad hoc manner in which decisions that had major financial implications for tax payers were made**. For example, it found that the decision to supply Glitnir with €600 billion in exchange for a 75% holding in the bank was made following a meeting between the Director of the Central Bank's board and the Chairman of the board of Glitnir. The amount proposed was nearly one quarter of CBI's foreign currency reserves.

The Parliamentary Review Commission, which followed the SIC in Iceland, was quite scathing about the processes. The PRC concluded that "the lack of government emergency procedures aimed at the protection of the country's financial system and other basic state and public interests is reprehensible and in no way in accordance with how countries with advanced financial markets and administration should operate."

It found that *the scope and responsibilities of the Coordinating Group on Financial Stability*, which included the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the Financial Regulator and the Central Bank, *was not clear*. Further, it found that "the chain of ministerial responsibility broke or became

disjointed in the period leading up to the collapse", and that "ministers trespassed in to other ministers' terms of reference."

PRC also found that "the supervision by ministers of independent institutions within their area of responsibility seemed lacking" (PRC, 2010, 2.2). It recommended that the Financial Regulator and the Central Bank be subject to an administrative audit in order to improve, amongst other things, the flow of information between supervisory institutions and Ministers. It proposed that a sharpened definition was needed on which institution is supposed to have the overview of systematic risks, financial stability and responsibility for coordination of government response to a possible financial meltdown (PRC, 2010, 2.3).

The Netherlands

As per Section 3.1 above, the second report of the Dutch Parliamentary inquiry focused on the actions of the Government since 2008. Central to the inquiry was an analysis of the manner in which major decisions were made and of how this affects the quality of decisions.

The report defines crisis management as "a systematic approach that aims to avoid or, at any rate, control possible crises" (Dutch Report, 2, 2012 p. 28). The committee examined the processes of policy decision-making during four phases of crisis management: the preliminary phase, the alarm phase, the acute phase and the follow-on phase.

The inquiry investigated (Dutch Report, 2012, pp. 28-31) the manner in which Cabinet, the Ministry of Finance and the supervisory authorities worked together to handle the preliminary and alarm phases. The preliminary phase includes planning, drafting scenarios and manuals setting out agreements on the division of tasks, communication lines and the anticipated responses of different bodies. The alarm phase is when possible risks are identified and analysed. It found that:

- While the Ministry for Finance set out guidelines for controlling financial crises,

the guidelines did not contain any concrete policy decisions for the Cabinet or descriptions of possible crisis measures.

- No exercises took place at Cabinet in which a financial crisis was simulated and such scenarios were never worked out. There was no analysis, for example, of the way in which the American mortgage crisis might form a threat to the Dutch financial system.

- The Ministry of Finance did not receive any warning signs from regulators (or financial institutions) that could have formed reason for concern about the solvability position of these institutions and, therefore, did not convey any warning to Cabinet.

- Existent agreements between the Ministry of Finance and the Central Bank were not sufficient in case of 'solvability' crises. The inquiry examined a Memorandum of Understanding agreed between the Dutch Central Bank and the Ministry for Finance in 2007 to exchange information and consult on matters pertaining to financial stability and crisis management. It concluded that the Memorandum was not sufficient in case of solvency crises: there were no clear agreements regarding the time at which the Central Bank would report situations potentially giving rise to solvability problems at financial institutions. As a result, the Central Bank only informed the Ministry for Finance when government intervention was unavoidable (Dutch Report 2, 2012, 30).

Examining the processes of decision-making during the acute phase, where the situation is monitored and controlled and decisions are taken on actions required to address the crisis, the inquiry found that:

- In spite of the limited preparation for a systemic crisis of that magnitude, the Minister of Finance and the Central Bank initially acted decisively.

- There was close cooperation between the Minister for Finance and the Prime Minister.

- However, there was a lack of communication between the Minister for Finance and the Cabinet: there were short-comings in decision-making on crisis measures by the Cabinet and no concrete decision-making took place there.

- In spite of the fact that a steering group was set up in order to keep the majority of government officials in the loop about the crisis measures to be taken, the steering group was not a contributory party to the decisions concerning a number of important measures with far-reaching financial consequences (for example, the capital injections and the establishment of the Illiquid Asset Fund for ING).

- The Deputy Prime Minister, in view of his function as a leader of a government party, should have been more extensively involved.

It also identified further problems with the way decisions were made:

- A tension was found to exist between the role of the Central Bank as an advisor to the Minister for Finance and as the prudential supervisor (with responsibility for the stability of the financial sector). The Committee concluded that the Central Bank performed its primary task of prudential supervision adequately during the crisis but that the uncertainty regarding its role when providing advice to the Minister was not desirable. It stated that clearer and more specific agreements about the role of the Central Bank as advisor should have been in place prior to the crisis (2012, p. 32).

Finally, the inquiry report was critical of the fact that there was no thorough evaluation of the crisis at the Ministry of Finance or the Cabinet. It pointed out that the Prime Minister's Ministry of General Affairs should have conducted an evaluation into the decision-making structures during the crisis and that the Ministry of Finance should also have assessed its performance during the crisis. It pointed out that the Central Bank had evaluated its performance and had drawn lessons for the future.

The Committee recommended on the future of crisis management:

- That a **special crisis structure** for financial crises be developed, which would include a clear division of tasks within the Cabinet and between the Cabinet, the Central Bank and the Financial Regulator (AFM);

- That agreements be made on **information exchange during liquidity as well as solvability crise**s, both between the Central Bank and the Ministry of Finance and within the Cabinet, and between the Minister of Finance and the House of Representatives;

- That contingency plans should be compiled setting out the form which solvability aid or other possible crisis measures, such as guarantees, should take;

- As each crisis is different, that the crisis management plan should be flexible and applicable in a number of different situations;

- That the Cabinet should approve the crisis management plan.

The first part of the Dutch inquiry had concluded that it is of huge importance that policymakers and legislators have access to **good and usable information** regarding the financial system, macro-economic developments and policy options for managing or preventing associated risks:

- The report found that the Bureau for Economic Policy Analysis[4] and the Dutch Central Bank did point to global developments as potentially risky. However, they did not recognise the exact nature of the relationship between risky international macro-economic conditions and the Dutch financial system, i.e. they underestimated the potential for the risk to threaten the Dutch financial system.

- As such, it recommended that the Dutch Central Bank and the Bureau for Economic Policy Analysis inform the legislature at least annually (more if

[4] This institution is similar to the recently-established Fiscal Council in Ireland. However, it operates from within the parliament.

circumstances demand so) about international and national macro-economic developments in the financial sector, focusing on the risks that these developments pose to the stability of the financial system in the Netherlands and identifying policy options in the face of such risks.

Norway

The Norwegian Commission also identified issues with how decisions were made:

- It called for clarity with regard to the division of legal and political responsibility between the Ministry of Finance, the Regulator and the Central Bank, for responding to and, if necessary, speaking out on warnings of a financial crisis.

- Finding the Government's key contribution to crisis to be its failure to address the conditions which facilitated the crisis in the early 1980s, it held the Government – in particular the Department of Finance – primarily responsible for the failure of the banking supervisory system. It found that there was no reason to claim that the Government and the Minster lacked the information necessary (provided by Central Bank and the regulators) to fulfil this responsibility (Chapter 5).

3.3 The role of parliament

The reports of the Dutch and the Icelandic inquiries examined and were critical of parliament's role in the crisis and its failure to take action to avert the crisis. They are also critical of the Government's failure to consult parliament and to provide it with information. The reports include several recommendations about how parliament can better perform its duty to scrutinise both legislation and government policy towards the financial system.

Netherlands

The first part of the Dutch parliamentary inquiry is critical of the House of Representatives for under-estimating and insufficiently discussing early warning signs,

which had been expressed by authoritative sources regarding the macro-economy and developments in the financial system. This was in part because:

- The House invested too little time in its own knowledge development and research on the financial system. This posed an obstacle to its ability to continue a well-informed dialogue with the Government and supervisory authorities regarding the principles and key pitfalls of the financial systems. It was therefore difficult for the House to influence developments effectively and in some cases led to ad hoc decision-making processes, which were vulnerable to influence by interest groups through lobbying.

- The House often learned too late of important initiatives regarding the development of international and European standards and regulations. It neglected to enter fundamental debate with the Cabinet over these issues or waited until the process of negotiation had progressed to a point where it could no longer influence it.

- The report recommended that there be increased parliamentary scrutiny of the reform of the financial sector: that the House intensify the fulfilment of its controlling and legislative duties in this regard and, in particular, through the Finance Committee. In particular (and as noted in Section 3.2), it recommended that the Central Bank and the Bureau for Economic Policy Analysis together submit an annual report to parliament about international and national macro-economic developments in the financial sector focusing on the risks that macro-economic developments pose to the stability of the financial sector (Report 1, Recommendation 1).

- It also recommended that the House investigate the possibility of ***increasing the transparency of stakeholder influence*** on the content and realisation of legislation. One option, it suggested, was to consider a system of ***legislative footprints*** *in which legislators must indicate which actors were involved in compiling legislation and regulations and in what ways* (Report 1,

Recommendation 18).

The second Dutch inquiry report made further findings concerning the House of Representatives (lower house of parliament). It concluded that throughout the crisis management period:

- The Minister did not provide timely or complete information to the House of Representatives thereby impeding the House in its role of holding the Government to account. In nearly all cases, the Minister informed the House about crisis measures after the fact and made it impossible for the Parliament to scrutinise the crisis measures (Report 2, p. 3).

- It recommended measures to change the interplay between Cabinet and Parliament. For example, it recommended that an ***information protocol*** is needed in order to inform the House of Representatives quickly and confidentially (if necessary) in advance of any crisis measures (Report 2, 2012, Recommendation 9).

- It also recommended that in cases where the budgetary authority of the House is infringed, the Cabinet be obliged to compose a ***retrospective memorandum of justification*** containing full information regarding the measures taken, as well as the arguments upon which these measures were based (Report 2, 2012, Recommendation 10).

- It recommended that the House's information position regarding financial measures be strengthened independently of the Government. The Inquiry Committee considered this important – that the House can examine information received from the Government alongside information that it has gathered itself. It welcomes that the research capacity of the Committee for Finance has been increased and that an annual sum of €50,000 is available to engage experts ad hoc (Report 2, 2012, Recommendation 11).

Iceland

The report of Iceland's SIC criticised the practices of the Icelandic Parliament and the Commission's Working Group on Ethics criticised Icelandic political culture. The main conclusions of PRC on foot of SIC's report were that:

- the independence of parliament from the executive power be increased, the role of parliament as supervisory authority reinforced and parliamentary bill preparations enhanced;
- parliament should not be a tool for executive power and individual representatives but instead should be a forum for debate conditioned by the interest of the public. Parliamentary debates are too militant to be a useful forum of debate and the place of democratic exchanges of views;
- an Article concerning the role of parliament be added to the constitution and that members of Parliament publish a code of ethics;
- the opposition as a force of restraint on the executive be strengthened – parliament needs a greater supervisory role and improved right to gather information, and better access to professional advice;
- parliament should receive an annual report on the execution of parliamentary resolutions and cases referred to Government by Parliament;
- a general law on working investigation committees be passed;
- parliamentary committee member arrangements should serve the needs of parliament and not the organisation of the Government offices and that a review of member arrangements and of the operations of working committees with a view to furthering this goal be undertaken;
- a review of procedures be undertaken regarding government bills in parliament in order to enhance the independence of parliament from executive power. Government must be bound to put their bill before parliament well in advance so that members of Parliament have time to consider them in a professional manner with relevant debate and resolution;

- an independent government institution operating under parliament be established to evaluate and predict the economy (like the Icelandic National Economic Institute, which had existed up until July 2002);
- A working parliamentary committee be assigned the task to supervise the legal reform proposed in PRC's report and that the reforms be completed by the conclusion of Parliament 2012. This committee was appointed.

While it was not examined in detail for this paper, it is worth pointing out that a parliamentary inquiry conducted into the financial crisis of the early 1990s in Sweden focused on parliamentary procedure and the budgetary process in parliament in particular. The budgetary process was considered to have played a significant role in creating the public finance crisis that resulted from the banking crisis.

3.4 Model of corporate governance

All inquiry reports, similar to the Irish reports, placed a large proportion of the blame for the crises on the behaviour of boards and senior management of the banks. They are blamed for either failing to understand the consequences of the rapid expansion in lending growth, which had the effect that their asset portfolios became fraught with risk, or understanding it yet allowing the rapid expansion in the interest of short-term gain.

However, some of the other inquiry reports examined in more detail and produced more recommendations on how **weaknesses in the model of the non-executive system of oversight, which is central to the model of corporate governance in all banks**, allowed this damaging behaviour by the banks.

Issues central to the discussion about the model of corporate governance are:

- the **qualifications, suitability and independence of board members**;
- the **amount of time board members dedicate** to their oversight role;
- the issue of remuneration and bonuses and the incentives they created in the past, and still possibly, create to ignore risk;
- the role of **external auditors** and whether or not it needs to be changed; and
- the manner in which the **risk management function** is connected to /

communicates with the non-executive board and, perhaps, the Regulator.

The Icelandic report points out that while banks are private institutions, they have special civic duties given that they must have the faith of the public if they are to be trusted with public property. As such, it argues that how they are governed internally is the business of government and parliament.

The UK House of Commons Treasury Committee published four reports as a result of its inquiry into the banking crisis (also a fifth one focused on the UK's links to the Icelandic banks), one of which was dedicated to the subject of corporate governance and pay.

Describing the model of corporate governance, the House of Common's Treasury Committee Report refers to the "complex web of assurances about liquidity and solvency currently provided by shareholders, bondholders, non-executive directors, auditors, credit rating agencies and the media." On the weaknesses of this model, the report looks at the failure of boards in their duty to promote the success of the company, in particular their **inability to understand the risks inherent in complex financial instruments** (eg. securitisation) and the links between rapid growth and **leverage (assets relative to equity**).

In this respect it identifies challenges to the non-executive system of oversight, which is central to the model of corporate governance in all banks. In the report:

- The background and banking experience of non-executive members of boards was considered as was the proposal that some did not understand complex financial instruments (which was acknowledged by some senior representatives from banks);
- A proposal was made that chairmen should give a greater time commitment to their role and be better resourced (which was later approved);
- It was recommended that risk management functions in banks report to non-executive directors (and not to the Chief Executive).[5] The purpose of this

[5] UK House of Commons, Treasury Committee, (May 2009) *Banking Crisis: reforming corporate governance and pay in the City* 9th Report of session 2008-2009. p. 57.

recommendation is two-fold. One is to improve the quality of information accessible to non-executive directors thereby enabling them to gain a better understanding of the company's position. The second is to prevent the "group think", "herding" or intolerance of contrary views, which may have led to the advice of risk managers being ignored by senior management. This was also a recommendation in Part 1 of the report of the Dutch inquiry (Recommendation 6);

- A Review of Corporate Governance in the banking sector established by the UK Treasury in February 2009 was considered.[6]

The Icelandic Special Investigative Commission was highly critical of how corporate governance in all three banks failed to prevent the irregular behaviour to which the SIC assigned most blame for the banking crisis.

In particular, it criticises the abnormal access the bank owners had to credit, which blurred the boundaries between the interests of the bank and the interests of their largest shareholders. It found that amongst all three banks, the principal owners were either the largest or among the largest shareholders.[7] The report concluded that the operations of the banks were, in many ways, characterised by their maximising the interests of the larger shareholders who managed the banks, rather than running solid banks with the interest of all shareholders in mind and where responsibility to creditors mattered. This incentive structure would help to explain the banks' early responses to the crisis, of which the SIC says "can hardly be considered as a justifiable response to such a crisis to be in line with healthy and normal business practice." The SIC summarised the banks' responses as "increased lending to the owners of the banks, acquisitions of foreign financing, and losses due to buying and selling of their own shares."

On the reform of corporate governance, the PRC recommended:

[6] The appointment of Sir David Walter as Chair was criticised by the Committee's inquiry report, which argued that a "city grandee" with his background and close links to the City of London was not the ideal person to take on the task of reviewing corporate governance arrangements in the banking sector.

[7] When Glitnir Bank collapsed, its loans to its largest owner, Baugur and affiliated companies, amounted to 70% of the bank's equity base. In Kaupthing Bank, the second largest debtor was the largest shareholder. In Landsbanki, the largest debtor was the largest shareholder.

- An analysis of an active competence for the Financial Supervisory Authority to change board members, directors and external auditors of financial corporations if risk management and affairs subject to control are deemed detrimental to the interests of investors and other creditors (PRC. 2.2).

Part 1 of the Dutch inquiry's report produced 27 recommendations, eight of which are directed specifically at the conduct of the private financial sector and measures it should take to change its structure, culture and conduct. The inquiry committee examined a new code of practice, which had been recently agreed by the Dutch financial sector[8], and the committee made recommendations about how to strengthen and how to ensure compliance with the code. It recommended:

- that measures are taken to ensure that the newly negotiated banking code is complied with (such as underpinning it with legislation or giving the Central Bank or Financial Regulator a role in ensuring compliance);
- that the banking code is supplemented in the area of risk management within financial institutions;
- that the code include a requirement that banks compile a plan of approach as to how it will fulfil its social responsibility; and
- that similar codes of practice be adopted by other financial institutions (such as **insurance companies and pension funds**).

3.4.1 External auditors

The role of **external auditors** in corporate governance was considered in all of the inquiry reports.

The House of Commons Treasury Committee Inquiry investigated:

- the performance of auditors;
- whether their role should change; and

[8] This code was based on the work of the Advisory Committee on the Future of Banks (the Maas Committee) which was established in 2008 by the Board of the Netherlands' Banking Association with the objective of restoring trust in banks. A copy of its report is available here: http://www.nvb.nl/scrivo/asset.php?id=290353

- how the knowledge of banks that auditors accumulate through their close working relationship with the bank could be absorbed more effectively into banking supervision.

In the hearings, Professor M. Power pointed out that external audit does not have a role at the frontline of systematic risk management and that the question was whether it should have such a role. On balance, the Committee recommended against changing the auditor's role to increase their role in assessing risk. Instead it ***recommends that supervision of risk be improved by focusing on the internal risk management function and a more invasive regulation of risk by the FSA (see Sections 3.5 and 3.6).*** As part of this it recommended examining the relationship between auditors and the Regulator (House of Commons Treasury Committee, Report 3, p. 79).

The Icelandic SIC is critical of external auditors. It concluded that auditors did not perform their duties adequately when auditing the financial statements of the corporations for 2007 and the semi-annual statements of 2008. It argued that:

- inadequate attention was given to the value of loans to the corporations' largest clients; and

- the treatment of staff-owned shares was not properly investigated.

The Parliamentary Review Committee further concluded that the internal and external accountants failed in their task as supervisors and carry considerable blame for the ongoing disregard for law and bad business practices of the banks. **PRC found it a grave matter that accountants had not seemed to have discussed the causes and results of the economic collapse within their own profession** (PRC, Section 2.3).

The committee suggests that Parliament's Trade Committee be ordered to lead a review of legislation (law no. 79/2008) regarding accountants. The basis for such a review would be a ***parliamentary audit of external accountants' performances*** leading up to the collapse of the banks in October 2008.

The Dutch Committee (Part 1) concluded that the accountancy profession fell short in its social duty to ensure a comprehensive and sufficient account of the financial health of financial institutions, especially with regard to the reporting of uncertainty in the valuation of financial assets. It recommended:

- that the professional association for accountants and the Financial Regulator together come up with measures to ensure that financial statements of financial institutions provide as clearly as possible an image of all relevant conditions, including possible risks and uncertainties with regard to continuity; and
- that accounts should also make more use of explanatory sections concerning situations of uncertainty in financial institutions.

The Committee welcomed a proposal for a tripartite conference (consultative) involving the Central Bank, the financial company and the external accountant.

3.4.2 Rating agencies

Rating agencies are part of the model of corporate governance in that they must understand banks' balance sheets with a view to rating their products. Both the Dutch and UK reports call for more regulation of rating agencies.

- Rating agencies in the UK were criticised for rating complex structures – such as CDOs – "which they did not understand but [rated] anyway" (UK House of Commons, Report 3, p. 67).
- The Dutch Report (Part 1) called for credit-rating agencies to be brought under financial supervision, stating that it would be desirable that this were at a global, or at least a European, level (Recommendation 22).
- Conflicts of interest inherent in rating agencies' business models, whereby the debt issuer (i.e. the institution borrowing) pays for the rating agencies' services, were also discussed during the UK hearings (UK House of Commons, Report 3).

3.4.3 Corporate governance and the bonus culture

The inquiry reports addressed the **bonus culture** and how it led to the crisis by incentivising short-term thinking to the detriment of the bank's overall long-term profitability.

- The UK House of Commons Committee found from its investigation that there is a widespread consensus that remuneration practices in the banking sector must change especially in those banks that have had recourse to any form of support from the taxpayer (UK House of Commons, Report 3, 18).
- The argument that the level of remuneration remains too high and that bonus and severance packages have continued at banks receiving substantial public funds was raised and discussed. The report outlined the steps the Committee believed were necessary to reform remuneration packages and looks at why they have yet to be taken by banks.
- The UK inquiry report also discusses the FSA's approach to reform of remuneration ***with a view to having a remuneration system that rewards stable consistent profitability in contrast with one-off gains based on more risky strategies.*** Guidance via a code of practice on how remuneration should be structured is a recommended approach (i.e. using a measure of risk-adjusted return and using other performance measures and not just annual profit alone).
- Possible sanctions the FSA could deploy to penalise remuneration practices that did not comply with such a code of practice were discussed. Amongst the possible sanctions was the imposition of higher capital requirements on banks and other financial services firms whose remuneration practices do not comply with the Regulator's code of practice. This approach was supported by the Inquiry Committee (UK House of Commons, Report 3, p. 21);
- It concluded that the FSA's function should be to regulate inappropriate remuneration practices but not to regulate the levels or the amount of pay within the sector.
- The usefulness of tools such as **caps on pay levels, bonus claw-backs, bonus**

deferral and share-based remuneration were discussed in reducing the possibility that remuneration encourages excessive risk taking. The Committee recommended that these mechanisms be central to the sector's remuneration practice.

- The Committee **recommends against self-regulation or "light touch" regulation in this respect**. It found that while some sections of the banking industry have adopted a proactive stance to reforming remuneration policy, it was concerned that genuine action lags behind and that many remain unconvinced by the need for change.
- In fact, the Treasury Committee has recently (2012) announced terms of reference for a fresh inquiry specifically on the issue of corporate governance and remuneration.[9] The outcomes boards should seek to achieve and alternatives to the current board structure of corporate governance will be discussed.

The Dutch Inquiry also identifies remuneration as an issue that should concern policy makers and the Regulator.

- The Committee recommended that the banking code is supplemented in the area of compensation policies. It suggests supplementary measures designed to limit severance pay including claw-back provisions for bonuses paid to directors, senior management *and* other functionaries, especially those in the dealing room. It also recommended (as indicated above) that the banking code either be put on a legislative footing or responsibility for institutions' compliance with it be given to regulators.
- For banks that receive government support, the committee recommended that far-reaching conditions regarding the compensation of directors be imposed. (This had recently also been proposed by the Dutch Minister for Finance.)

On remuneration practices for all corporation staff, the Icelandic PRC highlighted the weak position of financial corporation staff in cases "where their negotiating power regarding employee benefits included being forced to accept and make use of warrant

[9] For the terms of reference see http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/treasury-committee-announces-terms-of-reference-for-corporate-governance-and-remuneration-inquiry/

trading." It recommended that regulations be devised to ensure that the terms of employee wages and pension payments do not lead to increased operational risk (Iceland, PRC, Section 2.2).

3.5 "Inadequate capital" and risk analysis

From the inquiry reports it can be concluded that the proximate cause of the crises in all countries was **inadequate capital** held by the majority of financial institutions, which made them incapable of surviving the sudden drop in access to foreign capital without government intervention.

- The Norwegian Commission noted that "the single most important observation is that good capital adequacy is decisive to the stability of the banking system." It identified the capital adequacy and financial strength of financial institutions as central to understanding the banking crisis (Chapter 7).

Notwithstanding criticism of non-executive boards (Section 3.4 above) and Regulators (Section 3.7 below), the inquiries generally point out that it was not always possible for non-executive boards or regulators to fully understand the inadequacy of capital, and the risks that this created as the bad business practices (and accounting standards) of banks obscured it:

- For example, Iceland's SIC found that "weak equity" (in the form of share capital, which was the result of banks investing funds in their own shares) meant that it was no longer possible to take the capital ratio into account when evaluating the strength of a financial institution. Weak equity provides no protection against loss as is the intention of bank capitalisation. This "weak equity" represented more than 25% of the three banks' capital bases[10].
- The UK House of Commons inquiry found that "bankers complicated banking to the point where the location of risk was obscured, abandoned time-honoured principles of prudent lending, and failed to manage their funding requirements appropriately." (Report 2, p. 39).

[10] SIC Report, Chapter 2, p. 4. The Commission points out that if only the core component of the capital base is examined, the weak equity of the three banks amounted to more than 50% of the core component in 2008. Core component is described as "shareholders' equity, according to the annual accounts, intangible assets."

- The Norwegian Commission found a "qualitative deterioration" in banks' capital as a result of their use of "subordinated loan capital". It argued that such capital should not be used to cover running losses in banks and that the increased use of "subordinated loan capital" as capital made it easier for banks to increase their lending. The Commission blamed senior management in the banks but also the authorities for allowing the increased use of subordinated debt as capital in a period characterised by vigorous lending growth (Chapter 7).
- The Dutch inquiry (Part 1) found that financial institutions were permitted (by legislation) to set their capital requirements too low. This capital requirement was the basis on which financial institutions evaluated and took risks.

All inquiries recommended that capital buffers be increased.

- Lord Turner (UK Financial Regulator) suggested that the Regulator be empowered to impose higher capital buffers.
- The Dutch inquiry (Part 1) recommended that capital buffers be raised for banks with cyclical reserves.
- The Dutch report (Part 2) highlighted the importance of capital buffers that are sufficiently high so as to safeguard the stability of organisations and the financial system (Report 2, p. 24).
- The Norwegian Commission recommended that the regulator be allowed **to set requirements for capital adequacy differently for different financial institutions** in relation to each bank's activities and operations and consequential exposure to risk (Chapter 12).
- The Norwegian Commission found that the regulations in Norway for "loan-loss" provisions resulted in bank's maintaining low provisions in periods when the future looks bright. This meant that sufficient provisions are not made for losses that will occur when the economy has normalised i.e. provisions were in no way sufficient to cover losses during serious economic downturns. It compared the Norwegian regulations unfavourably to the Danish regulations on "loan-losses'", which, it argued, contributed to the stability of the Danish banking system (which did not suffer the same crisis as Norway, Sweden and Finland).

- The Bank of England's Executive Director for Financial Stability highlighted the fact that **determining the optimal level of capital for a bank was an area which has been chronically, and perhaps surprisingly under-researched and one which policy makers had "repeatedly ducked".** The Basel II capital regime was criticised by Lord Turner for ignoring what the aggregate level of capital should be. Setting the optimal level was, therefore, identified as an issue that needed much more debate amongst policy makers (UK House of Commons, Report 4, p. 32).

This leads to the inter-related issue of **how risk is assessed** both internally (by banks) and externally by external auditors, regulators and the Government and its departments. This was investigated in considerable detail by the UK House of Commons inquiry (Report 2, pp. 31-39), which highlighted risk and complexity (as well as leverage) as key themes in understanding the crisis (Report 2, pp. 31-2). Issues arising for banks were:

- Was it the methodology used by internal risk management in financial institutions to assess risk that was at fault or is it that the warnings from risk management were ignored by senior management and the non-executive board?

- How were risk analyses and stress tests performed by the banks? What systems had the Central Bank and Regulators in place to recognise risk?

- It concluded that when wholesale funding dried up, all actors realised that they did not know where the distributed risk was and then a freeze took place (p. 33).

- It found that the "originate and distribute" model of issuing loans was believed by many to reduce risk. Many in the banking sector believed that risk had declined and was being managed. One of the factors contributing to this belief was the theory that securitisation had distributed risk. Since the late 1990s, an "originate and distribute" model for issuing loans replaced the

> traditional "originate and hold" model for issuing loans. The former means that loans are issued and instead of retaining them until maturity, they are distributed (sold to investors). The theory was that this reduced risk to banks as they would hold a smaller proportion of the credit risk than in the past. However, when credit stopped flowing, an expert witness to the inquiry explained, the majority of the holdings of the securitised credit and of the losses that arose lay on the books of the banks and not the investors. *It left most of the risk on the balance sheets of banks and bank-like institutions but in a much more complex and less transparent fashion.*

This raises the issue of the methods employed by Central Banks and regulators to recognise **liquidity and solvency crises**. The report of the second Dutch inquiry (2012, 29) found that the special crisis monitoring team set up by the Dutch Central Bank in 2007 established that a liquidity crisis was occurring. However, it did not warn the Ministry of Finance that institutional solvency problems were a reason for concern. The issue of liquidity remained the focus of the Central Bank in the course of 2008 and it saw no reason, therefore, to increase capital requirements for financial institutions. The Committee concluded that it is precisely in a crisis that the distinction between liquidity and solvency becomes less relevant. The Central Bank maintained this distinction between liquidity and solvency problems for too long.

Recommendations on how to improve crisis prevention mechanisms, which appear in all of the inquiries, might be best understood in the context of this goal – how to ensure that financial institutions have adequate capital reserves to withstand such crises and that risk is not obscured by complex financial instruments. This is inextricably linked to the international regulatory framework Basel III and European Commission Directives, as is the issue of complex banks which are "too big to fail" – the subject of the next section.

3.6 Complex banks that are "Too big to fail"

Large, complex banks that are "too big to fail" pose a particular problem for the stability of the financial system. This was a finding in the UK, the Dutch and the Icelandic reports.

If a bank perceives itself as "too big to fail" there is a danger that it will take more risks in the knowledge that the bank will be bailed out if the risks taken prove to be unwise in the long-term. It was pointed out that there is an inappropriate incentive to become larger, because the bigger the bank, the more certain it can be of a Government bailout (UK House of Commons, Report 4, 18).

While it was accepted that there will always be banks that are "too big to fail", measures to reduce the incentives for bigger banks to engage in risky behaviour for private gain, on the implicit assumption that they will be covered by a government guarantee, are identified in some of the reports:

- A tax on size administered through the capital regime (UK House of Commons, Report 4, 55).
- The Dutch Inquiry (Part 1) recommended that *a bank levy which is related to risk be applied (and it argued that the global or European level is the most appropriate level for this policy).*
- That capital requirements be calculated on an expected loss basis, which takes into account not only the probability of a bank's failure but also the potential costs of such an event occurring (UK House of Commons, Report 4, 55).
- That capital requirements tackle any incentives that banks have to grow or merge merely for the sake of becoming "too big to fail". The Dutch Inquiry (Report 1) advocated *making an assessment of financial stability an important criterion for takeovers and mergers.*
- That if retail banks engage in proprietary trading activities, these activities be subjected to far higher capital requirements.
- That structures which render a bank un-supervisable should not be permitted. As such, highly complex, interconnected banks should face higher capital charges.

This raises an issue that was highlighted in the Icelandic and Dutch reports **about the separation of investment from retail or commercial banking.**

- The Dutch report (Part 1) advocated separating commercial and investment banking activities within the same institution.

- The Icelandic SIC report criticised the Regulator for authorising banks, ordinarily engaged in retail and commercial activities, to engage in investment banking activities in 2004 without increasing equity requirements and introducing other restraints to reduce risk (SIC, Chapter 2, 5).
- The UK House of Commons Report (Seventh of 2008-9. p. 91) looked at the future of banking policy and concerned itself with whether or not the co-mingling of retail and investment banking should be permitted. Expert witnesses favoured a policy that would separate risky investment banking from commercial and retail banking. However, the banks in their written responses favoured retaining the universal banking model. The Committee concludes that this issue requires further debate and, in the meantime, the best way to reassure depositors is to improve the regulatory regime for all types of banks.
- The UK House of Commons Inquiry Committee concluded that a ban on retail banking engaging in propriety trading (investment banking) might not be necessary if firms are given sufficient incentive to separate their trading units from their retail banking activities. However, it argued that such a ban should not be ruled out as an option (UK House of Commons, Report 4, 56).[11]
- An improvement in bank resolution mechanisms was proposed. The UK House of Commons Inquiry (Report 4, 56-7) points out that the complacency of "too big to fail" banks is encouraged by the fact that there is no means by which large, complex banks can be resolved. As such, each bank should "write a will", which would regularly be evaluated by the Bank of England (UK House of Commons, Report 4).
- The first Dutch report discussed the future of regulation and legislation in this respect. It concluded that the aim should be to ensure that risk taking by actors is always associated with costs and that these costs must be high enough to prevent systemic risks from reaching socially unacceptable heights. It should not, the report continues, be possible to shift these costs to society or to the financial system as a whole. It recommends that all proposed reforms should be evaluated

in this regard.

- In order to make the implicit guarantee enjoyed by bigger banks less attractive, the second Dutch Report (2012) recommends that the provision of capital injections by the State should be framed in stringent conditions for the institutions. A balance should be sought between the necessity of reinforcing the capital buffers and the ultimate price to be paid by the institution (Dutch Report, 2012, 24).

3.7 Financial regulators

While the findings of the inquiries about the role of the Financial Regulator in the crisis are quite similar to the conclusions found in the Irish reports, we summarise them briefly here and we note where they differ.

The **narrow approach taken by regulators** is criticised in the UK and Dutch inquiry reports. The Dutch reports found:

- There was an unmistakable excessive focus on evaluating and safeguarding the health of individual institutions (micro-prudential supervision) without consideration of the macro. This focus enabled the regulators to ignore or give insufficient attention to publically-voiced warnings about systemic risk (e.g. even though the Central Bank itself had published such warnings in the Netherlands).
- The second Dutch report (2012, 30) also found that the Central Bank was too narrowly focused and for too long on individual institutions and on meeting micro-prudential standards. It had "too little insight into the interwoven nature of the financial institutions and the possible problems that could arise on the scale of a systemic crisis." It concluded that the Central Bank assumed inaccurately that if the risks within individual financial institutions were manageable, the stability of the system would be sufficiently assured. As such, the Committee concluded that the requirements imposed by the supervisor were inadequate in avoiding a systemic crisis.
- The UK Report criticised the FSA for taking a too narrow approach and

focusing excessively on risks at the level of individual firms (Report 4, p. 10). Like the findings of the Irish reports, the inquiries found that **"moral suasion"** was the preferred approach of the regulators as opposed to a resort to the sanctions that were within their competence to apply. For example,

- Iceland's SIC concluded that the FME lacked firmness and assertiveness. FME did not sufficiently ensure that formal procedures were followed in cases where it had been discovered that regulated entities did not comply with the laws and regulations applicable to their operations. According to the law, the FME can demand that a remedy is made within a reasonable time and if a regulated entity does not comply within the time limit, the FME can respond through coercive instruments. There are examples where the only action taken in response to a violation of law was the submission of written comments to the relevant financial corporation.

- Iceland's PRC says "it is clear that financial operations were greatly influenced by bad business practices and a disregard for laws and regulations made apparent by the conduct of owners and directors towards supervisory and administrative authorities." What enabled this disregard to occur?

- SIC's report (Chapter 2, 17) explains that "when the size of the financial system of a country is, for instance, threefold its gross domestic product, the competent authorities of the country have, in general, the potential to set rules for the financial system to comply with and to ensure compliance with such rules. When the size of the financial system of a country is nine times its gross domestic product, the roles are reversed. This was the case in Iceland."

- Like the Irish reports, the UK House of Commons report found that the regulatory philosophy was "light touch" – based on a non-intervention/free market.

- Explaining this light touch and a reliance on "moral suasion", one expert witness (William Buiter, LSE) to the UK Committee talked about the difficulty for

regulators who supervise in a way that "leans against the wind" in an economic boom. He concluded that there was "**universal capture of the regulators and the political process by the financial sector.**"

- The UK inquiry proceeded to examine how the Regulator, and the regulations in place, might prevent this "universal capture" from happening again in the future. One proposal to enable regulators to impose their judgement on financial institutions during economic booms would be to empower regulators with **rules-based counter-cyclical supervisory tools**.

- The current Chairperson of the Financial Regulator in the UK, Lord Turner, suggested a three-pronged solution to the failure of the Regulator to avert the financial crisis: improve market transparency by requiring the Regulator to provide information about financial institutions that it supervises; require regulatory authorities to make judgements at the macro as well as the micro levels. The third defence he suggested is that the Regulator be empowered to impose higher capital buffers.

In Iceland and Norway, the inquiry reports highlight **organisational or resource issues** which affected the Regulator's performance.

- Iceland's SIC found that the FME's tasks demanded vast expert knowledge on the operations of banks, economics, accounting and legislation on financial markets. The FME's budget up to 2006 makes it clear that it could not keep pace with the rapid growth of the financial system, the more complicated ownership links within the financial market, and the increased activity of regulated entities abroad.

- Iceland's SIC also found that FME prioritised the wrong things. It needed an advanced IT system to conduct proper monitoring of complex financial instruments but this was not prioritised. It lacked the technical expertise and equipment to produce surveys of the position and development of financial

institutions from its own database. This meant that the Authority did not have the overview of the activities of the financial institutions that it needed.

- The Norwegian report found that organisational issues connected to the establishment of the Regulator (Norway Banking, Insurance & Securities Commission) weakened its performance during the late 1980s and early 1990s.

In spite of this weakness in approach and in resources, the reports conclude that the regulators should have understood at least some of the risks from the information that they did have:

- Iceland's FME was found not to have concerned itself with some basic questions such as the size of the banking system. It found that the Authority should have reacted to the banking system's much too rapid growth. The FME had, it points out, the power to require increased equity of financial institutions but it did not exercise it.
- The UK House of Commons inquiry committee criticised the FSA for being "extremely slow off the mark in recognising the risk that inappropriate remuneration practices within the banking sector could pose to financial stability" (Report 3, 19). The current head of the FSA (Lord Turner), while acknowledging the failures of the Regulator, said that in 2005-6 the issue of remuneration was not believed to be the responsibility of the FSA: "if we had suggested it was we would have been met with a wildfire of criticism from the industry and… from politicians as well." (UK House of Commons, Report 3, 18)
- The Dutch report (Oart 1) also criticised the Regulator for missing the basic issue about pay and bonus structures and the incentives they created for risk taking.

The Dutch report (Part 1, Recommendation 26) found that fear of damage claims may have prevented the supervisory authorities from pursuing optimal policy decisions. It therefore recommends restricting **the liability of financial supervisory authorities**.

The Dutch inquiry (Part 2, 2012, 38) identified the concept of supervisory confidentiality as in need of reform. Supervisory confidentiality can be invoked (according to Dutch law) by the Regulator if information held by the Regulator might affect the competitive position of a financial institution. The information must be then kept confidential. The Committee recommended that criteria be set to test whether or not supervisory confidentiality is justified when invoked. It also recommends that it should be possible to discontinue supervisory confidentiality when the information would no longer damage the competitive position of a financial institution.

The Icelandic and Dutch reports recommend **that insurance companies and pension funds** be subject to similar supervision and/or self-supervision via codes of practice as banks are.

Specifically, the Icelandic PRC recommends that an evaluation be made as to how insurance companies, pension funds and securities trading should be supervised based on the interest of the public. The Dutch inquiry Report (Part 1) similarly recommends that insurance companies, pension funds and investment corporations establish their own codes, which would be based on the banking code. It also proposed that its recommendations regarding bonuses and pay, risk management and supervisory boards be applicable to all financial institutions and not only banks (Recommendation 8).

3.8 The international context

Issues concerning international and EU-levels of governance identified in the reports fall into five categories.

Firstly, the future of the global trade and monetary system, and how it is regulated, is identified as critical to the pursuit of financial stability. The UK House of Commons Committee dedicated several hearings and its fifth report to the issue of "global imbalances" in the international monetary system. **Global imbalances** are the persistent current account deficits in the developed world and persistent surpluses in countries such as China and Russia and have been identified as a source of instability in the international financial system. It called on the Treasury to provide it with a range of options about the future of the policy on the global monetary system.

Secondly, **specific regulations (or lack of regulations in some cases) at a global or European level** are identified as creating incentives to engage in risky behaviour and allowing complex financial transactions that obscure risk. Most reports consider that the incentives to risky behaviour outlined in points 5 and 6 above – capital adequacy in banks, risk management practices and the issue around banks which are seen as "too big to fail" –require solutions at the global and European levels in addition to, or instead of, at the national level (see Sections 3.5 and 3.6 below). Among solutions identified are: that all states raise minimum capital levels along the lines of the Basel III recommendations (Dutch Report, Part 1, Recommendation 11, Part 2, Recommendation 3); that new agreements on burden sharing when intervening to save banks that are "too big to fail" be agreed between states; that a European Deposit Guarantee Scheme that is based on banks depositing risk-related premiums (Report 1, Recommendation 15) replace the existing deposit guarantee scheme into which banks pay the same regardless of the riskiness of their banking practices.

Thirdly, and related to the above, the Dutch reports were critical of the inadequacies of the existing **"cross-border transnational supervisory system"**, which is based on trust between national supervisors within the European Economic Area (EEA) and voluntary agreements outside of the EEA. It found this system to be inadequate in dealing with financial institutions that operate across national borders or where the main supervision of an institution of systematic relevance to one country takes place outside the country in question (Part 1, Recommendation 10, Part 2, Recommendation 6). Both the Dutch and the Icelandic reports (PRC, 2010, 13) found that when problems emerge at financial institutions that cross borders, national interests undermine the trust-based system. The Dutch Committee suggested that cross-border supervision be based on transparency, rather than trust, between national supervisors (Part 2, Recommendation 2), and that it should include agreements on burden-sharing in the event of interventions to guarantee deposits. As a further solution, it called for a single powerful European Supervisor, along with an appropriate mechanism for burden sharing (Dutch Report 2, 2012, 34).

The issue of **burden sharing**, and the extent to which guarantees issued by one state cover deposits in foreign branches of their financial institutions, was also raised in the

Icelandic report from a different perspective. The SIC criticised the uncertainty within the Icelandic administration on the obligations of EEA members states in the event that a guarantee scheme was established (under the deposit guarantee directive of the EU) and a state could not make its payments (SIC, 2010, 12). When foreign governments queried whether the Icelandic State would guarantee the Icelandic Guarantee Fund's ability to pay, the administration had not cleared up these uncertainties. This also raised questions about the adequacy of the EU Directive and the manner in which states implement it (see below).

This leads to a fourth international issue: the broader European architecture **to crisis management provided by the European Commission** is addressed in the reports, in particular the Dutch and the UK reports. As mentioned above, the absence of international and European burden sharing agreements and assurances in the event of intervention to save banks is highlighted as creating instability. Also raised was the compatibility of the dual role of the European Commission as supervisor of competition and prudential matters. Further, the Dutch report highlighted the importance of the objectives of the European Antonveneta Directive, which aims to ensure that financial stability, and not political whims, determine the assessment of acquisitions, mergers or takeovers.

Finally, how national authorities – Government Ministers, senior officials and governors of central banks – engage and represent their interests in the quest to secure financial stability at the international level is investigated in the inquiry reports. The Icelandic SIC inquiry, in particular, examined the interaction between authorities, primarily the Central Bank, at the bilateral and the international levels throughout the crisis management period and was critical of the Icelandic authorities. The Dutch reports highlighted the importance of influencing the development of international and European regulations and called on the Dutch authorities to clearly articulate to parliament the implications of these regulations and agreements for financial stability in the Netherlands.

Sources

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Part 1: Report of the Parliamentary Committee Inquiry Financial System (TCOFS). TweedeKamer House of Representatives, Netherlands Parliament (2010), *Credit Lost* (Summary in English).

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1. **Special Investigative Committee**, (April 2010) *Report to the Althingi*
   The parts of the report published in English are available here and include the executive summary: http://sic.althingi.is/

2. **Parliamentary Review Commission**, Report of the Parliamentary Committee on the Report of the SIC, September 2010. Chapter 2, Main Findings
   (Translated from Icelandic for the Committee of Public Accounts).

Norwegian Parliamentary Inquiry

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Appendix 3a

Overview – Parliamentary inquiries into banking and financial crises

	UK	Iceland	Netherlands	Norway	Finland	Sweden
How was the Inquiry Committee appointed?	House of Commons Treasury Committee made a decision to hold the inquiry	Parliament elected an ad hoc committee to examine the report of the Special Investigate Commission (SIC) (approved by an Act of Parliament in 2008 to examine the process leading up to collapse of the banks).	Finance Committee proposed to the Presidium of the House and the House approved the Presidium's proposal to set up a Temporary Committee which included 8 members of parliament (including all parties). The Committee elected its own chair (de Wit).	Standing Committee on Finance delivered a report to parliament and the Committee was appointed in response to this report. Appointed by parliament and included 5 members (experts, not MPs).	Commerce Committee undertook inquiry. It inquired into 2 statements/reports by Government to parliament (one in 1996, one in 1999). Two inquiries	By parliament on foot of a government initiative. Commission was led by the Speaker of the House.
Terms of Reference	Wide ranging.	To prepare Parliament's	Investigate causes of the crisis of the	a. Reasons for and circumstances	Inquire into a government	The budgetary process was

	UK	Iceland	Netherlands	Norway	Finland	Sweden
	a. Sources of financial instability (i.e. what and who caused the instability including rating agencies, auditors, different financial instruments, banking system etc.) b. Government response c. Banks and role in society d. Shareholders' rights	response to SIC report namely a. Opinion on reasons for the crisis b. Follow up on SIC's recommendations on constitutional, legislative change and parliamentary reform c. Assess responsibility of Cabinet ministers (i.e. are there grounds for impeachment on the basis of violating ministerial accountability?) Parliament would then vote on this and can, by a	financial system (Part 1) Document implementation of government measures (since 28 September 2008) during the crisis focusing on the use of government funds (Part 2).	leading to the financial crisis b. Evaluate decisions of public authorities, banks and bank guarantee funds before and during the crisis c. Compare with handing of crises internationally d. Recommend on ways to avoid such a crisis in the future.	statement to Parliament and a government report to parliament concerning: The assistance package for the banks Government's plan to overhaul the financial system and, generally, how the Government addressed the crisis.	considered by the Government of the time to have played a significant role in creating the crisis in public finances that accompanied the banking crisis. Inquiry Committee was to make recommendations on how to make the budgetary work of parliament faster, more effective and easier to understand and to consider a finding that placed Sweden second last in a study of budgetary institutions in 13 countries (all other 12 were EEC countries at the time).

	UK	Iceland	Netherlands	Norway	Finland	Sweden
		majority, refer ministers to a special court.				
	a. Sources of financial instability (i.e. what and who caused the instability including rating agencies, auditors, different financial instruments, banking system etc.)	a. Opinion on reasons for the crisis	Document implementation of government measures (since 28 September 2008) during the crisis focusing on the use of government funds (Part 2).	b. Evaluate decisions of public authorities, banks and bank guarantee funds before and during the crisis	The assistance package for the banks	
	b. Government response	b. Follow up on SIC's recommendations on constitutional, legislative change and parliamentary reform		c. Compare with handing of crises internationally	Government's plan to overhaul the financial system and, generally, how the Government addressed the crisis.	
	c. Banks and role in society	c. Assess responsibility of Cabinet ministers		d. Recommend on ways to avoid such a crisis in the		

	UK	Iceland	Netherlands	Norway	Finland	Sweden
		(i.e. are there grounds for impeachment on the basis of violating ministerial accountability?) Parliament would then vote on this and can, by a majority, refer ministers to a special court.		future.		
	d. Shareholders' rights					

Mechanisms of the Inquiries						
	UK	**Iceland**	**Netherlands**	**Norway**	**Finland**	**Sweden**
Power to access documentation	Yes	No	Part 1 – not to all documents Part 2 - Yes	Yes (with some restrictions and after legislative change exempted individuals from "professional confidentiality".	Yes (from government sources. This is a right guaranteed in the Constitution).	Yes from government and government institutions.
Power to demand attendance of witnesses	Yes	No. Consultative meetings only	Part 1- No Part 2 – Yes	Yes But power was not used (only one former bank official refused to attend).	No	No
Were there oral hearings? **Public or Private?**	Yes Public	Yes (consultative meetings) Private	Yes All witnesses are heard in private and then in public (answering the same questions each time)	Yes Private	Yes Private	Yes Private

Nature of oral hearings	UK	Iceland	Netherlands	Norway	Finland	Sweden
How many?	17 oral hearings with many witnesses at each.	63 meetings	**Part 1** 40 public hearings with 39 witnesses **Part 2** Over 40 public hearings with 53 witnesses	Don't know	Don't know	Don't know
Over what time period?	4.5 months 3 November 2008-19 March 2009	9 months 15 January – 25 September 2010. Report published September 2010.	18 Jan – 4 Feb 2010 Committee report published in June 2010 Part 2 - 7 Nov – 9 Dec 2011 and on 25 and 27 January 2012. Final report due in March 2012.	The inquiry took place over a year and hearings and other evidence gathering gook place within this time period. Final report was June 1998.	4.5 months (1999 inquiry)	3 years February 1991-March 1994 Main report published in June 1993 with recommendations on the budgetary process
Who were the witnesses?	Ministers	Specialists/experts;	Senior government and banking	Public officials	Officials from the Ministry of	The Commission had deliberations

	Central Bank Financial Regulators Chairmen of nationalised banks Auditors, rating agencies Experts Investment bankers associations Former bank executives (full list in full document). Received 172 written submissions many from private banks.	Members of SIC Members of Governmental Committee on Ministries' responses to SIC report; Ministerial senior officials, lawyers and a former banker who had been very critical of the banks publically in the 3-4 years running up to the crisis Received Written evidence from 16 of 19 former Ministers	officials, regulators, private bankers. Included the Former PM and his Finance Minister.	Heads or Board Members of Banks MPs	Finance, Ministry of Justice, Bank of Finland, Financial Supervisory Authority and National Institute for Health and Welfare. There were also experts from Property Administration Company Arsenal, Guarantee Foundation, The Federation of Finnish Enterprises and Federation of Finnish Financial Services. Altogether the Commerce Committee heard 10 experts.	with the State Secretary and the Budget Director of the Ministry of Finance. Moreover, a group of experts from the Commission had deliberations with top level civil servants of the Riksrevisionsverket (the former National Audit Office) and also with the heads of secretariats of the committees.

Appendix 4: Additional information on bank funding

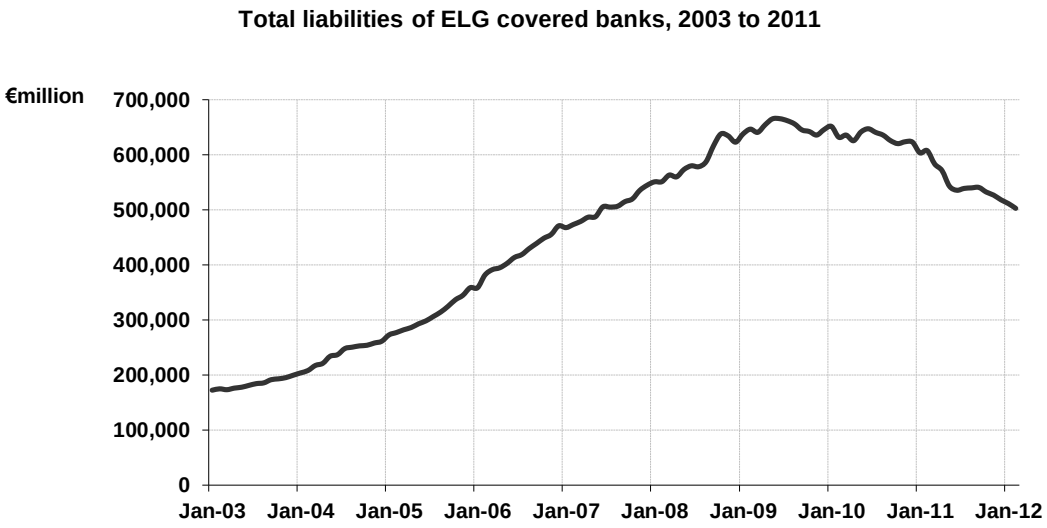
Trends in liabilities of the covered banks

The following analysis is based on time series data on the aggregate balance sheets of the banks covered under the Eligible Liabilities Guarantee (ELG) scheme. The data used is published on the Central Bank website, and is updated monthly. Data currently available includes all months from end January 2003 to end February 2012.

Total liabilities of the covered banks

As indicated in Figure 1, total liabilities of the covered banks increased from just under €173 billion at the start of 2003 to a peak of €666 billion in June 2009. Thereafter, it declined gradually to a level of €503 billion at end February 2012.

Figure 1



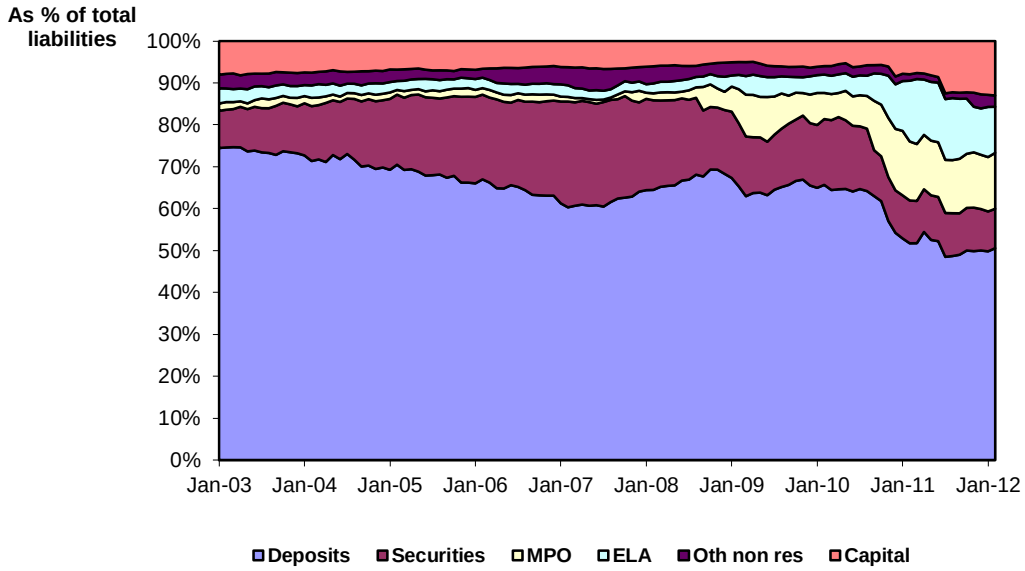
There appears to be an inflexion point at the start of 2004. Growth based on the 2003 trend would have resulted in a much slower accumulation of liabilities.

The growth in liabilities included a significant shift in the nature of the liabilities, as indicated in Figure 2. Over the full period examined, deposits decreased from around three quarters of all liabilities to around half. The relative decline in reliance on deposits was associated with an increase in reliance on securities issued by the covered institutions, which peaked at around 25% of all liabilities around the end of 2006. There was a resurgence in the contribution of deposits up to autumn 2008 (examined further below). Thereafter, the covered institutions increased their reliance on borrowing from the Eurosystem and from the Central Bank, under its Exceptional Liquidity

Assistance (ELA) facility.

There was a gradual decline in the relative level of capital and reserves held, from 8% of total liabilities in January 2003 to under 6% by end August 2008. Thereafter, the percentage fell to as low as 5% in April 2009, before being progressively restored by a series of State capital investments. At February 2012, it stood at 13%.

Figure 2

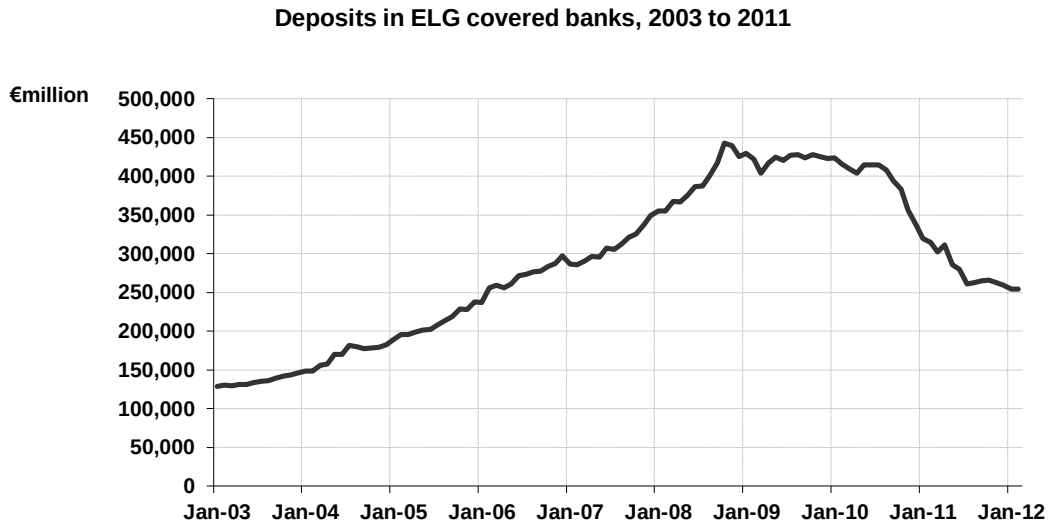


Bank deposits

While deposits declined as a proportion of overall liabilities between 2003 and 2008, there was a very substantial increase in the cash amount of deposits. These increased from under €150 billion in 2003 to almost €450 billion by late 2008. They have since fallen back to around €250 billion.

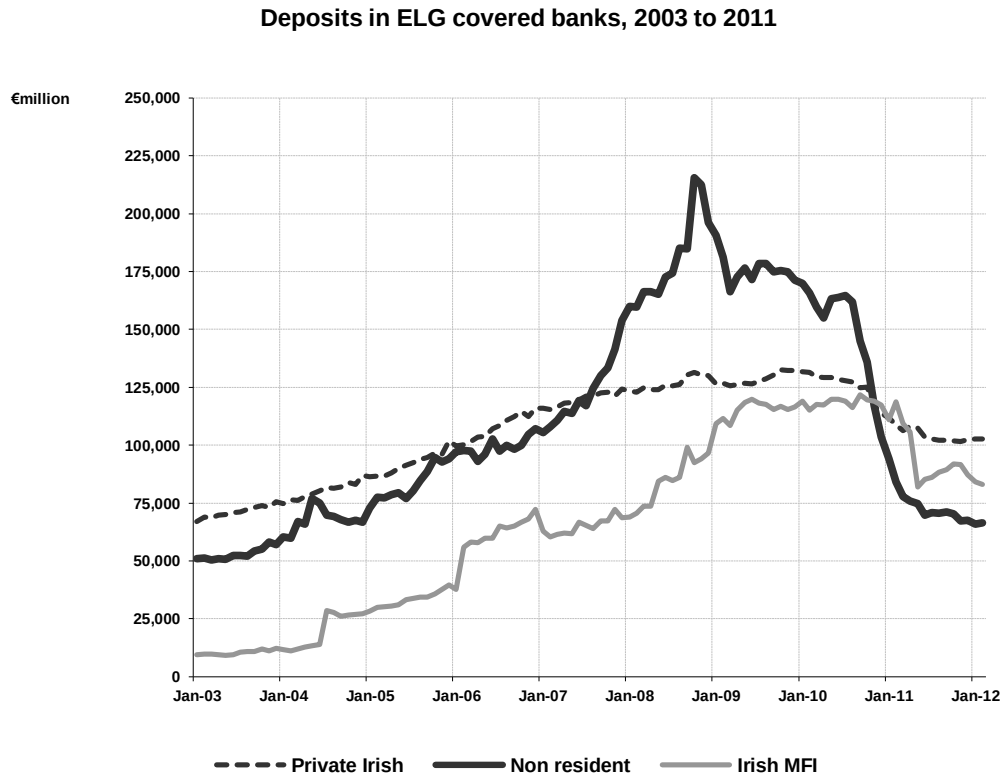
Deposit levels were relatively stable for about 20 months after the issuing of the bank guarantee, but began to decline very steeply after May 2010, following the first Greek bailout deal.

Figure 3



As Figure 4 shows, the movements in deposits differed significantly by source. There was a gradual increase in deposits of private Irish residents – households and businesses. Over the period from January 2003 to December 2009, these increased from around €67 billion to around €132 billion. Since then, the total deposits from this source have dropped by around €30 billion.

Figure 4



Deposits in the covered banks by non-Irish residents and by Irish monetary financial institutions

(MFIs) have been more volatile.

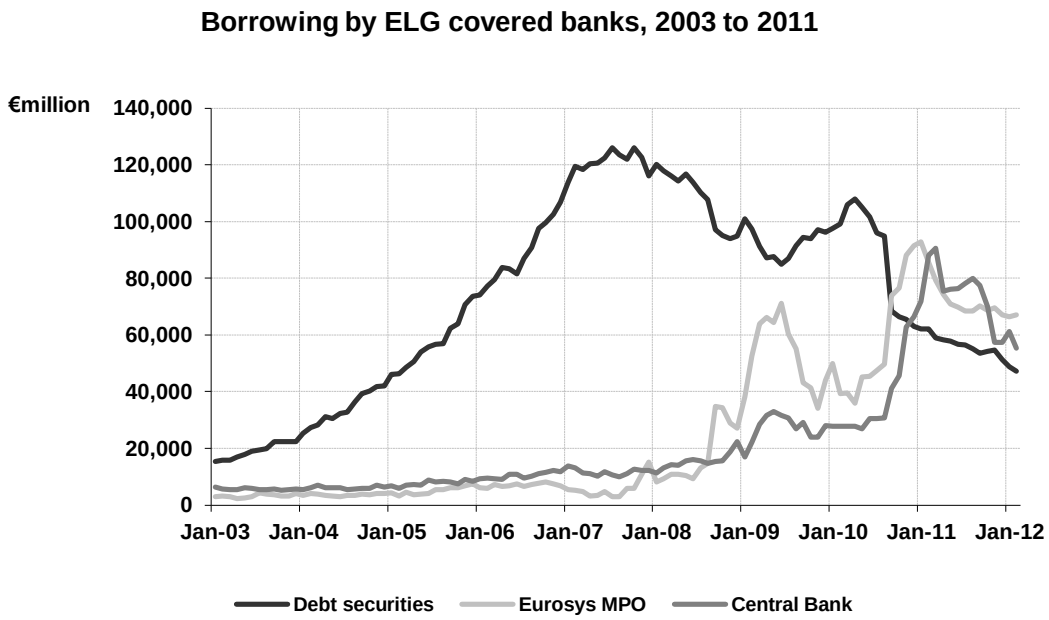
From a base of around €50 billion in the first half of 2003, non-resident deposits began to increase rapidly, reaching a peak of some €185 billion by August/September 2008. They peaked at €216 billion in October 2008, following the issuing of the banking guarantee. By June 2010, they had declined to around €165 billion, and fell by almost €100 billion more in the period to end February 2012.

Deposits by Irish MFIs moved broadly in line with movements in non-resident deposits up to about the middle of 2007. The graph shows clear changes at certain stages over this period (e.g. mid-2004, early 2006 and early 2007). Overall, such deposits moved from around €11 billion in early 2003 to stabilise at around €115 billion – €120 billion from mid 2009 to September 2010. Thereafter, they declined to around €83 billion by February 2012.

Bank borrowing

Figure 5 indicates the movement in the levels of borrowing undertaken by the covered banks. The level of debt securities issued increased rapidly from the start of 2003 right through to the end of 2007.

Figure 5



After strong growth in the period 2004 to 2006, debt security borrowing by the banks abruptly levelled off early in 2007. The step change in early 2007 effectively marks the commencement of the international financial crisis. Market borrowing started to fall in the autumn of 2007, dropping from €126 billion in October 2007 to €97 billion by end September 2008 (a drop of almost €30 billion, or 23%). At the end of February 2012, market borrowing stood at around €47 billion.

Recourse to Eurosystem Monetary Policy Operations (MPO) and the Irish Central Bank (mainly in the form of Exceptional Liquidity Assistance (ELA)) increased from around a 3-4% of total liabilities in 2006 to around 4-5% in 2007. There was a spike in recourse to MPO in late 2007, as international liquidity tightened, and again in late September 2008, following the Lehmans collapse. MPO borrowing increased to a peak of €71 billion by June 2009, and after falling back to a level of €40 billion for a period, increased to a new peak of €93 billion in January 2011. Central Bank lending increased similarly, but lagged, peaking at €91 billion in March 2011.