SEARCHING FOR RECKLESS LENDING AND LIABILITY AMIDST THE WRECKAGE OF IRISH BANKING GOVERNANCE

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August 2010

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INTRODUCTION AND OVERVIEW

If the domestic economic collapse was examined in terms of a catastrophic plane crash it would be easy to find the numerous and mutilated bodies of the reckless borrowers and lenders. The causes too become clear with the passage of time. An unlikely coincidence of pilot error, global climatic conditions and sleeping air traffic controllers is suspected but the black box of liability remains elusive. Nobody wants to take the blame and a bomb would be so much easier to explain.

The aims of this paper are threefold: -

(i) To trawl through the legal and governance wreckage of the Irish financial system and the related economic collapse as it impacts on Ireland in the context of the global recession;

(ii) To argue for reckless lending liability from a policy point of view and to challenge the perceived wisdom that once monies were actually received by a borrower that that is effectively the end of the matter as far as the Courts are concerned;

(iii) To examine how liability has been imposed in other jurisdictions and examine liability and significant defence opportunities and reform proposals in Ireland.

CHAPTER 1

BOOMTIME BANKING GOVERNANCE IN IRELAND

Introduction

The scope of this segment is to consider how frailties in corporate governance in Irish banks contributed significantly to the recent economic turbulence, and to examine how certain individual weaknesses in this system played a key role in the near collapse of the Irish banking system. Consideration is given to the use of private law remedies as a supporting agent in the reformed regulatory environment. It is proposed to analyse the area under the following headings: -

(i) The boom and Irish bank boards;

(ii) The failure of regulation;

(iii) Lending practices;

(iv) Institutional amnesia;

(v) Towards credibility.

THE BOOM AND IRISH BANK BOARDS

Boardroom attitudes to the rules

The key role of the board in any corporate governance system is so well established that one might be forgiven for thinking that it would hardly need mention at all, however, given the scale of the economic storm, the role of bank boards as a causative factor must be considered. The disregard of Anglo Irish Bank for the Combined Code of 2003 (later

updated to the Combined Code, 2006)[1] was notable in that the Code had set its face against the chief executive becoming chairman, and contemplated this only in exceptional circumstances and where major shareholders would have to be consulted.[2]

Indeed, this matter had already been canvassed directly in the Higgs Review, which report dated January 2003 included a recommendation that a chief executive should not also become chairman of the same company.[3] The willingness to discard ruthlessly the combined code when it suited has been the subject of predictable comment.[4]

The lack of consequences for Mr. Fitzpatrick, arising out of this decision, from his own institution, its shareholders or from regulators was an unfortunate signal to others. The ease with which Mr. Fitzpatrick made the transition and overcame any objection from the Irish Association of Investment Managers is noteworthy. The machinations concerning the succession to the post of chief executive, and the eventual success of a 38-year-old relatively inexperienced candidate, despite the presence of safer and more senior personnel in the field, ought to have been a warning sign. The new chief executive went on to report massively increased profits, which soared by forty-one per cent in his first year and forty-five per cent in his second year, based on what is now

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[1] Available at http://www.frc.org.uk/corporate/combinedcode.cfm.

[2] *Ibid.* at A.2.2.

[3] Available at http://www.berr.gov.uk/files/file23012.pdf. See also Mallin, Christine A., *Corporate Governance* (Oxford, 2nd ed., 2007) at 26.

[4] See Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 56.

known to have been mainly based on careless lending on property speculation.[5] This suggested an underlying profit increase of forty-seven percent before tax for the six months ended 31st March 2007.

Quite apart from the careless lending by this institution, the close and inappropriate manner in which the board operated was also revealed in the revelations concerning the unwinding of the ill fated Quinn shareholding. The intertwined fates of Quinn and Anglo have since been revealed as mutually destructive.[6]

Of course the utopian picture carefully presented, particularly during the Fitzpatrick's presidency of the Irish Banking Federation, was by no means unique. Enron had a model board laden with outsiders with only two insiders and had an audit committee composed entirely of outside directors chaired by a Professor Emeritus in Accounting of Stanford University.[7] The whole board structure at Enron seemed to be a shining example of good corporate governance and, as stated by Eriksson: -[8]

"However, even though Enron's board structure appeared to be at the height of good corporate

[5] Available at http://www.angloirishbank-interim-results.com/financialhighlights.asp. See also Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 59.

[6] See Clerkin, David, 'Money and Markets', *The Sunday Business Post*, (6 December 2009) available at http://www.thepost.ie who described the efforts made by Anglo to circumvent the Company's legislation in relation to financial assistance for the purchase of its own shares in order to assist unwinding the Quinn family shareholding in Anglo which had gone badly wrong. It appears the Bank supported this to the extent of €450m. This eventually led to the High Court appointing Inspectors to the Quinn group in March, 2010, *Irish Times*, 30th March 2010 available at www.irishtimes.com/newspaper/breaking/2010/.../breaking32.html.

[7] See Eriksson, Karolina, 'Corporate Governance in the European Union Post-Enron', *Bond Law Review* (2003, Vol. 15, Issue 1, Article 9).

[8] *Ibid.* at 187. See also Gillan, Stuart L. and Martin, John D., 'Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?', *Journal of Corporate Finance* at 6 available at http://www.ssrn.com/abstract=977585.

governance practice, it was partly illusionary. The report of the Investigation Committee concludes that the independence of almost every board member was undermined by various side payments or by bonds of long service and familiarity. If the Investigation Committee is accurate, it demonstrates that a monitoring board has to be independent in function, and not only in form, if it is going to be effective in its monitoring role."

Clearly, similar familiarity problems existed in the Anglo and other bank boards in this jurisdiction, which hindered any objective monitoring role. The warning signs from Enron and other scandals including excessive director remuneration, undue focus on short-term stock prices, and special purpose vehicle transactions as well as director loans, were features which were all repeated again in Anglo.[9] It is now well established that questionable accounting practices were systemic in Anglo, as well as arrangements for investors who were lent money to buy shares in the bank to unwind the Quinn stake, which loans, it now appears, were lent on a non-recourse basis.[10] It is clear from the Anglo example that the board, as constituted in that case, saw nothing wrong with hiding loans of close to a hundred million euros to chief executive and later chairman, Sean Fitzpatrick with another institution, Irish Nationwide, prior to the end of the financial year. There was also the arrangement whereby €4 billion in deposits were transferred from Irish Life and Permanent to Anglo Irish Bank using funds that originated in Anglo Irish Bank.[11] Indeed, the involvement of another financial institution in such an arrangement, especially one with the standing and reputation of Permanent TSB leads

[9] See Gillan, Stuart L. and Martin, John D., 'Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?', *Journal of Corporate Finance* at 10 and 11 available at http://www.ssrn.com/abstract=977585.

[10] See Clerkin, David, 'Reviewing the 'Enormous Contribution' of Sean Fitzpatrick - Anglo Probes Continue to Widen', *The Sunday Business Post* (13 December 2009) available at http://archives.tcm.ie/businesspost/2009/12/13/story46159.asp.

[11] *Ibid.*

one to look way beyond Anglo in the examination of problems within boards of directors at the Irish banks. It has recently emerged that the operation of the board in the Irish Nationwide Building Society also bordered on a sham. We now know that essential committees such as the credit committee, who ought to have a key role in a bank's system of internal controls and approval of credit, appear in some cases to have been little more than window dressing.[12] In Colorado, a lawsuit has been launched against board members of a bank by investors for $13 million in losses.[13] Some of the allegations include the moving of deposits on loans to avoid regulators and set up 'straw borrowers'. Although a small bank compared to Anglo striking resemblances exist.

The picture now emerging of credit committees only existing to satisfy the regulator and senior staff not having met the credit committee for seven years, indicates the fundamental breakdown in the system that had become the 'norm'.[14] The practice of lending vast sums without either credit committee or board approval, together with an over reliance on the managing director, and weak internal audit expertise against a background of weak and ineffective regulation has no doubt led to this particular institution being in the position where the huge sum of €8.3 billion of its loans now have

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[12] See Prime Time Investigates documentary 'The Bankers' available at http://www.rte.ie/news/2009/1221/primetimeinvestigates_avhtml. The contribution of the former Home Loan Supervisor/Personal Assistant to the Chief Executive confirmed that fast tracked loans were common with the money paid out fast, sometimes before even application forms had been filled out with no income verification, no Bank details and no involvement of the Credit Committee.

[13] See Dunn, Sharon, 'Investors Sue New Frontier Bank Board Member Officers', *Greeley Tribune* (16 January 2010) available at http://www.greeleytribune.com/article/20100116/news/100119782 - updated report dated 5 April 2010.

[14] *Ibid.* See also 'Bank of America Governance Guidelines Outlining the Necessity of the Role of the Credit Committee' available at http://www.investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-govguidelines.

to be transferred to the National Asset Management Agency.[15] The eight basic corporate governance principles for banks set out in the Basel Committee Report, 2006 appear to have been ignored by institutions like Irish Nationwide Building Society and Anglo Irish Bank.[16] The principles most ignored were the capital adequacy requirement, risk management process and credit risk, (particularly bypass of the credit committees). Recent reports suggest that AIB and Bank of Ireland put together need to raise an extra €5.1 billion in core capital under new rules put forward by the Basel Committee on banking supervision for 2010. Changes involve deducting pensions and deferring tax assets, which would mean that both banks would have to put in much more capital and sell foreign assets.[17]

Bank Responsibility

While it is all very well to blame the regulator and corporate governance systems, nevertheless, ultimate responsibility must rest with the board of a financial institution. If it chooses to recklessly lend in a redistributive manner the result is that future incomes of borrowers are transferred to the present, in order to support mortgage approval, the board must take the blame when the house comes crashing down amidst such folly.

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[15] See Prime Time Investigates documentary 'The Bankers' available at http://www.rte.ie/news/2009/1221/primetimeinvestigates_avhtml. See also in same documentary details of soft loans to politicians exposed where no proper internal Banking procedures were gone through and where it appears the institution was effectively run as if Mr. Fingleton owned it. See also 'Enhancing Corporate Governance for Banking Organisations', Basel Committee on Banking Supervision (2006) available at http://www.bis.org/publ/bcbs129.pdf.

[16] Directive 2006/48/EC of the European Parliament and of the Council (14 June 2006). The Directive has since come into force in Ireland by virtue of Statutory Instrument No. 661 of 2006 with the vast majority of the Directive coming into force on the 1st January 2007 - OJ L 177, 30.6.2006 at 1–200. See Lambe, Geraldine, 'Will It Be Third Time Lucky For Basel?', *The Banker*, 2010, Apr, 124.

[17] See 'Strengthening the Resilience of the Banking Sector' – Consultative Document, Bank of International Settlements available at http://www.bis.org/publ/bcbs164.htm. See also Sunday Tribune (20 December, 2009) available at www.tribune.ie/.../boi-and-aib-face-pressure-to-find-51bn-in-capital/

As Kinsella puts it: - [18]

> "A system which ignores risky investments based on even riskier tranches of unsecured debt, which still manages to play by the rules as set down by the governing authorities of the day, is a system with too little financial governance."

There were straws in the wind at the top of the market in 2006 that the banks at board level were aware of impending problems, which was demonstrated among other ways by the large scale offloading of bank property assets.[19] This disturbingly suggests that although aware, to some extent, at board level, of the problem that was emerging, nevertheless, reckless lending continued with the two major banks in particular following Anglo's disastrous lead.[20] While not underestimating the multiplicity of international factors, which contributed to the boom, especially from 2003 onwards including the historic low interest rates and influx of Chinese money into US treasury bonds, nevertheless, it is undoubtedly the case that had the bank boards operated as they ought to have had, the scale of the problem now faced would be much more moderate.[21]

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[18] See Kinsella, Stephen, 'Financial Fragility and Corporate Governance in Ireland', *Corporate Governance and Regulation* (Round Hall, 2009) at 154.

[19] See Callanan, Neil, 'AIB Bank Centre to Fetch Over €320 million', *The Sunday Business Post* (6 March 2005) available at http://www.archives.tcm.ie/businesspost/2005/03/06/story2911.isp. See also Carey, Brian, 'Quinlan Forks Out €200 million for Bank of Ireland's HQ', *The Sunday Times* (18 June 2006) available at http://www.business.timesonline.co.uk/tol/business/article675865.ece. It is to be noted also that the Bank not alone sold headquarters but also sold many branches with lease back arrangements.

[20] See contribution of Des Peelo on the 'Bigger Fool Theory' describing the bizarre behaviour of Bank of Ireland and Allied Irish Bank in following Anglo Irish Bank available at http://www.rte.ie/radio1/podcast/podcast_patkenny.xml. For a recent analysis from an accountancy standpoint of the behaviour of the Irish banks, see McCormick, Tim, ' Responding To The Irish Banking Disgrace: First Steps Towards Restoring Confidence', *Accountancy Irl*. (2010, 42(3)) at 30-32.

[21] *Ibid.* at 165. See also discussion of the role played by securitization of mortgages, which enabled Banks to provide home loans and create unsecured debt instruments.

Non-Executive Directors as a feature of principles based regulation

It has been said that non-executive directors are the mainstay of good governance.[22] The dual role of being a counter-weight to executive directors, thereby preventing undue influence of an individual person or group on the board, and secondly making a contribution to the overall leadership and development of a company is well established. While the Combined Code[23] and, indeed, the earlier Cadbury Report[24] all emphasise the importance of non-executive directors in setting and maintaining some proper standards of corporate governance, nonetheless, time and again examples have emerged of how companies with seemingly sufficient adherence to the non-executive director formula, have yet fallen victim to lax corporate governance in reality.[25]

Therefore, it seems that some analysis is called for of the real position of non-executive directors at the Irish banks. It is also noteworthy that tensions appeared to have surfaced in some boardrooms between ordinary member directors and more senior board members including agitation by some in relation to corporate governance issues.[26]

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[22] See Mallin, Christine A., *Corporate Governance* (Oxford, 2nd ed., 2007) at 132.

[23] Available at http//www.frc.org.uk/corporate/combinedcode.cfm.

[24] 'Cadbury Report (The Financial Aspects of Corporate Governance)', (1 December 1992) available at http://www.frc.org.uk.

[25] See Eriksson, Karolina, 'Corporate Governance in the European Union Post-Enron', *Bond Law Review* (2003, Vol. 15, Issue 1, Article 9). See Gillan, Stuart L. and Martin, John D., 'Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?', *Journal of Corporate Finance* available at http://www.ssrn.com/abstract=977585. In the Enron situation, there were twelve outside directors and only two insiders and the number of outsiders were said to be higher than the average US Board.

[26] See Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 95 and 96. It is claimed that Ron Bolger, a member of the remuneration committee of the Society, was constantly agitated about corporate governance issues and demanded a corporate governance audit of the Educational Building Society with the board apparently in crisis. The author also describes the struggle of an ordinary member director, Ethna Tinney to have her voice heard at board level, which the author contended was a campaign to get rid of her.

It is unclear as to whether or not the lack of action in corporate governance issues, such as the independent member director issue, led to the Society making serious mistakes going deep into commercial property at the peak of the market.[27] However, it seems to be safe to say that not enough independent voices were being heard at board level, and the particular institution, in an effort to emulate some of its more aggressive and reckless rivals, was endangering itself.

Resistance to regulatory change

Honohan has illustrated the manner in which the industry exerted pressure to avoid change in the area of Directors' Compliance Statements before the crash.[28] Even afterwards Allied Irish Bank were slow in making the required changes to their board to introduce outsiders and did so, seemingly under some political pressure with the positions of chief risk officer and chief financial officer, both seen as key positions, given to senior outsiders in the recent past.[29] Bank of Ireland have also displayed a willingness to continue with insiders despite the economic carnage.[30] Attention has been drawn to the lack of a clean break in the Irish banks subsequent to the collapse with people, who

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[27] See Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009). See also 'EBS Comes Under State Control', *Irish Times* (28 May 2010) available at www.irishtimes.com/newspaper/breaking/2010/…/breaking27.html where Chairman Philip Williamson is quoted as having said '*we have been lying in bed with the elephant.' 'I wish we had not done that commercial lending.*'

[28] See Honohan, Patrick 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank', (31 May 2010), at 51 available at http://www.bankinginquiry.gov.ie/The%20Irish%20Banking%20Crisis%20Regulatory%20and%20Financial%20Stability%20Policy%202003-2008.pdf.

[29] See Taylor, Cliff, 'AIB To Appoint Two Outside Executives', *The Sunday Business Post* (15 November 2009) available at http://www.thepost.ie.

[30] See Clerkin, David, 'Bank of Ireland Stuck in the Twilight Zone', *The Sunday Business Post* (8 November 2009). See also Clerkin, David, 'Meet The New Boss, Same As The Old Boss', *The Sunday Business Post* (22 November 2009).

were non-executive directors during the boom when catastrophic policy mistakes were made, subsequently being promoted to chairman and chief executive roles.[31] It seems to be the case that only under significant political pressure have bank boards been even semi-reformed, with admittedly more public interest directors now sitting on boards. Meanwhile, the nationalised Anglo board consists solely of individuals handpicked by the Minister for Finance.[32]

Although it appears that approximately fifty non-executive directors were operating in the main banks, they did not succeed in reigning in the reckless lending at the peak of the property bubble.[33] A former bank insider makes the point that the non-executive director club had become too cosy with non-executives being drawn from: -

> "A shallow gene pool and public perceptions of a golden circle are well-founded. The key success factor for a non-executive has been to retain one's club membership and so remain available for other lucrative appointments. A tenure for a difficult and argumentative non-executive is short. Few of the non-executives appear to have had the emotional resilience to stand out from the crowd and challenge the consensus view that took hold in Celtic tiger banking. None of the fifty or so non-executive directors in our main banks succeeded in reigning in the reckless lending at the top of the property bubble."

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[31] See Clerkin, David, 'Bank of Ireland Stuck in the Twilight Zone', *The Sunday Business Post* (8 November 2009). See also Clerkin, David, 'Meet The New Boss, Same As The Old Boss', *The Sunday Business Post* (22 November 2009).

[32] *Ibid*. See also Ross, Shane, 'The Ghost of Bankers Past', *The Sunday Independent, Business Section* (29 November 2009) available at http://www.independent.ie Particular reference is made to the elevation of Dan O'Connor at Allied Irish Bank and Donal O'Connor at Anglo Irish Bank.

[33] See Casey, Donal, 'Cosy Directors Failed To Reign In Autocratic Chief Executives' *The Irish Times*, (19 February 2009) available at http://www.irishtimes.com/newspaper/opinion/20090219/1224241416245.html.

The author goes on to make the point that: -

> "Thirdly, it is very clear that the non-executive director community knows very little about what is really going on in their organisations. Ignorance is far too frequently used as a defence. This should not come as a surprise. How can the multiple directorship model accommodate anything other than a scratching of the surface of the real culture? Worse still, the non-execs are forced to rely on a diet of stage-managed presentations and sanitised written reports. In a rebuilt governance model, the non-execs need to spend much more time immersed in the real culture of their organisations. A committed non-executive director who had spent just one week in a busy bank branch during the lending spree would surely have questioned its sustainability. Unfortunately, this critically important issue of corporate governance has been over complicated by the so-called experts. The various codes are dense documents, inaccessible to all but a tiny minority of lawyers, academics and governance practitioners. We have lost sight of the essence of good governance. It starts with the old-fashioned word – caring. Good governance happens automatically when non-executive directors care about the companies over which they have been given stewardship. They will care enough to disagree with the management and care enough to find out what is really going on in the company…"

The above perhaps summarises what was wrong with the non-executive director culture and what needs to change. Worryingly, conflict issues continue to arise, particularly with the operation of NAMA and the participating institutions.[34]

GLOBAL FAILURE OF REGULATION

Looking at the failure of regulation in the Irish context, one has to be careful not to

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[34] Leave for judicial review was recently granted by Peart J. in the case of *Flanagan & Ors. v. Anglo Irish Bank* (Unreported, High Court, 26 July 2010) where a decision to appoint a receiver who was a director of the National Asset Management Agency was challenged on the grounds of bias given that the loans were NAMA bound and the NAMA unit of the bank had been involved in calling in the loans and appointing the receiver and the receiver was a board member of NAMA. The case revolves around the perception of bias.

engage in excessive naval gazing. Consideration of the international and indeed global position is called for. The case for treating the international factors as causative in the Irish context is strengthened by the fact that 2004 appears to be the key year, both at home and abroad, with the OECD listing four specific factors as follows: -[35]

(i) The Bush administration's 'American Dream' of zero equity mortgage proposals, which became operative;

(ii) Regulatory changes in the United States, which weakened the position of Fannie Mae and Freddie Mac;

(iii) The Basel II Accord and International Banking Regulation, which allowed banks to accelerate off balance sheet activity; and

(iv) The Securities and Exchange Commission allowed investment banks to benefit from regulation changes altering previous stringent rules on broker dealers.

A combination of these changes caused the banks to accelerate off balance sheet mortgage securitisation as a key avenue to drive the revenue and share price of the banks.

An explosion of home mortgages followed between 2004 and 2007. Ireland was certainly no exception. The change in the banking business model referred to by the

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[35] See Blundell-Wignall, Adrian, Atkinson, Paul and Lee, Se-Hoon, 'The Current Financial Crisis: Causes and Policy Issues', *Financial Market Trends*, (OECD, 2008) available at http://www.oecd.org/dataoecd/47/26/41942872.pdf.

OECD with increased risk taking, and upfront revenue recognition certainly appeared to take hold of this jurisdiction also, with the two main banks anxious to pursue Anglo at all costs.[36] The key role of the transition from Basel I to Basel II in particular must be noted and, in particular, the period during which Basel II was anticipated and arbitraged.[37] This led to the freeing up of possibly up to a half a trillion US dollars and possibly more thereafter depending on the formula used. Of course, it is also noteworthy that Ireland, like the US, had a history of home ownership and incentivised it through the tax system. The replacement of top risk managers with people from a sales background was also an international problem.[38] It is noteworthy that the Federal Reserve chairman now accepts regulatory failure as a causative factor while still controversially denying that the low interest rate monetary policy had any bearing.[39]

In Europe too, the prevarication about devising corporate governance architecture for banks was lamentable and in fact contributed to delay in Ireland.[40]

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[36] See Blundell-Wignall, Adrian, Atkinson, Paul and Lee, Se-Hoon, 'The Current Financial Crisis: Causes and Policy Issues', *Financial Market Trends*, (OECD, 2008) at 5. Also available at http://www.oecd.org/dataoecd/47/26/41942872.pdf.

[37] *Ibid.* at 7. Directive 2006/48/EC of the European Parliament and of the Council (14 June 2006). The Directive has since come into force in Ireland by virtue of Statutory Instrument No. 661 of 2006 with the vast majority of the Directive coming into force on the 1st January 2007 - OJ L 177, 30.6.2006 at 1–200. In particular, the disclosure requirements under the Directive at Annex 12 afforded certain safeguards had they been adhered to.

[38] *Ibid*. at 10. See also Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 57.

[39] See Bernanke, Ben S., 'Monetary Policy And The Housing Bubble' (3 January 2010) available at http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm.

[40] See Honohan, Patrick 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank', (31 May 2010) at 54 where he contrasts the lack of action on this front with the reinsurance area. Available at http://www.bankinginquiry.gov.ie/The%20Irish%20Banking%20Crisis%20Regulatory%20and%20Financial%20Stability%20Policy%202003-2008.pdf.

Standards of Regulation in Ireland

The 'light touch' regulation model adopted in Ireland appears to have resulted in an even lighter regulation than what prevailed internationally.[41] The UK Code at least tries to set out what is permissible and what must be recorded and rules out, except in exceptional circumstances, exclusive or expensive hospitality, which would include major sporting or cultural events. By contrast no such restrictions appear to have existed in this jurisdiction where opulent hospitality was accepted.[42] The culture of lax regulation in Ireland, together with the 'light touch' model, made this jurisdiction particularly vulnerable to the international trends emerging from 2004. The artificial division, which had occurred between the Central Bank and the financial regulator from 2003 served little purpose.[43] Although the Central Bank had, as early as 2002, requested credit institutions to undergo an independent review of their internal control and risk management systems in the wake of the Rusnak affair at AIB, nothing much appears to have been done subsequently. A study concluded that from a 'top down' stress testing

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[41] See 'Code of Conduct Financial Services Authority', (UK, Revised, December 2008) at 14. Also available at http://www.fsa.gov.uk/pubs/staff/code_conduct.pdf. See also new UK Code in force since 29th June 2010 at www.frc.org.uk. See also Prime Time Investigates documentary 'The Bankers' available at http://www.rte.ie/news/2009/1221/primetimeinvestigates_avhtml. Note that banking contributors to the programme contrasted the difference between an impending visit from the Irish regulator and one from the UK. Commentators have also contrasted the hospitality accepted by Irish regulators with the attitude of the UK regulators. See Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 71. See also Singh, Dilvinder, *Banking Regulation of UK and US Financial Markets* (Ashgate, 2007) at 186.

[42] *Ibid.*

[43] Central Bank and Financial Services Authority of Ireland Act, 2003. See also Jackson, Howell E., 24 *Yale Law Journal* (2007) Reg. 253 at 274 - there seems to have been no question of Irish regulators being underpaid with Jackson finding "six of the ten jurisdictions reported regulatory costs in the relatively narrow range of $134,000 to $164,000 per staff member, with the Irish Republic being slightly above that range at over $175,000 per staff member and both Canada and Australia being somewhat below at $112,000 per staff member. Only Germany's reported expenditures per staff member (at less than $83,000) seem out of line."

analysis conducted looking at shock scenarios: -[44]

> "These scenarios were forecasted using the SBFSAI's macro economic model and were designed to reflect a plausible adverse economic environment. The overall conclusion of this element of the 'top down' stress testing is positive in two respects: first, the results are in broad agreement with the credit institutions' 'bottom up' stress test results and, secondly, the results suggest that the extra provisioning required to fund the expected increase in loan losses would not pose a threat to the financial health of any of the institutions included in the test."

Regling and Watson do not blame the choices made in regulatory structure to go rules based but rather the lack of intrusiveness into risk management and governance.[45]

The Importance of Enforcement

The 'light touch' principle-based system continued and the banks had a free run with very infrequent site inspections.[46] Likewise, the contrast between the fines regime in Ireland where the financial regulator had never fined a bank until 2008, and only then under apparent political pressure, contrasts with the UK situation where during the period 2002 to 2007, £14 million in fines had been imposed with a further £27 million for the

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[44] See Kearns, Allan, 'Loan Losses and the Macro Economy: A Framework for Stress Testing Credit Institutions' Financial Wellbeing', *Central Bank Financial Stability Report* (2004) available at http://www.centralbank.ie/data.finstarepfiles/loan%20losses%20&%20the%20macroeconomy%20-%20A%20framework.

[45] See Regling, Klaus and Watson, Max, 'A Preliminary Report on the Sources of Ireland's Banking Crisis', (May 2010) at 17. Also available from government publications

[46] See Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 80 which records only eight onsite inspections for all of 2005 and there was no record of a single unscheduled inspection of a Bank during 2005.

eighteen months between January 2008 and June 2009.[47]

The description of Ireland as the 'wild west of European finance' now seems in hindsight to have been remarkably apt.[48] However, it could be argued that the more aggressive regulations in the United States, through the Sarbanes-Oxley Act, 2002, with criminal penalties of up to a $1 million fine or ten years in prison or both still appear to have failed to protect the US banking system.[49] As the international factors already mentioned helped the explosive growth in property and mortgage activity from 2004 to 2007, in addition the regulator quite simply failed to do his job. Given the level of inactivity in the area of regulation in the Irish sector, it is hard to understand the regulator's contentions in the 2007 Annual Report.[50]

> "I believe our actions and increased vigilance and monitoring have provided useful supports to a strong system of supervision, which has enabled the industry in Ireland, which had no sub prime exposure to any degree, to withstand this prolonged period of serious turmoil in international markets."

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[47] See Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 80 which records only eight onsite inspections for all of 2005 and there was no record of a single unscheduled inspection of a Bank during 2005. See also Jackson, Howell, 'Variation In The Intensity Of Financial Regulation: Preliminary Evidence and Potential Implications', E. 24, *Yale Law Journal*, (2007), Reg. 253 at 256. Problems with varying approaches to enforcement has been the subject of an impressive article by Jackson who points out that between 2002 and 2006 in the United States approximately 3,600 enforcement actions per year were brought yielding $5bn in revenue and, in addition, there were thousands more private lawsuits including class actions on the private liability side.

[48] See Lavery, Brian and O'Brien, Timothy L., 'Foreign Insurance Regulator, Trail Leads to Dublin', *New York Times* (1 April 2005). For an illustration of how Ireland was sold abroad by interested professionals as a tax haven and a place where there was 'excellent banking and robust regulation', see Diamond, Liam, 'Location of Choice', 18 *International Tax Review* (2006-2008) at 61.

[49] See Mallin, Christine A., *Corporate Governance* (Oxford, 2nd ed., 2007) at 37.

[50] Available at http://www.centralbank.ie. See also Ross, Shane, *The Bankers: How the Banks brought Ireland to its Knees* (Penguin Ireland, 2009) at 84.

This kind of self-delusion on the part of those responsible for implementing the system of regulation, which existed, even if 'light' left the entire banking sector, and by extension the economy, unprotected with disastrous consequences. Although the Central Bank did make warning sounds about the property sector from as early as 2004 in the financial stability report, notwithstanding these concerns nothing appears to have been done.[51] The banks were allowed continue to expose themselves and their clients to huge risks on property, and the regulator chose to do little or nothing while mortgage lending continued to run on to dangerous levels.

For instance, thirteen thousand six hundred and five people took out interest-only mortgages in 2007 representing fifteen per cent of mortgages sold that year with fifty three thousand borrowers taking out interest-only mortgages from 2004 to 2008.[52] The banks too continued in denial about the reasons for the failure in regulation preferring to believe that the regulator took its eye off the prudential ball, while concentrating too much on consumer regulation.[53] Barrington correctly points out that the main regulatory failure was the failure to stop banks from selling consumers unsuitable lending products, leading property developers to believe that consumers had endlessly deep pockets. The relaxation of lending criteria to the point where it was considered normal to take out a mortgage of five or six times income, is correctly identified as the crux of the failure.

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[51] See Kearns, Allan, 'Loan Losses and the Macro Economy: A Framework for Stress Testing Credit Institution's Financial Wellbeing', *Central Bank, Financial Stability Report, 2004* available at http://www.centralbank.ie/data.finstarepfiles/loan%20losses%20&%20the%20macroeconomy%20-%20A%20framework.

[52] See Barrington, Kathleen, 'The Scale of Interest Only Mortgages Revealed', *The Sunday Business Post* (8 November 2009) available at http://www.archives.tcm.ie/businesspost/2009/11/08/story45450.asp. See also http://www.environ.ie.

[53] See Barrington, Kathleen, 'Banks Blame Regulator – For Wrong Reason', *The Sunday Business Post* (15 November 2009) available at http://archives.tcm.ie/businesspost/2009/03/08/story40059.asp.

It is correctly stated: -

> "The reality is that the banking system in Ireland and elsewhere collapsed, not because we had too much consumer protection, but because we had far too little. The fact that the prudential supervision was also inadequate merely compounded the problem."[54]

Honohan correctly identifies the lack of a universally applicable enforcement strategy consistent with principles-based regulation.[55] He also charts the impotence of the regulator in Ireland by his failure to carry any "big stick" and both the architecture and more importantly risk of enforcement was far too benign. A climate of tolerance and excessive trust of recidivist offenders is described.

Jackson summarised the goals of financial services regulation in the United States as involving: -[56]

(i) Protection of the general public;

(ii) Elimination of negative externalities from financial failures;

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[54] See Barrington, Kathleen, 'Banks Blame Regulator – For Wrong Reason', *The Sunday Business Post* (15 November 2009) available at http://archives.tcm.ie/businesspost/2009/03/08/story40059.asp.

[55] See Honohan, Patrick 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank', (31 May 2010) at 54 and 55.

[56] *Ibid.* at 59. See Jackson, Howell, 'Variation In The Intensity Of Financial Regulation: Preliminary Evidence and Potential Implications', E. 24, *Yale Law Journal* (2007), Reg. 253 at 285 where Jackson has drawn attention to the differing approaches of formal enforcement across the jurisdictions and in comparing the United States and the United Kingdom noted 'a further complexity in comparing enforcement data is that jurisdictions have different preferences in terms of what they report as formal enforcement. In some countries, such as the United Kingdom, regulatory officials prefer to resolve investigations without formal actions, often relying on private parties to take remedial steps without formal compulsion. The SEC, by contrast, has a preference for completing actions through some sort of official resolution, including settlements that are announced to the public and recorded in the Commission's annual tally of enforcement action.' Note this article was written before the global credit crunch.

(iii) Advancing various equitable and redistributive goals; and

(iv) Promoting certain aspects of the political economy.

The second goal is explained as follows: -[57]

> "The most prominent sort of negative externality is the elimination of systemic shocks to the economy that financial crises could precipitate. A variant of this objective is the elimination of the costs that society would bear if members of the general public suffered losses from financial institution failures and then demanded ex-poste compensation from public resources."

The Institutions, Gatekeepers and Enforcement

It is difficult to take the current views in banking circles on the inadequacy of regulation at face value in circumstances where bank attitudes to enforcement of the mild regulations in existence were unhelpful and belligerent.[58] The response of the regulator to the growing property bubble emerging had become well documented by 2006, at home and abroad.[59] The 'light touch' model still appears to persist with regulation still designed to suit the market albeit moderated post the appointment of administrators at

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[57] See Jackson, Howell, 'Variation In The Intensity Of Financial Regulation: Preliminary Evidence and Potential Implications', E. 24, *Yale Law Journal* (2007), Reg. 253 at 259.

[58] See *Director of Consumer Affairs v. Bank of Ireland* [2003] 2 I.R. at 217.

[59] See Honohan, Patrick, 'Resolving Ireland's Banking Crisis', *The Economic and Social Review* at 215. Also available at http://www.esr.ie/vol40_2/vol-40.2.honohan.pdf. The author draws attention to the external reviews by the IMF and the OECD, particularly an IMF Report of 2004 and a Report by David Rae and Paul van den Noord in 2006 as well as other contributions at home by authors including Patrick Honohan himself highlighting the extent of foreign borrowing being used to finance the boom.

Quinn Insurance.[60] The gatekeepers too complain perhaps not unjustifiably about the confusion caused by new corporate governance code requirements being put on a statutory footing and more recently about divergence between the new UK code and the emerging new Irish code.[61]

Ultimately, Honohan concludes that the financial regulator's attempts to make itself more robust and intrusive by introducing Directors Compliance Statements and a Corporate Governance Code failed and ran into the sand.[62] An incomplete administrative sanctions scheme and over reliance on 'moral suasion' also characterised the failure of regulation.

LENDING PRACTICES

Regling and Watson make the point on this heading: -

> "Broad errors of economic judgement aside, some countries also saw lamentable failures of bank governance over lending practices – with a scandalous disregard for the adequacy and documentation of collateral, scant interest in borrowers' incomes, and insufficient attention to the risk of falling

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[60] See Clerkin, David, 'Money and Markets', *The Sunday Business Post*, (6 December 2009) available at http://www.thepost.ie who described the efforts made by Anglo to circumvent the Company's legislation in relation to financial assistance for the purchase of its own shares in order to assist unwinding the Quinn family shareholding in Anglo which had gone badly wrong. It appears the Bank supported this to the extent of €450m. This eventually led to the High Court appointing Inspectors to the Quinn group in March, 2010,Irish Times March, 30th, 2010 available at www.irishtimes.com/newspaper/breaking/2010/.../breaking32.html.

[61] S.I. 450 of 2009, which amends Section 158 of the Companies Act, 1963 and makes new requirements for certain companies for corporate governance statements and code compliance and has been criticised by the Chartered Accountants of Ireland. See also McCaughren, Samantha, 'Confusion Reigns Over New Corporate Reporting Law' *The Sunday Business Post* (3 January 2010) available at http://www.sbpost.ie/themarket/confusion-reigns-over-new-corporate-reporting-law-46495.html.

[62] See Honohan, Patrick 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank', (31 May 2010) at 59.

collateral values. The most severe financial episodes seem to have featured such egregious errors. Clearly, one key goal of banking investigations is to pursue such cases, identifying the responsibility for those extreme governance failures."[63]

The lending practices, which offended good governance principles, adopted by the Irish financial institutions can be summarised as follows: -

(i) The introduction of the one hundred per cent mortgage product and its extension to a wide client base in a low interest rate environment which did away with the idea of any need to save, or for customers to make sacrifices, and was also extended to first time buyers.[64]

(ii) The one hundred percent mortgage, when combined with other factors at a critical time in the market, gave all the wrong signals, and commentators have compared variable rate Irish mortgage products, with the model adopted in Denmark.[65] In Denmark, one hundred per cent mortgages were not allowed and borrowers were required to put up twenty per cent of the value of their homes by way of deposit, thus insulating home owners in Denmark from negative equity

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[63] See Regling, Klaus and Watson, Max, 'A Preliminary Report on the Sources of Ireland's Banking Crisis', (May 2010) at 17. Also available from government publications.

[64] See Prime Time Investigates documentary 'The Bankers' available at http://www.rte.ie/news/2009/1221/primetimeinvestigates_avhtml. Some politicians also appear to have benefited from 100 or 115 per cent mortgages including former Finance Minister and Commissioner, Charles McCreevy. See also Kinsella, Stephen, 'Financial Fragility and Corporate Governance in Ireland', *Corporate Governance and Regulation* (Round Hall, 2009) at 163.

[65] See Barrington, Kathleen, 'Danish Mortgage Model Is One To Back', *The Sunday Business Post* (25 October 2009) available at http://archives.tcm.ie/businesspost/2009/10/25/story45168.asp. See also Soros, George, 'Denmark Offers a Model Mortgage Market', *The Wall Street Journal* available at http://www.online.wsj.com/article/sp122360660328622015.html.

when the credit crunch struck. Although not all banks in Denmark were unaffected, the mortgage banks did not require a bail out. The system in Denmark also relies on fixed rate home loans, which insulates the consumer against volatility. The fixed rate is operated through a system of bonds, which investors invest in for a period of usually ten years, and which also allow the homeowner to redeem a bond and reduce what they owe. The stability of the system has attracted widespread praise. Commentators have drawn attention to the sharp jump in high LTVs in 2005 and 2006 with two-thirds of loans to first time buyers in 2006 having a loan to value in excess of ninety per cent while one third were getting one hundred per cent LTV loans.[66] Honohan highlights their negative role in the macro prudential choices made.[67]

(iii) Self certified loan products[68]

Although now difficult to find any trace of these products, which were available at the height of the market, these allowed loans to be drawn down, and in the case of Permanent TSB, one hundred per cent loans in the region of €1 million, on a self-certified basis where the borrowers simply certified that their income was: -

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[66] See Honohan, Patrick, 'Resolving Ireland's Banking Crisis', *The Economic and Social Review*, (Vol. 40, No. 2, 2009) at 207 - 216. Also available at http://www.esr.ie/vol40_2/vol-40.2.honohan.pdf.

[67] See Honohan, Patrick 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank', (31 May 2010) at 97.

[68] Reference to these can be still found on the websites of mortgage brokers together with form downloads confirming involvement of the institutions - for instance, at http://www.aspire-wealth.com/docs/ptsb_self_certification_declaration .pdf.

> "Sufficient to service and repay existing and proposed commitments…".[69]

Irish Life & Permanent also got involved with Merrill Lynch in a joint venture to target their Irish subprime mortgage market, which also allowed for self-certification of incomes.[70] While the Permanent TSB product was aimed at 'experienced' or 'professional' investors who had at least two existing buy-to-let properties, the subsequent 'Spring Board' venture was aimed at the subprime market with the chief executive of 'Spring Board', Mr. O'Sullivan pointing out that: -

> "The specialist mortgage or sub prime market caters for a growing number of individuals who are experiencing difficulty in securing lending from traditional banks and building societies. They may be encountering problems because they have irregular income sources, they need to 'self certify' their income or because they may have had difficulty repaying loans in the past. Spring Board will offer mortgage products to address the needs of such borrowers providing borrowers and mortgage brokers with a compelling choice in this important section of the market."[71]

Meanwhile, it seems that another provider of so-called 'liar's loans', GE Money

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[69] See Prime Time Investigates documentary 'The Bankers' available at http://www.rte.ie/news/2009/1221/primetimeinvestigates_avhtml. See also http://www.aspire-wealth.com/docs/ptsb_self_certification_declaration .pdf.

[70] See http://www.finfax.com/irelandbusinessnews/publish/article10008882.shtml and it is to be noted that this dubious venture was launched as late as 2007 and one might have thought the writing was on the wall. The joint venture was called 'Spring Board'.

[71] *Ibid*.

altered the practice in 2008.[72] The UK Financial Services Authority have since proposed an outright ban on self-certified mortgages, however some argue that this is meaningless as such lending has collapsed in any event.[73]

(iv) Insufficient Stress Testing and Credit Risk Analysis

Despite the revised Basel Core Principles for effective banking supervision, the banks appear to have discarded the stress testing and credit risk part of the process or relaxed it, in some cases to the point of oblivion, by going so far as to bypass the essential credit committee stage in some institutions.[74] The importance of stress testing ought to have increased rather than decreased after the de-regulation of the financial markets, which meant that Irish banks were no longer lending from Irish deposits. By 2006, forty-six per cent of all monies lent were coming from foreign sources, which meant that while the regulator could not prevent this from happening, he ought to have elevated the importance of stress testing.[75] The focus on stress testing means has become more topical

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[72] See Weston, Charlie, 'GE Money Halts Liar's Loans', *The Irish Independent* (14 May 2008) available at http://www.irishindependent.ie. It is to be noted that Start Mortgages also operated self-certified loans.

[73] See Finch, Carol, 'FSA's Mortgage Affordability Plans May End Self Cert Mortgages', (14 July 2010) available at http://news.suite101.com/article.cfm/fsas-mortgage-affordability-plans-may-end-self-cert-mortgages-a261250.

[74] Available at http://www.estandardsforum.org/about_standards/core-principles-for-effective-banking-supervision. It should also be noted that the International Monetary Fund in 2001 carried out an examination of Ireland's compliance with the then Basel Core Principles on the basis of information supplied to it by the Irish Authorities and found it to be compliant. See http://www.imf.org/external/np/rosc/irl/bank.htm.

[75] See Curran, Richard, 'Why Regulation Failed to Curb Runaway Banks', *The Sunday Business Post* (28 December 2008) available at http://www.thepost.ie.

subsequent to the banking crisis.[76] The detailed analysis by the Central Bank stress testing from a 'bottom up' position in shock scenarios does little to enlighten one as to what was actually happening on the ground with lenders on a case-by-case basis. The lending practices, which the above are but a few examples, were a key part of the 'bigger fool' system, which recklessly lent to developers usually one hundred per cent of the site cost and building cost, including acquisition costs such as stamp duty and professional fees.[77] Banks then in turn lent to consumers one hundred per cent to buy individual properties while in some cases a number of flipped deals were also financed along the way before reaching the end user and sometimes by the same institutions.[78] Anglo appear to have been particularly guilty of this cannibalisation. The flipped deals were often incentivised by bonuses and arrangement fees, which further discredited the lending model.[79]

Regling and Watson conclude: -

"Errors of judgement in bank management and governance contributed centrally to Ireland's financial

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[76] See Woods, Maria, 'Financial Stability Analysis of the Irish Commercial Property Market', *Central Bank of Ireland Financial Stability Report* (2007) available at http://www.centralbank.ie/data/finstarepfiles/A%20financial%20stability%20analysis%20of%20the20Irish%20commercialproperty.

[77] See contribution of Des Peelo on the 'Bigger Fool Theory' describing the bizarre behaviour of Bank of Ireland and Allied Irish Bank in following Anglo Irish Bank available at http://www.rte.ie/radio1/podcast/podcast_patkenny.xml.

[78] See Prime Time Investigates documentary 'The Bankers' available at http://www.rte.ie/news/2009/1221/primetimeinvestigates_avhtml.

[79] See Pottow, John A. E., 'Private Liability for Reckless Consumer Lending', 2007 U. Ill. L. Rev. 405 (2007) at 414. Also available at http://www.lawreview.law.uiuc.edu/publications/2000s/2007_1/pottow.pdf.

> crisis. It seems that there were key weaknesses in some banks' internal risk management in areas such as stress testing; the assessment of credit risks; and in some cases major lapses in the documentation of loans – and that these were factors that allowed vulnerabilities to develop."[80]

The same authors also concluded that: -

> "Lending guidelines and processes seem to have been quite widely short circuited."[81]

Interestingly they also note that a credit register would have helped to identify and focus on large or connected borrowers. The Icelandic Banking Report has found that the financial regulation there was under-resourced with gross negligence among key individuals at government and financial regulation level. The similarities between the failure in regulation in both States is said to have been striking.[82]

INSTITUTIONAL AMNESIA

A lesson too late for the learning

This condition seemed to afflict banks worldwide and not just in Ireland. For instance, in France Credit Lyonnais had collapsed and was the biggest ever banking disaster in France as of July 1997. It had once been Europe's biggest bank and its losses, after a decade of reckless lending, had reached FFR100 billion ($US17 billion).

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[80] Regling, Klaus and Watson, Max, 'A Preliminary Report on the Sources of Ireland's Banking Crisis', (May 2010) at 17. Also available from government publications.

[81] *Ibid*. at 35.

[82] See Healy, Alison, 'Iceland Has Lessons To Teach On Bank Crisis, Report Finds', *Irish Times* (19 July 2010) available at http://www.irishtimes.com/newspaper/ireland2010/0719/1224275020177.html.

According to sources France's entire political elite was implicated in the affair with the socialists having encouraged the building of a global empire to rival that of Germany's Deutsche Bank.[83] In turn, a former right wing government had, it seemed, played down the difficulties with the bank. *The Economist* summed it up thus: -[84]

> "To keep its books looking healthy enough to allow yet more expansion, Credit Lyonnais was not above revaluing assets. When the French economy slumped in the early 1990s, it had no cushion of unrealised gains to fall back on. Red ink started gushing almost immediately.
>
> Although megalomania and mismanagement are the main reasons for the bank's losses, fraud is also to blame. In March, Mr. de Courson sparked a furore when he revealed the sum of FFR5 billion of fraud had been uncovered as auditors delved into the bank's dud loans."

As recently as 2002, AIB were rocked by the Rusnak scandal with the loss of close on a billion euros.[85] Rusnak's activities at AIB led to the biggest losses in the banking world since Nick Leeson had brought down Barings Bank with 1.4 billion losses in 1995.[86]

Drennan underlines the importance of the industry culture, which allows such scandals

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[83] See Beckett, Paul and Remond, Carol S., 'Banking's Biggest Disaster, *The Economist* (7 May 1997, Vol. 344, Issue 8024) at 69 – 71.

[84] *Ibid.*

[85] See O'Cleary, Conor, 'Rogue Trader 'A Bit Cocky' But Just Seen As A 'Regular Guy' By His Colleagues', *The Irish Times* (8 February 2002) available at http://www.irishtimes.ie.

[86] See Mallin, Christine A., *Corporate Governance* (Oxford, 2nd ed., 2007) at 131. See also Drennan, Lynn T., 'Ethics, Governance and Risk Management: Lessons from Mirror Group Newspapers and Barings Bank', *Journal of Business Ethics*, (July 2004, Vol. 54, No. 3) available at http://www.springer.link.com/content/q8uv576367368rx3.

to happen thus: -[87]

> "They were highly secretive in their business dealings, setting up false accounts and transferring monies inappropriately but they were able to get away with it, for as long as they did, because their actions were not questioned by others, and the systems which should have been in place to prevent such abuse were inadequate. Clarke (1997, p. 32) describes it in these terms: 'behind the façade of rogues and scoundrels are corporations and industry practices'."

Of course AIB had almost collapsed in the wake of the Goodman Food Industries crisis two decades ago leading to the introduction of examinership legislation in this jurisdiction for the first time.[88] The banks, and most notably AIB, having been brought to the brink, allowed Goodman to keep forty per cent of his shares and a mere four years later Goodman raised the money to buy out the banks for just £50 million, the banks accepting a bad debt in the region of £300 million.[89] There was the celebrated *Bank of Credit and Commerce International* case, which had become the seventh largest private bank in the world before collapsing in 1991.[90] This to some extent displayed

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[87] See Mallin, Christine A., *Corporate Governance* (Oxford, 2nd ed., 2007) at 131. See also Drennan, Lynn T., 'Ethics, Governance and Risk Management: Lessons from Mirror Group Newspapers and Barings Bank', *Journal of Business Ethics*, (July 2004, Vol. 54, No. 3) available at http://www.springer.link.com/content/q8uv576367368rx3.

[88] Companies (Amendment) (No. 1) Act, 1999. See also Keane, Ronan, *Company Law* (3rd ed., 2000) at 536.

[89] See Cooper, Matt, *Who Really Runs Ireland?* (Penguin Press, 2009) at 390 and 391.

[90] See Finder, Joseph, 'The Worst of All Possible Banks', *New York Times*, (2 May 1993) available at http://www.nytimes.com/1993/05/02/books/the-worst-of-all-possible-banks.html?pagewanted =1. See also Beaty, Jonathan and Gwynne, S.C., *The Outlaw Bank – A Wild Ride Into The Secret Heart Of BCCI* (New York, Random House, Beard Books, 1993) available at http://www.books.google.com/books. See also *Bank of Credit & Commerce International* case, [2002], 1 A.C. 251 where the House of Lords had to grapple with the issue of validity or otherwise of settlements and releases entered into by employees of the bank who were unaware at the time of settlement of the fraudulent nature of the bank and the impact it would have on their reputations.

several Anglo features. While not identical, the personality factor and the willingness to play fast and loose with the rules allows certain parallels. The failure of the banks themselves and indeed the regulators to learn from the past experience is summarised by Honohan as follows: -[91]

> "A very simple warning sign used by most regulators to identify a bank exposed to increased risk is rapid balance sheet growth. An annual real growth rate of 20 per cent is often taken as the trigger. Each of the locally controlled banks had at least one year in which this threshold was triggered. One of them, Anglo Irish Bank, crossed it in eight of nine years, and indeed its average annual rate of growth from 1998 to 2007 was 36 per cent. Another, Irish Nationwide, crossed the line six out of the nine years, for an average rate of growth over the nine years of just above 20 per cent. So this was a very obvious and public danger sign, not only for these two banks, but because of the potentially destabilising effect of reckless competition in the entire sector."

The failure to learn is not limited to banking examples, as many previous corporate scandals, although not directly involving banks, had banking elements including bank complicity and wilful blindness to wrongful activity.[92] Other commentators have gone so far as to say: -[93]

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[91] See Honohan, Patrick, 'Resolving Ireland's Banking Crisis', *The Economic and Social Review*, (2009, Vol. 40, No. 2) at 217. Also available at http://www.esr.ie/vol40_2/vol-40.2.honohan.pdf.

[92] A good example being the Enron scandal where it is believed that the Banks were aware that loss making contracts were being shifted off balance sheet as well as liabilities being shifted leading ironically to the Banks being among the main losers in the Enron collapse themselves. For a good discussion, see Kuzwayo, E., 'Worldcom Corporate Scandal - Lessons For Corporate Governance', (19 February 2003) available at http://www.reservebank.co.za/internet/publication.nsf/ladv/…/annexure_d2.pdf. The author's conclusion that proper governance is not a list of procedures and the quantity of Board Committees but rather is the old principle of substance over form and as a state of mind is a powerful point of discussion.

[93] See Hamilton, Stewart and Micklethwait, Alicia, *Greed and Corporate Failures: The Lessons From Recent Disaster* (Palgrave MacMillan, 2006) at 55.

The importance of learning the lessons has been underlined: -

> "Whenever a major incident occurs, whether a physical event, such as a rail crash, or financial disasters such as those involving MGN and Barings, it is important to analyse the factors involved in the incident, with a view to learning lessons and preventing similar events from reoccurring in future."[94]

Irish financial institutions had also been hit by the DIRT scandal.[95] A level of denial exists to this day in relation to the National Irish Bank scandals of the late 1990s despite a High Court inspector's report in July 2004.[96] The former CEO continues to contend that there were few, if any, shortcomings on his watch, and that the earlier inspector's report was 'fatally undermined'. These claims were made by Mr. Lacey in response to an application by the Director of Corporate Enforcement to have him disqualified as a director.

The Director claims that there was 'a catastrophic failure of governance' during Mr. Lacey's tenure as CEO of National Irish Bank and that Mr. Lacey should bear responsibility for the serious wrongdoing by the bank.

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[94] See Drennan, Lynn T., 'Ethics, Governance and Risk Management: Lessons from Mirror Group Newspapers and Barings Bank', *Journal of Business Ethics* (July 2004, Vol. 54, No. 3) available at http://www.springer.link.com/content/q8uv576367368rx3.

[95] See Collins, Liam, 'Banks Use New Tax Scam After DIRT Scandal Broke', *The Sunday Independent* (8 October 2000) available at http://www.independent.ie. These earlier scandals continued to surface in recent times especially in the debate of the NAMA related legislation including the earlier AIB ICI controversy, which required a government bail out. See, for instance debates of the 3rd March 2009 at http://www.debates.oireachtas.ie/ddebate.aspx?f=dal20090303.xml.

[96] See Carolan, Mary, 'Lacey tells High Court of Crucial Bank Documents', *The Irish Times* (18 June 2009) available at http://www.odce.ie/en/media_general_publications_article.aspx?article=9d1fa0b0-81a7-460c-9092-5cd5ee3e9441.

It seems that in the Irish case no lessons were learnt from the earlier banking difficulties, which were by no means insignificant in scale and notoriety. Nevertheless, the regulatory response was negligible and, as pointed out by Honohan, a slight tightening of capital requirements by the regulator on the 31st March 2006 only increased total capital requirement to back one hundred per cent loan from 4 per cent of the loan to 4.8 per cent, a mere €4,000 on a loan of €500,000.[97] Other respected commentators have drawn attention recently to the lack of appetite that existed for enhancing whistleblower protection even in 2007.[98]

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[97] See Honohan, Patrick, 'Resolving Ireland's Banking Crisis', *The Economic and Social Review*, (2009, Vol. 40, No. 2) available at http://www.esr.ie/vol40_2/vol-40.2.honohan.pdf. See also Honohan, Patrick 'The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank', (31 May 2010) at 103 available at http://www.bankinginquiry.gov.ie/The%20Irish%20Banking%20Crisis%20Regulatory%20and%20Financial%20Stability%20Policy%202003-2008.pdf.

[98] O'Toole, Fintan, 'Listen Up: We Need To Protect Whistleblowers', *Irish Times* (23 January 2010) available at http://www.irishtimes.com/newspaper/weekend/2010/0123/1224262905852.html. The article draws attention to the treatment of whistleblowers in Irish banks including Eugene McErlean who uncovered a problem of overcharging at AIB and was subsequently fired and according to O'Toole was wrongly tainted with blame. O'Toole also discusses the case of Tony Spollen who had discovered the bogus non-residents accounts and DIRT scandal at AIB in 1991 who was according to himself 'painted by some as somebody who is a disgruntled guy, a chip on his shoulder…. who was out to cause trouble'.

CHAPTER 2

ARGUING FOR RECKLESS LENDING LIABILITY

In this part, consideration is given to where the seeds of reckless lending liability already exist in our law and the possibility of establishing an independent tort of reckless lending as well as notion of a contractual defence of reckless lending leading to more established defence opportunities also. Statutory options for imposition of reckless or negligent lending liability are examined as well as developments at European level and in other jurisdictions.

Reckless lending liability can be promoted as an efficient method of redressing and deterring loans that do end up proving harmful and by keeping harm as an integral part of the equation; a more accurate, efficient and fair outcome will be more achievable.

The use of private liability for reckless lending is a useful, efficient administrative tool to compliment any amendment to personal insolvency or bankruptcy laws contemplated post the introduction of NAMA and as an aid to enforcement on the public side.[99]

The United States has reported that nearly 3.5 billion per year of private sanctions were also imposed in the US securities market, mostly through class action settlements

[99] See Minihan, Mary 'Expert Group To Advise On Ways To Help Those In Debt', *Irish Times* (26 February 2010) available at http://www.irishtimes.com/newspaper/finance2010/0226/12244265203969.html. The National Asset Management Agency Act, 2009 (No. 34 of 2009) was established by Statutory Instrument S.I. No. 547 of 2009, which designated the 21st December 2009 as the establishment day. Other relevant Statutory Instruments include S.I. No. 568 of 2009 and No. 88 of 2010. Most pieces of the NAMA jigsaw were in place by early March 2010.

and arbitration awards, thereby contributing significantly to the securities enforcement picture.[100]

What is Reckless Lending?

American commentators have defined the closely related, although perhaps not identical concept of predatory lending. The following constituent parts have been identified: -[101]

(i) Loan structured to result in seriously disproportionate net harm on borrowers: This occurs where lenders have overridden conventional underwriting norms in relation to loans. A rule of thumb here seems to be where a loan is made where it is obvious that the borrower cannot afford the monthly payments causing borrowers to file for bankruptcy or lose their homes;

(ii) Rent seeking: This involves fees and interest rates that are exorbitant compared to the risk;

(iii) Loans involving illegal fraud or deception;[102]

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[100] See Jackson, Howell, 'Variation In The Intensity Of Financial Regulation: Preliminary Evidence and Potential Implications', E. 24, *Yale Law Journal* (2007), Reg. 253 at 281.

[101] See Drury III, Lloyd L., 'Predatory Lending and its Impact on Consumer Credit', 10 Loy.J.Pub.Int.L137 2008/2009 at 137. See also Fuentes, Nicole Lutes, 'Defrauding the American Dream: Predatory Lending in Latino Communities and Reform of Californian's Lending Law', 97 Cal.L.Rev. (2009) at 1279.

[102] This could be argued in respect of the McGrath case - *ACC v. Fahey & McGrath* [2010] IEHC 41, High Court (Commercial Court), 12th February, 2010. See also Carolan, Mary, 'Action Urged Over Forged Signatures On Loan Papers', *Irish Times* (13 February 2010) available at http://www.irishtimes.com/newspaper/finance2010/0213/122464351746.html.

(iv) Other forms of non-transparency that do not amount to fraud but can involve more technical omissions to do with non compliance where information is withheld from borrowers even though that omission falls short of fraud;

(v) Loans requiring borrowers to waive meaningful legal redress. Drury relying on the work of Engel and McCoy detail American examples of mandatory arbitration clauses and clauses prohibiting litigation against lenders;[103]

(vi) Lending discrimination: This involves more onerous terms on members of certain groups;

(vii) Servicing abuses: This has been seen in America in securitised loans where the 'servicer' typically becomes responsible for mechanical processes such as collecting loan payments and distributing proceeds and has been the subject of adverse comment.[104]

Of all of the above the first test must surely be the most relevant and sensible. It is clear from the American experience such as that detailed by Fuentes that such definitions are easier to meet for litigants from a lower socio-economic and educational background. Minority ethnic groups such as Latinos tend be easy targets for predatory lenders with

[103] Kathleen C. Engel and Patricia A. McCoy, 'A Tail of Three Markets: The Law in Economics and Predatory Lending', Actex.L.Rev.1255 (2002). See also the European Communities (Unfair Terms in Consumer Contracts) Regulations, 1995, S.I. 27 of 1995, which may be useful in this jurisdiction. See also footnote 101.

[104] Note, arguments are beginning to emerge in American Courts that where loans have been assigned to another servicing agent or bank, that the original bank (or indeed the new bank, if the assignment has not been made) lacks *locus standi*. See, for instance, *HSBC Bank USA v. Dammond*, New York Supreme Court where detailed submissions were made as to the ownership of the mortgage and its assignment or non-assignment and the consequent effect on *locus standi*. The Defendant's written submissions are available at http://www.responsiblelending.org.

falsified records by brokers and lenders being less likely to be detected. Although California had taken some action through its financial code in 2001 to combat subprime practices, the law ultimately was not strong enough and attempts to protect minority communities failed.[105] According to Fuentes, one quarter of all subprime lending in America took place in California and California's Predatory Lending Act, which was codified in Division 1.6 of the California Financial Code in 2002 was criticised as being insufficient in regulating the area.[106] The law did not cover loans in excess of $250,000 initially and later $417,000 and, as a result, was ineffective considering that the median home price in California at the time was $576,000.[107] There were also other traits in the legislation which excluded many loans and subprime lenders were able to tailor home loans so as to avoid the Act.

Variations within the United States

The California law compared poorly with its equivalent in North Carolina where the broker had to ensure as follows: -

(i) Safeguard and account for any money handled by the borrower;

(ii) Follow reasonable and lawful instructions from the borrower;

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[105] See Fuentes, Nicole Lutes, 'Defrauding the American Dream: Predatory Lending in Latino Communities and Reform of Californian's Lending Law', 97 Cal.L.Rev. (2009) at 1282.

[106] *Ibid.* at 1295.

[107] This was the median price in mid 2006. See Fuentes, Nicole Lutes, 'Defrauding the American Dream: Predatory Lending in Latino Communities and Reform of Californian's Lending Law', 97 Cal.L.Rev. (2009) at 1296.

(iii) Act with reasonable skill, care and diligence; and

(iv) Make reasonable efforts to secure a loan that is reasonably advantageous to the borrower considering all the circumstances, including the rates, charges and repayment terms of the loan and the loan options for which the borrower qualifies with such lenders.[108]

The misleading of Latino borrowers in California displayed two common predatory tactics as follows: -

(i) Misleading borrowers about loan terms and then falsifying assets and income on loan applications; and

(ii) Steering borrowers into expensive loans they could not afford, with the goal of profiting from refinancing the loan when the borrower was unable to meet payments.[109]

The brokers played a key role in falsifying loan applications and income and assets. Commission incentives were the key. Factors such as lack of credit or poor credit history and disengagement from mainstream financial institutions increased vulnerability. Discussions as between American States on the need for a duty on a lender to secure a

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[108] See Fuentes, Nicole Lutes, 'Defrauding the American Dream: Predatory Lending in Latino Communities and Reform of Californian's Lending Law', 97 Cal.L.Rev. (2009) at 1298.

[109] *Ibid.* at 1307.

loan that was reasonably advantageous to the borrower is one that is relevant to this jurisdiction also.

A new Federal Reserve Board amendment has recently been introduced in America effective from October 1st, 2009 requiring the lender to verify a borrower's income and assets and evaluate his ability to repay.[110]

While accounts of the American subprime experience identify the wreckage in vulnerable communities that is the result of reckless lending, the black box of liability remains somewhat elusive, outside of specific statutory provision. A panel on predatory lending in Louisianna[111] concluded that in both State and Federal Courts the basic contractual defences such as fraud, unconscionability, duress and incapacity were the most effective in representing consumers.[112]

Pottow characterises it as: -[113]

> "Even if the lender knows that his loan is highly likely to bankrupt the debtor and be written off in whole or in part, he does not care because he makes back his investment in penalty interest and fees

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[110] See Fuentes, Nicole Lutes, 'Defrauding the American Dream: Predatory Lending in Latino Communities and Reform of Californian's Lending Law', 97 Cal.L.Rev. (2009) at 1328 at footnote 387.

[111] 10 Loy.J.Pub.Int.L.183 (2008/2009).

[112] See Drury III, Lloyd L., 'Predatory Lending and its Impact on Consumer Credit', 10 Loy.J.Pub.Int.L137 2008/2009 at 148.

[113] See Pottow, John A. E., 'Private Liability for Reckless Consumer Lending', 2007 U. Ill. L. Rev. 405 (2007) at 414. Also available at http://www.lawreview.law.uiuc.edu/publications/2000s/2007_1/pottow.pdf. John A.E. Pottow is an internationally recognised expert in the field of bankruptcy and commercial law and is Professor of law at the University of Michigan Law School.

> relatively quickly regardless of the remaining principal balance. Once this point passes, he is content to let the chips of his improvident loan fall where they may, indifferent to the harm on the debtor and the potential externalities imposed on others."

He argues for either a contractual defence as a bar to enforcement of the contract, which will either be complete or partial or a more aggressive private remedy which would allow a Court inside or outside bankruptcy to award affirmative damages in tort for a causally linked harm.[114]

His analysis of creditors versus debtors as regulatory targets has merit.[115] He frames it in terms of fairness and symmetry in these terms: -

> "It takes two to tango with reckless loans, and so holding the lender liable in contract or tort for these unreasonable extensions of credit places liability on the hitherto unblamed party to the transaction (in contrast to congress' narrow focus on the debtor loan)."

A public interest approach

In the recent case of *Cleveland v. Ameriquest Mortgage Securities Inc. & Others*, the city of Cleveland sued several banks in a public nuisance action and the city alleged that the defendants had become more brazen in their lending activities from 2003 and

[114] See Pottow, John A. E., 'Private Liability for Reckless Consumer Lending', 2007 U. Ill. L. Rev. 405 (2007) at 425.

[115] *Ibid.* at 429. See also http://www.gov.track.us/congress/bill.xpd?bill=h111-1728. The bill is sponsored by Republican, Bradley Miller and as of June 27th, 2010 has not yet been voted on in the Senate. It is part of the comprehensive Dodd-Frank Wall Street reform package. The related Dodd-Frank legislation known as the Restoring American Financial Stability Act, 2010 was passed in the US Senate on the 20th May 2010 – H.R. 4173. The legislation was signed into law by President Obama on the 21st July 2010 – available at http://www.gov.track.us/congress/bill.xpd?bill=h111-1728.

subverted the normal operation of the mortgage market.[116] The loss alleged was thousands of foreclosed homes in neighbourhoods throughout Cleveland that became eyesores, fire hazards and easy prey for looters and drug dealers in search of a place to conduct their business. The city claimed tangible loss in respect of each foreclosure including expenditure for fire and police protection and maintenance and demolition costs. Losses in tax revenues were also claimed. The claim failed for a number of reasons including finding that subprime lending could not form the basis of a public nuisance because it was an activity which was legal. Another reason cited was the failure to demonstrate a direct causal relationship between the defendant's conduct and the injury.[117]

As can be seen both in terms of litigation and academic work America would appear to be ahead of Europe in terms of responses. This is unsurprising given the previous high profile corporate disasters such as Enron in that jurisdiction and the emergence of the sub prime problem in America.

Legislative Reform in the US

The Mortgage Reform and Anti Predatory Lending Act is currently making its way through Congress with the Act having been passed in the House and now has to be voted on in the Senate.[118] Its short title reads: -

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[116] United States Court of Appeal sic. Circuit No. 09/3608, (27 July 2010) available at http://www.leagle.com/unsecure/page.htm?shortname=infc020100727166.

[117] The Court relied on the United States Supreme Court case of *Holmes v. SCC. Investor Prot. Cor*p., 503 US 258, 268 (1992) on the causation issue. Holmes has been widely cited, see for instance 'Statutory Interpretation – Second Circuit Holds That Health Care Funds Lack Standing To Sue Tobacco Companies Under RICO (cases)', 113 *Harvard Law Review*, 1063 (1999-2000).

[118] HR 1728, 111th Congress 2009/2010.

> "To amend the Truth in Lending Act, to reform consumer mortgage practices and provide accountability for such practices, to provide certain minimum standards for consumer mortgage loans, and for other purposes."

Interestingly, Section 204, which deals with liability, provides for the remedy of rescission of a mortgage where the creditor violates provisions of the Act. It also provides for the lender being liable for additional costs as a result of the violation and, in connection with obtaining a rescission of the loan including a reasonable attorney's fee.[119] Calhoun, while acknowledging that the Bill establishes 'ability to pay' and

> "a requirement that refinancing loans provide a net tangible benefit to the home owner",

nevertheless, argues that the consequences are too minimal for those who break the law.[120] He calls for a ban on the steering of borrowers into more expensive loans than those for which they qualify as well as several other protections including a ban on prepayment penalties for all loans.

The Act also provides at Section 205 that where a creditor seeks a judicial or non-judicial foreclosure, the consumer, who has a right to rescind under the Section, may assert such right as a defence to foreclosure or a counterclaim to such foreclosure against

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[119] The Act has been the subject of some criticism. See, for instance, the testimony of Michael Calhoun, Centre for Responsible Lending before the US House of Representatives Committee and Financial Services, April 23rd, 2009 available at http://www.responsiblelending.org. Calhoun argues that the Bill does not do enough to reduce Wall Street's appetite for risky loans and feels the consequences for wrongdoers are too minimal.

[120] *Ibid.*

the holder.[121]

[121] There appear to be many complaints in the United States in respect of loans made where no consideration was given to the borrower's ability to repay. See, for instance, Defendant's submissions/brief in the case of *Howard v. Countrywide*, Superior Court of the District of Columbia, proceedings initiated March 5th, 2008 where the homeowner alleged he was refinanced 4 times in the course of 3 years into loans that he could not afford including several brokered loans that provided the broker with high compensation including yield spread premiums and a 'no income, no asset' loan from Countrywide Home Loans. Available at http://www.responsiblelending.org.

CHAPTER 3

EMERGING IRISH TRENDS AND REFORM

Recent Irish Decisions

Reckless lending has been raised as a potential defence in the recent case of *ICS Building Society v. David Grant.*[122] The Plaintiff originally bought an investment property in the countryside in Wicklow consisting of a house and land, which he thought might have had potential to be turned into a housing estate. He bought the property in 2002 and paid IR£293,000 (€372,033.26). He subsequently refinanced the property in October 2003 borrowing €788,000 from the Plaintiff Building Society and subsequently topping this up by a further €92,000. The Building Society valued the property for mortgage purposes at €1.1 million and for insurance purposes at €500,000. By May 2007 the Defendant had an arrears balance of €22,679.37 and a redemption balance of €811,028.66. The Building Society repossessed the property in December 2008 and sold it in September 2009 for €355,000. The Plaintiff then sought Judgment in the Master's Court for the balance of €1,007,102.89 less the gross sale proceeds and thereby sought a net Judgment of €663,059.62. Charleton J. specifically found that while it was possible to arrange a mortgage, which would only have recourse to the asset, that this was not the factual position in this case. Nothing was pleaded before the Judge to suggest the Building Society had been negligent in selling the property and the Plaintiff (a lay litigant) seemed to have presented a fairly narrow case.

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[122] *ICS Building Society v. Grant* [2010] IEHC 17, Charleton J.

In responding to the reckless lending defence, which seems to have been put forward in a very generic way, Charleton J. concluded: -

> "Here, what is asserted as some alleged wrong akin to reckless lending. I have no material whereby I could come to any such conclusion in this case since both the Plaintiff and the Defendant seem to have taken the same over-valued view as to the worth of the security. But, more fundamentally, the argument for tort of reckless lending does not exist in law as a civil wrong. It is not within the competence of the Court to invent such a tort. The Oireachtas could, if it saw fit, pass a law creating such a civil wrong. It is difficult to imagine the parameters of such a law since those who seek a loan will have a view of what should be borrowed, and if a loan is badly made by a Bank, how can the issue of contribution be escaped from by the borrower who sought the money in the first place. Defining that civil wrong would tend to remove the presumption of arms length dealing as between borrower and bank and replace it with a new relationship based on a duty of nurture that other common law countries do not see it as their duty to put into the market place as any argued for law as to reckless lending does not appear in the works on tort that I have consulted from other common law jurisdictions.
>
> In any event, I am unable to act on this argument because such a law does not exist beyond the principle of undue influence, which is not raised in any way on the facts in this case."

It may be unfortunate that this particular case, presented in a particular way, has been one of the first to be the subject of a written Judgment by the High Court in this jurisdiction. Another recent Irish case yet to go to a full hearing is *Anglo Irish Bank v. Daly.*[123] The Defendant in this case contends he was a favoured developer in the Midwest region and could pick up the phone to the plaintiff where he would be told to buy. His company spent more than €300,000,000 in development projects plus

[123] See Carolan, Mary, 'Daly Blames Anglo For Large Loans', *Irish Times* (26 January 2010), Charleton J., High Court (Unreported, 16 April 2010).

€100,000,000 in projects in Germany and the Defendant contends that the Bank were anxious that the group make additional investments in Germany and that the chief executive made it clear that funds of up to €500,000,000 were available. He also alleges that the bank targeted this group for annual additional borrowings of up to €150,000,000 for various projects. The bank subsequently failed to get Summary Judgment against the Defendant and the High Court found that he had made out an arguable defence such as required that the matter go to a full plenary hearing.[124] Discovery is being sought of the minutes of all credit control meetings in an apparent effort to demonstrate recklessness among other matters.

More recently the anticipated reckless lending case against AIB was settled.[125] The Plaintiff's claim against the bank, as pleaded, contained a number of allegations and could be summarised as follows: -

(a) Reckless lending to the partnership;

(b) Negligence;

(c) Failure to afford independent legal advice;

(d) Documentation and certification issues;

(e) Departures from the letter of sanction;

(f) Reckless increase of indebtedness;

(g) Guarantee issues.

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[124] *Irish Times* (20 April 2010) available at www.irishtimes.ie.

[125] *Fogarty and Others v. AIB,* High Court Record No. 5416/09, settled on 4th of May, 2010 available at www.irishtimes.com/newspaper/finance/.../1224269733470.html.

In the recent case of *AIB Bank v. Maguire and Others*, Peart J. had to consider an action by a bank seeking compliance with a solicitor's undertaking where a solicitor alleged that had the bank appointed its own solicitor for the transaction, it would have protected itself more effectively and prudently and the issue of contributory negligence arose.[126] In rejecting such a notion, Peart J. stated: -

> "There was no particular difficulty identified either to Ms. Walsh or Mr. Duggan, which should have put them on their guard. In fact, Mr. Hynes wanted the matter to be dealt with urgently, and there is no doubt that the use of Mr. Dowling facilitated that. But there is something singularly unattractive, and untenable, about an experienced firm of solicitors, such as the Defendants are, pleading in its Defence effectively that the type of transaction, which they freely undertook was not one which they ought to have been entrusted with, and that by being so entrusted, the Plaintiff bank in some way failed in its duty of care to itself."

The Plaintiff sought relief that the guarantees were unenforceable, void or voidable at the instance of the Plaintiff or that they had been vitiated by the Bank's conduct and the Bank was also accused of misrepresentation.

On the consumer front, the Irish Courts also had to deal with a flawed endowment mortgage sold to an elderly couple in *Kilmartin v. Bank of Ireland*.[127] Deery, P. found in the Circuit Court that: -

> "I concluded without hesitation that the documentation, far from warning of risk to the sum available at

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[126] [2009] I.E.H.C. 374; [2009] 7 JIC 2805.

[127] See Managh, Ray, 'Pensioners Awarded €16,000 For Bad Mortgage Advice', *Irish Times* (21 May 2010) available at http://www.irishtimes.com/newspaper/ireland/2010/0521/1224270803198.html.

the end of the mortgage, suggested there was no risk."

The Circuit Court President found that the advice given had been deficient in many respects leading him to conclude that there was negligence on the part of the bank in the advice that they gave. The Court held that the Plaintiffs were entitled to recover the shortfall of the endowment policy to meet the €63,000 mortgage on maturity and measure that sum at €6,039 and, in addition, were entitled to €1,963 compensation for additional premiums and interest and €8,000 for loss of projected surplus making a total award of €16,002.

The duty on Irish banks however to take reasonable care with regard to transmission of information and potential for liability and negligent mis-statement was underlined again by the Supreme Court in *Wild Gust v. Bank of Ireland*, the Supreme Court held that for a person who is not the enquirer was, nevertheless, damaged as a consequence of a wrong answer negligently given and where the existence of such a person and the reasonable foreseeability of such damage ought to have been present in the mind of the person giving the information, liability followed.[128] The Court in citing with approval the case of *Hedley Byrne & Co. Ltd v. Heller & Partners Ltd* could give some ground for optimism of fringe liability.[129]

Emerging arguments on illegality and public policy

The prevailing view in the Courts, as set out by Kelly J. in the recent *Fahey and*

[128] [2006] 2 I.L.R.M. 28.

[129] [1964] A.C. 465.

McGrath case[130] seems to be that even where there are 'troubling issues' that if the Defendants accept they got the money, the bank was entitled to Judgment.[131] It is considered that further scope existed in the *McGrath* case when developing a defence on the grounds of illegality given the allegations, which seem to have been uncontradicted that a P60 had been forged and that the Letter of Offer allegedly did not bear the signature of the defendants.

In the recent case of *Anglo Irish Bank Corporation v. Flanagan and Others*[132] an argument was advanced by the Defendants who were being pursued for summary judgment that the facility letters on which the bank based its claim were all brought into existence for the express purpose of avoiding the bank's duties to disclose impaired or bad loans under the EU Capital Requirements Directive.[133] Email evidence demonstrated an expressed intention on the part of the relevant bank personnel to keep the disclosure of the impaired loans to the market at a minimum. This was to avoid penalties under Basel 2. The argument was advanced that this breach of the Directive tainted these facility letter contracts with illegality rendering them unenforceable.[134] It was argued that all of

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[130] *ACC v. Fahey and McGrath*, High Court (Commercial Court) [2010] IEHC 41. See also Carolan, Mary, 'Action Urged Over Forged Signatures on Loan Papers', *Irish Times* (13 February 2010) available at http://www.irishtimes.com/newspaper/finance2010/0213/122464351746.html.

[131] *Ibid.*

[132] Ex tempore High Court (23 July 2010), Finlay Geoghegan J., the issue of illegality was not decided.

[133] Directive 2006/48/EC of the European Parliament and of the Council (14 June 2006). The Directive has since come into force in Ireland by virtue of Statutory Instrument No. 661 of 2006 with the vast majority of the Directive coming into force on the 1st January 2007. Speculative property loans had also been added to the class of loans attracting a higher capital ratio in the Irish context – See Honohan, P., 'The Irish Banking Crisis: Regulatory and Financial Stability Policy, 2003-2008. A Report to the Minister for Finance by the Governor of the Central Bank' at 102.

[134] The relevant part of the Directive was Annex 12, Part 2 and, in particular, paragraph 6(g) and 6(h), which provided for mandatory disclosure of the amount of impaired exposures and past due exposures broken down by geographical area.

the facility letters in question were brought into existence to hide the reality of what were impaired loans going back a number of years where no interest had been serviced.[135] The arguments in the *Flanagan* case, although not expressly ruled upon by the Court, echo comments of the panel on predatory lending in Louisiana which emphasise basic contractual defences.[136] The Defendants had relied on the case of *Lemenda Trading Co. Limited v. African Middle East Petroleum Co. Limited* and the extract from the Judgment of Phillips J.: -[137]

> "It is well settled that in judging this question one has to look at the tendency of the acts contemplated by the contract to see whether they tend to be injurious to the public interest. In my judgement, a contract of the kind has a most pernicious tendency. At a time when public money is being advanced to private firms for objects of national safety it would tend to corrupt the public service and to bring into existence a class of persons somewhat like those who in ancient times of corrupt politics were described as 'carriers', men who undertook for money to get titles and honours for those who agreed to pay them for their influence…"[138]

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[135] Reliance was also placed on Section 6 of the Criminal Justice (Theft & Fraud) Offences Act, 2001, which provides at Section 6(1) that 'a person who dishonestly, with the intention of making a gain for himself, or herself or another, or of causing loss to another, by any deception induces another to do or refrain from doing an act is guilty of an offence.' Further, Section 11(2)(a) provides that 'a person who dishonestly, with the intention of making a gain for himself, or herself or another, or of causing a loss to another, by any deception procures the execution of a valuable security is guilty of an offence.' It is interesting to note that Section 6 has been used as a basis in which to freeze assets by the Criminal Assets Bureau who alleged a gain by deception by the alleged use of fictitious names by an Aviation company trading abroad. See *CAB v. MacAviation & Anor*. High Court (Unreported, 22 March 2010), Feeney J., which decision concerns mainly the issue of an in camera hearing and deals also with the factual background.

[136] 10 Loy.J.Pub.Int.L.183 (2008/2009).

[137] [1988] 1 A.L.L. E.R. 513. (Commercial Court). See also *Westacre Investments Inc. v. Jugoimport* [1999] 3 WLR 811, [2000] QB 288.

[138] There were also allegations of fictitious deposit accounts and a forged guarantee in the *Flanagan* case.

Chitty on the subject of legally objectionable features to a contract states: -[139]

> "Legally objectionable features unknown to one party.
>
> It follows from what has been said that if the performance of a contract necessarily and to the knowledge of the Plaintiff involves or has as its object the commission by one or both parties of an act known to be legally objectionable, the Plaintiff cannot sue on the contract. This is so irrespective of the state of knowledge of the Defendant."

> "Illegality may affect a contract in a number of ways but it is traditional to distinguish between (1) illegality as to formation and (2) illegality as to performance. Broadly speaking, the first refers to the situation where the contract itself is illegal at the time it was formed. Whereas the latter involves a contract, which on its face, is legal but which is performed in a manner, which is illegal. In this latter situation it is possible for either both or only one of the parties to intend a legal performance. Where a contract is illegal, as formed, or it is intended that it should be performed in a legally prohibited manner, the Courts will not enforce the contract, or provide any other remedies arising out of the contract. The benefit of the public, and not the advantage of the Defendant, being the principle in which a contract may be impeached on account of such illegality, the objection may be taken by either of the parties to the contract. 'The principle of public policy' said Lord Mansfield 'is this: *ex dolo malo non oritur action*. No Court will lend its aid to a man who founds his cause of action upon an immoral or illegal act. If, from the Plaintiff's own stating or otherwise, the cause of action appears to arise *ex turpi causa* or, the transgression of a positive law of this country, there the Court says he has no right to be assisted. It is upon that ground the Court goes: not for the sake of the Defendant, but because they will not lend their aid to such a Plaintiff. So if the Plaintiff and the Defendant were to change sides, and the Defendant were to bring his action against the Plaintiff, the latter would then have the advantage of it; for where both are equally at fault, *potior est conditio defendentis*."

It remains to be seen whether or not the Defendants will be able to make out such a

[139] See Chitty, J., *Chitty on Contracts,* 'General Principles' (Sweet & Maxwell, 27th ed., para. 16/07).

defence at the full hearing.[140]

Other commentators have also underlined the point: -[141]

> "Banks and other persons who lend money should note that money lent for an illegal purpose is not recoverable. In *Anthony v. Shay*, the Circuit Court held that money knowingly lent for the purpose of gaming was irrecoverable. Similarly, where the lender of money exceeds its statutory restriction on lending, loans made exceeding such limits may not be recovered by lawful action. In *Irvine v. Teague*, the Plaintiff exceeded its statutory power of being permitted to lend £10.00 to a borrower. It was held that the loan being contrary to statute could not be recovered and the mortgage given as security could not be enforced. There may however, be circumstances where an unauthorised loan is not necessarily illegal and irrecoverable."

In mortgage litigation too, illegal or deceitful behaviour has met with traditional disapproval from the Courts usually where banks were the victims of fraudulent or double mortgaging or concealment of encumbrances. Relief has been sought and granted traditionally and indeed recently in this jurisdiction. Therefore, where banks themselves have engaged in such behaviour borrowers should be afforded an opportunity to avoid

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[140] The Summary Judgment Motion was adjourned to plenary hearing with the Plaintiff Bank failing to get Judgment. It is expected to be heard in early 2011.

[141] See Johnston, William, *Banking and Security Law in Irelan*d (Butterworths, 1998) at 1.22; *Anthony v. Shay* (1951) 86 I.L.T.R. 29; *Irvine v. Teague* (1898) 32 I.L.T.R. 109.

the contract.[142]

As can be seen from the above, Irish litigants both in an attempt to resist banks rushing to judgment and, as Plaintiffs, are beginning to push for relief for loss caused by reckless lending practices whilst the Courts have correctly identified the lack of any specific tort. Nevertheless, in line with the American experience, the issue is being addressed in the context of laws already in existence. Further development is inevitable.

Ideas For Reform

The South African Experience

It is surprising to find that a relatively new society such as modern South Africa has an Act known as the National Credit Act, 2005, which among other aims includes aims of: -[143]

(i) To promote responsible credit granting;

(ii) To prohibit reckless credit granting;

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[142] *Rimmer v. Webster* [1902] 2 CH.163 where the owner of a property was refused relief against a fraudulent broker because a Deed entered into had acknowledged that the broker had paid the price of the property when no money had been paid and the Plaintiff had acknowledged payment wrongly. The Court found that he was estopped from asserting his title in the circumstances. See also Maddox, Neil, *Mortgages: Law and Practice* (Thomson Round Hall, 2007) at 3/24 – 2/24. For a discussion on other potential illegalities which may afflict a mortgage contract, see 'Restraint of Trade and Other Potential Illegalities' at 4/24. In the notorious case of Michael Lynn, numerous banks scrambled for position after his multiple mortgaging of properties came to light. See for instance, 'Lynn Sandymount Home Will Be Sold', (28 January 2008) available at http://www.rte.ie/business/2008/0128/solicitor.html. Also the recent case of *McAleenan v. AIG* [2010] IEHC 128, [2010] 5 JIC 0601 is a spin off from the double mortgaging of Lynn. Finlay Geoghegan J. held that the plaintiff in the proposal forms signed for professional indemnity insurance had misrepresented to the defendant that she had the status of partner in the practice and she ought to have been aware of the obligations to give full and accurate disclosure. She had made untrue statements in the form. She had no intention to deceive the defendant as to her status in the firm. The misrepresentation was a material one and the defendant had discharged the onus of establishing that the misstatement as made recklessly, giving the defendants grounds to avoid the policy.

[143] Act No. 34, 2005 signed into law on the 10th March 2006.

(iii) To provide for debt reorganisation in cases of over-indebtedness;

(iv) To prohibit certain unfair credit and credit marketing practices.

Section 3 sets out the purposes of the Act, which includes promotion of responsibility in the credit market, i.e. –

(i) Encouraging responsible borrowing, avoidance of over indebtedness and fulfilment of financial obligations by consumers;

(ii) Discouraging reckless credit granting by credit providers on contractual default by consumers; and

(iii) Promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers.

The even-handed approach and recognition that both parties to a loan have responsibilities is impressive. The Act has a wide application to credit agreements with monetary limits as set from time to time by the Minister.[144] Credit agreements are divided into small, intermediate and large agreements with mortgage agreements falling in the latter category.[145] Large agreements appear to be excluded from the application of the National Credit Act as followed by the introduction of the National Credit

[144] See Section 7 (1) of the National Credit Act, 2005.

[145] See Section 9 of the National Credit Act, 2005.

Regulations introduced on the 31st May 2006.[146]

The Act is the subject of a detailed analysis by Goodwin-Groen and Kelly-Louw.[147] They point out that credit is deemed to have been lent recklessly if: -

> "(i) The credit provider took no steps to assess the proposed consumer's general understanding and appreciation of the risks and costs of the proposed credit agreement and his rights and obligations under the agreement; his debt repayment history for credit; existing financial means, prospects and obligations (i.e. assessment whether a consumer can make the repayments); and whether there is a reasonable basis to conclude that any commercial purpose may prove to be successful, if the consumer has such a purpose for applying for the credit; or
>
> (ii) After conducting an assessment, the credit provider still entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that the consumer did not generally understand or appreciate his risks, costs or obligations under the proposed credit agreement; or if entering into that credit agreement would make the consumer over-indebted (see Section 81, read with Section 81(2) of the National Credit Act)."

The Act also contains a Section providing for the removal of the record of debt adjustment or judgment.[148] Part (d) of the Act from Section 78 to 88 provides for over-indebtedness and reckless credit allowing a Court to suspend reckless credit agreements

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[146] Regulation Gazette No. 8477 of 489.

[147] Kelly-Louw, Professor M. and Goodwin-Groen, R.P., 'Regulations in the Context of Access to Finance in South Africa' available at http://www.amfisa.org.za/downloads/finmark%20trust%20paper%20on%20NCR.pdf. See also http://www.theNCT.org.za/acts/theact-test/actindex.

[148] See Section 71 of the National Credit Act, 2005 available at http://www.theNCT.org.za/acts/regulations%20NC-202006.pdf.

and declare and relieve over-indebtedness as well as powers for the Magistrates Court to rearrange the obligations of the consumer.

It seems to the writer that the provisions of the Act and, in particular, Section 80 (1) (b) (ii), which deems credit reckless if granting that credit would make the consumer over-indebted, would transplant well to this jurisdiction. Of course, this does not solve the problem of what to do with all the historic debt unless an Act was to have retrospective effect. It seems unjust to attach the stigma of bankruptcy to the borrower while granting Judgment to the lender who lent when he either knew or ought to have known that the borrower was not in a position to repay or where no stress testing took place. The Act requires the borrower to have made a full and truthful answer to any requests for information by the credit provider. If the borrower is not truthful, this is a full Defence to any allegation of reckless lending.[149] The National Consumer Tribunal conducts the analysis and hears the cases under the Act. The suspension of reckless credit agreements means that all of the consumer's rights and obligations under the agreement are set aside.[150]

The Court then has power to restructure in accordance with the consumer's means and his ability to pay current financial obligations.[151] The suspended agreement can be later revived but only insofar as any amendment by the Court then applies, which are otherwise fully enforceable.[152]

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[149] See Section 82 (3) of the National Credit Act, 2005.

[150] See Section 83 (2) of the National Credit Act, 2005.

[151] See Section 83 (4) of the National Credit Act, 2005.

[152] See Section 84 of the National Credit Act, 2005.

Whittaker examines the South African experience in its context as a developing society.[153] However, just because a European society might be more sophisticated does not necessarily mean the goals of such an Act should be dramatically different. In a recent address, the Chairman of NAMA referred to the psychologist, Irving Janis in the context of the Irish bubble noting factors no doubt common to folly everywhere: -[154]

> "Janis was fascinated by the ways in which groups that were comprised of otherwise intelligent, well-meaning and moral individuals could make decisions that turned out to be unintelligent and have unfortunate consequences. In 1972 he coined the term 'group think' to describe the conditions under which this happened and noted a range of symptoms of this process. Among these he included: -

- The illusion of invulnerability that creates excessive optimism, makes people ignore obvious dangers and encourages excessive risk taking;
- Unquestioning belief and the inherent morality of the group that inclines people to ignore the ethical or moral consequences of their decisions;
- A collective rationalisation in which people discount warnings that challenge the group consensus;
- Self censorship, by which doubts and deviations from the perceived group consensus are not expressed or tolerated;
- Stereotyping those opposed to the group as weak, biased, impotent or stupid;

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[153] 'South Africa's National Credit Act: A Possible Model for the Proper Role of Interest Rate Ceilings from Micro Finance', Whittaker, Megan, *North Western Journal of International Law & Business,* (Spring 2008, Vol. 28, Issue 3) at 561-582.

[154] Addressed by Frank Daly, Chairman of the National Assets Management Agency at the Association of Compliance Officers Annual Dinner (27 May 2010) available at www.nama.ie.

- Direct pressure to conform placed on any member who questions the group in terms of disloyalty."

The South African Act also ensures that in assessing whether credit is granted there must be a consideration of whether credit being granted to a consumer is being made recklessly. Furthermore, retailers are required to undertake extensive checks on the state of a consumer's finances before offering credit. An exhaustive financial means test also has to be carried out.

Towards Reform in Ireland

The Law Reform Commission are currently considering reform of the law in the area of personal debt management and debt enforcement.[155] A final report is expected later this year. Regrettably, the Commission's focus does not seem to be on the area of responsible lending although some reference has been made to same in terms of credit reporting.[156] The proposed reform of the bankruptcy area currently under review would, if implemented, force credit institutions to be more responsible about their lending as they would be stripped of the current draconian powers. The reduction in time for discharge from the current twelve years to at least six years would be an important step in allowing debtors to rehabilitate.[157] The Commission criticised the philosophy behind the 1988 Bankruptcy Act as a creditor's enforcement mechanism of last resort rather than the

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[155] See Law Reform Commission Interim Report on Personal Debt Management and Debt Enforcement, LRC 96/2010 available at www.lawreform.ie.

[156] See Law Reform Commission Consultation Paper on Personal Debt Management and Debt Enforcement, (22 September 2009) available at www.lawreform.ie.

[157] The Minister for Justice at the launch of the recent report on the 17th May 2010 indicated a personal view that it should be much lower.

view prevailing in other legal systems of a personal insolvency laws tool for the social rehabilitation and economic recovery of debtors.[158] Whilst noting that Ireland is in breach of its commitments under the Council of Europe's *Recommendation of the Committee of Ministers to member states and legal solutions to debt problems*.[159] The Commission concluded: -

> "The Commission therefore recommended a comprehensive reform of Irish personal insolvency law, composed overall of a judicial bankruptcy law and the introduction of a new parallel non-judicial debt settlement system."

The issue is to be revisited in the final report for the Commission.[160] The restriction of the draconian sanction of imprisonment in line with the recent *McCann* decision will also hopefully have a positive effect on lending standards.[161] The Commission have recommended reform of the credit reporting system in Ireland and made many other interesting suggestions, however the focus seems to be on dealing with the mess rather than seeking to advance matters to private liability.[162]

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[158] See Law Reform Commission Interim Report on Personal Debt Management and Debt Enforcement, LRC 96/2010 at p. 62. Also available at www.lawreform.ie.

[159] Council of Europe, CM/REC (2007) 8, 2007.

[160] See Ford, Michael and Simms, Daniel, *Bankruptcy Law*, (Round Hall, Thomson Reuters, 2009).

[161] *McCann v. The Judge of Monaghan District Court & Ors*. [2009], I.E. H.C. 276; [2010] I.L.R.M. 17.

[162] See Law Reform Commission Interim Report on Personal Debt Management and Debt Enforcement, LRC 96/2010 at p. 43.

EU Proposals For Consumer Credit Harmonisation

Proposals were made to the House of Lords enquiry in relation to the European Consumer Credit Directive Proposal calling for the need to balance market harmonisation with measures to prevent over-indebtedness and to enshrine the principle of responsible lending within the Directive and calling for more debate.[163] The European Directive on credit agreements with consumers, Directive 2008/48/EC of the 23rd April 2008, repealed the earlier Council Directive of 1987/102/EEC.[164] Market harmonisation is the main motivation behind the Directive. Article 2 expressly excludes mortgages and therefore, this Directive is ill equipped to deal with the challenges now facing member states. The requirements for pre-contractual information are comprehensive and does include at Article 8 an obligation to assess the credit worthiness of the consumer. This is with a view to establishing the consumer's credit history before any significant increase in the total amount of credit and provision is made for a central database. Chapter 3 of the Directive has extensive provisions on database access on a cross-border basis. This is with a view to assessing creditworthiness of consumers.

Member states were given until the 12th May 2010 to adopt and publish the provisions necessary to comply with the Directive. It is to be noted that Recital 26 of the Directive provides, *inter alia*,

> "In the expanding credit market, in particular, it is important that creditors should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness and the member

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[163] See http://www.publication.parliament.uk/pa/ld200506/ldselect/ldeucom/37/37we05.htm.

[164] OJ L 133, 22.5.2008, at 66–92 available at http://www.eur/lex.europa.eu/lexuriserv/lexuriserv.do?uri=oj:l:2008:133:0066:0092:en:pdf. Credit agreements involving a total amount of credit of less than €200 or more than €75,000 are also excluded.

> states should carry out the necessary supervision to avoid such behaviour and should determine the necessary means to sanction creditors in the event of their doing so. Without prejudice to the credit risk provisions of Directive, 2006/48/EC of the European Parliament and of the Council of the 14th June 2006 relating to the taking up and pursuit of the business of credit institutions, creditors should bear the responsibility of checking individually the creditworthiness of the consumer. To that end, they should be allowed to use information provided by the consumer not only during the preparation of the credit agreement in question, but also during a longstanding commercial relationship. The member state authorities could also give appropriate instructions and guidelines to creditors. Consumers should also act with prudence and respect their contractual obligations."

Therefore, the Directive may be of some assistance in respect of consumer reckless lending. The writer still cannot understand the need to exclude mortgage holders from such provisions given the manner in which the mortgage market grew in this jurisdiction and others, particularly from 2004 onwards. In many cases it also represented the consolidation of several consumer loans. Article 8 of the Directive, whilst requiring an assessment of creditworthiness, avoids the terminology of responsible lending. Overall and whilst accepting one is not comparing like with like, the Directive compares poorly with the South African legislation.

Unfair Contract Terms Directive

Interestingly and in an admirable advance, which may well assist stressed mortgagors, the European Court of Justice in the *Pannon GSM* case found that a national Court is required to examine of its own motion, the unfairness of a contractual term where it has available to it the legal and factual elements necessary for that task.[165]

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[165] *Pannon GSM ZRT v. Erzsébet Sustikné Gyorfi*, Case 243/08 available at http://eur-lex.europa.eu/lexuriserv/lexuriserv.do?uri=celex:62008j0243:en:ht. See also European Commission Legal Service Summary of the Judgment at http://ec.europa.eu/dgs/legal_service/arrets/08c243_en.pdf. See also European Court Reports, 2009 at I-04713.

Where it considers such a term to be unfair, it must not apply it, except if the consumer opposes that non-application. The Court also found that the duty was incumbent on the national Court when it is ascertaining its own territorial jurisdiction. This decision could have far-reaching consequences in the reckless lending area. In particular, it appears that each national Court is now obliged to consider the applicability or otherwise of the unfair contract term Directive. It is clear that the regulations, as applicable in Ireland, present considerable scope for seeking to avoid liability for consumer loans and potentially housing loans to consumers.[166] The central theme of the Regulations is that a term will be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance on the parties' rights and obligations under the contract to the detriment of the consumer, taking into account the nature of the goods or services for which the contract was concluded and all circumstances attending the conclusion of the contract and all other terms of the contract or of another contract on which it is dependent.

Housing Loans

The whole area of housing loans has seen a significant reform recently under the Land and Conveyancing Reform Act, 2009. This could become significant where loans, which were not genuinely housing loans were labelled as such.[167] Under the new regime the Circuit Court has exclusive jurisdiction in respect of housing loans.[168] In addition to these reforms, quasi legal protections exist for housing loan borrowers under the

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[166] The Directive was implemented in Ireland by Statutory Instrument No. 27 of 1995, European Communities (Unfair Terms in Consumer Contracts) Regulations, 1995.

[167] See for instance *Flynn v. Irish Nationwide Building Society*, Lavan J. (Unreported, High Court, 31 July 1995) where a loan was extended for the rebuilding of a cottage set among a village crafts centre and was held not to amount to a housing loan.

[168] Land and Conveyancing Reform Act, 2009, Section 101(5).

Consumer Protection Code issued in August 2006 by the Financial Services Regulator.[169]

The Code specifically provides that a lender shall not act recklessly, negligently or deliberately mislead a customer and also imposes a duty to act with due skill, care and diligence in the best interest of the customers as well as a duty to act honestly, fairly and professionally in the best interest of customers and the integrity of the market.[170]

While scope exists both for the use of existing doctrines, regulations and laws to meet the current situation caused by reckless lending nevertheless a comprehensive legislative reform package to deal with the entire housing and consumer lending sector is urgently required. Piecemeal reform and ingenuity in pleading can only go so far.

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[169] The Consumer Protection Code, which was issued in August 2006 and implemented in July 2007 available at http://www.complianceireland.com/documents/consumerprotectioncodeclarifications-9jul071.pdf.

[170] See Kenna, Padraic, *Housing Law, Rights and Policy*, (Dublin, Clarus Press, 2010) at Chapter 6.

CHAPTER 4

CONCLUSION

Not unusually, the law is left to catch up with events, only this time those events were global and catastrophic. Banks who were supposed to be sophisticated and unsinkable have sunk to the fiscal floor. Others bob along helpless and adrift waiting for sovereign rescue teams and winch men. However, as the rescue progresses these maimed giants have sought to use legal processes to arrest their dramatic slide. This paper has had the advantage and disadvantage of recording what is still a live show. The causes of the banking collapse are becoming clearer across jurisdictions and in Ireland it remains to be seen whether any criminal or civil liability will be imposed on bank directors. This writer considers it unlikely and even if this were to occur, all the signs indicate a lack of assets to meet any judgment. Therefore, the plight of individual borrowers when faced with the might of banks in commercial and other litigation has been the focus of the latter part of this paper. Irish Courts, in the absence of legislation, have so far shown a distinct lack of appetite for extending tort to meet the circumstances. Questions arise too about whether any banking governance lessons have really been learned at all. Significant conflict issues have arisen with regard to the operation of NAMA and Anglo, which is now very arguably an emanation of the State and amenable to judicial review.[171]

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[171] *Flanagan & Others V. Anglo Irish Bank*, Ex tempore High Court (26 July 2010), Peart J. See also expressed views of the NAMA chairman's address to Association of Compliance Officers on the alleged impossibility of avoiding conflicts of interest and the need instead to manage them (27 May 2010) available at http://www.nama.ie. On the issue of legals and other service providers, Mr. Daly said "The question of potential conflicts of interest among service providers is also one that has received some comment. The guiding principle here has also been one of disclosure. Under Section 45 of the Act, NAMA must seek to ensure that expert advisers and service providers make every effort to avoid or manage conflicts of interest and to declare any potential or actual conflicts to NAMA. In the case of legal firms or property valuers, for instance, they have been required to declare in advance the institutions and borrowers for whom they have carried out work in the past. This information is used by NAMA to allocate workload so that conflicts can be effectively managed."

The trend therefore in Ireland and abroad, in the absence of such legislation, seems to be to resort to existing contractual defences such as fraud, mistake, illegality, public policy, duress, lack of capacity, undue influence and unconscionability[172] Although our Commercial Court has shown little enthusiasm for elements of these defences, nevertheless, distinct defence opportunities exist.[173] It is also undoubtedly the case that a gulf is emerging between the jurisprudence of the Commercial Court and the Supreme Court on the availability of summary judgment, which is the current weapon of choice. The Supreme Court, per Denham J. in the case of *Danske Banke v. Durkan New Homes*[174] have reiterated the earlier dicta of Hardiman J. in *Aer Rianta v. Ryanair*[175] reminding the Commercial Court that unless it is 'very clear', such an application should not be acceded to. The interests of justice test and the implied constitutional issue of access to the courts has also been underlined in that decision.[176] Indeed, Finlay Geoghegan J. in the recent *Anglo v. Flanagan and Others* case expressed the view in refusing summary judgment that a gap was appearing between the Commercial Court and the Supreme Court jurisprudence on this important issue.[177] Therefore, while the Courts

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[172] See *Prendergast v. Joyce & Ors* [2009] I.R. 519 where Gilligan J held in setting aside improvident banking transactions of an elderly lady, that a banking official who had a financial interest in effecting the impugned transactions, could not supply the donor with independent advice necessary for rebutting the presumption of undue influence.

[173] In the recent *Mansfield* case where Commercial Court rejected Mr. Mansfield Junior's protestations that he had the reading ability of a child available at http://www.irishtimes.ie. A defence of unconscionability and undue influence was traditionally used in banking contracts and in some cases successfully. See *James v. Kerr* (1889) 40 C.H.D. 449 where a young and impoverished heir to an estate entered into a mortgage transaction with a solicitor to secure funds. While there was no question of fraud, the Court found that some of the terms were voidable as an undue advantage where the parties were not on equal terms. For a more detailed discussion, see Maddox, Neil, *Mortgages: Law and Practice* at 4/20 – 4/23.

[174] [2010] I.E.S.C. 22.

[175] [2001] 4 I.R. 607 at 623.

[176] *Ibid.*

[177] Ex tempore High Court (26 July 2010), Peart J.

cannot and should not invent a basis for liability of banks for reckless lending where none exists, other opportunities are ripe for defendants. It is expected that the banking enquiry now imminent will in due course uncover material, which will be of significant use to defendants. The question is certainly open as to whether a defendant with a stateable fraud or illegality defence ought to be entitled to delay a hearing until such time as that material is available either through discovery or by way of detailed final report.[178] Surely a Defendant who makes such a defence on reasonable grounds ought to be entitled to full access by way of discovery, third party or otherwise, to all material which might tend to assist him, as a matter of justice.

The emerging arguments on the contractual defence of illegality and public policy as argued for in the *Flanagan* case could yet be of some significance.[179] The flouting of Basel requirements cannot be brushed over as a simple matter of the banks prudently avoiding penalties when in fact what seems to have been the motivation was to avoid mandatory reporting requirements and penalties under the Directive.[180] The approach of the neighbouring Commercial Court in the *Lemenda* case[181] and relying on the earlier decision of *Montefiori v. Menday Motor Components*[182] correctly identifies the core issue

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[178] See 'Veteran of Finland's Financial Crisis To Lead Banking Inquiry', *Irish Times* (9 July 2010) available at http://www.irishtimes.com/newspaper/frontpage/2010/0709/1224274349869.html.

[179] Ex tempore High Court (23 July 2010), Finlay Geoghegan J.

[180] Directive 2006/48/EC of the European Parliament and of the Council (14 June 2006). The Directive has since come into force in Ireland by virtue of Statutory Instrument No. 661 of 2006 with the vast majority of the Directive coming into force on the 1st January 2007 - OJ L 177, 30.6.2006 at 1–200.

[181] [1988] 1 A.L.L. E.R. 513. (Commercial Court). See also *Westacre Investments Inc. v. Jugoimport* [1999] 3 WLR 811, [2000] QB 288.

[182] [1918] 2 K.B. 241 at 245.

being whether the acts contemplated in the performance of the contract tend to be injurious to public policy. It is no longer necessary in this jurisdiction or, indeed many others, to explain the injurious nature of acts designed to disguise or hide the capital inadequacy of financial institutions.

The ability of defendants to assert such defences on the basis of circumstances of reckless and illegal lending will necessarily and in large measure be a matter of fact and degree. It is this proposition that will, as the picture becomes clearer, establish a closer and more effective link between the first and second part of this paper. In short, if the conduct of the banks and their executives is confirmed by inquiry and/or in private litigation as being as base and quasi fraudulent as one suspects then the Courts may become a very cold house indeed. In the absence of legislative reform the Courts will, on the existing contractual doctrines, have little option, if not inclination, but to grant relief to defendants in certain cases not for their sake but in the interests of public policy and the common good.[183] However, the policy orientation of the Irish Superior Courts should not be underestimated. Meanwhile, unfortunate borrowers with no such factual features are left defenceless with no appropriate legislation where lending might have been reckless but otherwise unimpeachable. As if that were not enough they must also wait in the insolvency tube for a slow reform train while others make good their escape.[184] The American approach of using private liability to supplement regulatory enforcement has significant attractions both in terms of deterrence and cost.[185] Whether private risk for

[183] [1988] 1 A.L.L. E.R. 513.

[184] See Law Reform Commission Interim Report on Personal Debt Management and Debt Enforcement, LRC 96/2010 available at www.lawreform.ie.

[185] See Jackson, Howell, 'Variation In The Intensity Of Financial Regulation: Preliminary Evidence and Potential Implications', E. 24, *Yale Law Journal* (2007), Reg. 253 at 264.

the non compliant should be limited to impediments to recovery when difficulty arises or through straightforward civil liability, is open to debate.

The feasibility of maintaining such divergence in regulatory approach in the European jurisdictions is in significant doubt in a new regulatory order. Neither is *de jure* convergence sufficient but rather some effort must be made to reach *de facto* convergence, not only in Europe but globally as economic earthquakes recognise no borders.[186] There must be a place for more streamlined private regulatory infrastructure to supplement reforms now happening on the public side.[187] This should be based on comprehensive and careful legislation to allow the private sector use private liability to punish irresponsible and illegal activity in the financial sector in addition to the crafting of a more comprehensive and equitable shield rooted in contract law.

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[186] See Jackson, Howell, 'Variation In The Intensity Of Financial Regulation: Preliminary Evidence and Potential Implications', E. 24, *Yale Law Journal* (2007), Reg. 253 at 287.

[187] See Central Bank Reform Bill, 2010, No. 12 of 2010 and note the objectives in the title, "an Act to establish the Central Bank of Ireland as a single fully integrated structure with a unitary board – the Central Bank Commission – replacing the Boards of the Central Bank and Irish Financial Services Regulatory Authority; to enhance the system of regulatory control and to confer additional powers on the Central Bank, the Governor and the Head of Financial Regulation to prevent potential serious damage to the financial system in the State, support the stability of that system and to protect users of financial services; to transfer certain functions of the Central Bank to the National Consumer Agency; to amend the enactments relating to the Central Bank and certain other Acts consequential on that reorganisation; to amend the law relating to the regulation of lending by credit unions; to extend the range of persons who can be authorised to investigate the affairs of an insurer; and to provide for related matters." See also recent commentary on the changes in structure in Irish Regulation by David Went available at http://www.financialregulator.ie/…structural%20reform%20of%20financial%20regulation%20in%20. It is considered that the recommendations of David Went reflect the grudging acceptance of change by a chastised industry. Not surprisingly no ideas for private liability are canvassed.
See article 'Irish Regulatory Reform: Central Bank Outlines Radical Overhaul of Financial Regulation' (21 June 2010). "The Central Bank outlined in June 2010 a radical overhaul of financial regulation with a new Central Bank as a unitary organisation with responsibility for both regulation and oversight of banking in Ireland: at an individual institutional level ('micro prudential') and at a system-wide financial stability level ('macro prudential'). The need for a credible threat of enforcement has been outlined." - available at www.finfacts.ie/irishfinancenews/article_1019968.shtml.