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Joint Committee Hearing – Initial Statement on the ”Nyberg Report” 17.12.2014

Mr. Chairman, Members of the Joint Committee,

Tasks of the Commission

I'm pleased to have been invited to assist the Joint Committee by clarifying the work and report of the Banking Commission which finished some 3½ years ago. The Commission worked strictly as mandated by the Commission of Investigations Act 2004 and by the Commission of Investigation (Banking Sector) Order 2010 containing its Terms of Reference.

This has some implications for today's hearing:

- For instance, I have no other documentation available than the published report to assist me in answering Members' questions. All documents used were securely deposited according with the Act when the Commission was dissolved and have not been available to me since. I will do my best but I hope the Chairman will keep this constraint in mind, as well as the years which have elapsed since my work was completed
- The Terms of Reference in the Commission Order were quite explicit in specifying the tasks of the investigation. Summarizing, the main tasks were to examine
    - the main causes of the serious failures within the covered banks that led to the need for public support;
    - the main causes for the failures of the Financial Supervisor, the Central Bank and the Department of Finance to properly discharge their duty to prevent bank problems; and
    - whether the external auditors commented on the failures in the banks.
- Special attention should be given to Board and senior management implementation of policies and practices leading to financial distress.
- The time period of interest was specified as January 1, 2003 to January 15, 2009.

As an independent outsider I was struck by the many similarities between the causes of the Irish crisis and earlier crises elsewhere including Finland. Investigations in the US, UK and IMF on the causes of the present crisis tend to confirm these similarities.

I understand that not all commentators in Ireland were fully satisfied with the contents of the report. Nevertheless, it represents my independent and objective assessment at the time of what happened. Having had reason to once again review the report, my assessment remains unchanged.

Working assumptions and methods

The Commission’s work was in essence about ”the why” of the Irish crisis, and not ”the who”. Consistent with its governing legislation and Terms of Reference, the Commission was not required to name names and decided from the beginning not to do so. The reasons were straightforward:

- Useful information and co-operation were much easier to get when reputations were not simultaneously under publication threat.
- Legal challenges were much easier to avoid.
- The risk of redactions to the report were minimized.
- Responsibility for mistakes was already obvious:
    - directors and staff are responsible for decisions they are empowered to make (the names of directors and senior management are listed in the published annual accounts);
    - heads of institutions are responsible for how the institution fulfills its mandate alone or in

    cooperation with others;
    - each person is responsible for both what they do and what they leave undone;
    - borrowers are responsible for the debt and risks they voluntarily take on.

This approach speeded up the work, improved the quality of information, reduced costs, and made it possible to stay within the required time limit and budget.

Previous scoping reports were used as useful background material as much as possible to reduce the need for duplicate efforts.. The Commission's work included dealing with issues which the previous reports were not mandated to do:

- Forensic study of individual decisions and events in the institutions mentioned in the Terms of Reference, particularly those which were known to have caused problems.
- Exploration of why all the existing private sector and public-sector mechanisms to mitigate risk failed at roughly the same time in Ireland. These simultaneous sector-wide failures are a necessary precondition for the systemic crisis which happened in Ireland.

My work required not only access to documentation; but also discussions with representatives of the institutions about the events leading up to the documented decisions.

I was aware that broadly similar reviews had already been carried out or were in progress in several other countries, notably the UK, the US and Iceland, as well as in the IMF. Iceland was, of course, in a very different position than Ireland as it controlled its own currency and bank balances relative to the economy were very much larger than in Ireland.

Banks, external auditors as well as public-sector bodies were requested to provide access to the Commission to a large array of possibly relevant internal documents:

- teams of Commission investigators visited these institutions to identify relevant documents;
- when necessary, they clarified document contents and existing procedures through technical discussions with staff;
- identified documentation was copied to the Commission's secure data system for closer inspection and used as source for producing the report;
- via this work approach, I was able to assess and draw conclusions from a very large volume of data for my report.

At the same time the Commission requested formal but confidential interviews with decision makers of the bodies being investigated. The interviews had two primary aims:

- to broadly verify the preliminary conclusions reached on the basis of the documentation;
- to understand why risk assessment and processes, broadly defined, had failed and how governing bodies in practice had functioned or malfunctioned.

Particular attention was given to the extent and quality of deliberations by decision makers, adherence to and control of agreed internal procedures and to any presence of voiced contrary opinions or doubts. No issues where criminal investigations were ongoing or to be expected were considered.

The final report:

- contains the results of these interviews in a general format to allow the informants to remain anonymous as promised;
- does not contain easily repetitious individual examples of, for instance, lending processes gone bad for individual loans in various banks;
- instead, does include such observations in the form of more generalized conclusions, valid for many or even all the banks which were subject to my report.

As Anglo and Nationwide had been previously identified as having more serious and numerous problems than the other banks, they are often discussed separately as also mandated by the Terms of Reference.

A different Commission Order, a more lengthy timetable and fewer legal constraints might, of course, have allowed a different approach. It would also probably have been more expensive. It nevertheless remains unclear to me whether this would have produced an essentially different view of the main causes of the Irish crisis.

Observations that could be particularly relevant for the the Joint Committee investigation include the following:

- Responsibility for the crisis must be very widely allocated and any investigation should thus be wide-ranging:
    - a systemic banking crisis can arise only when a large number of risk mitigating functions in many institutions have become weakened;
    - for instance, assigning blame primarily to lenders tends to ignore the fact that a bad loan also implies that the borrower's risk assessment turned out to be wrong.
    - pleas to avoid such responsibility by referring to surprises or external shocks or to not having been told, are irrelevant. Unexpected and difficult situations are part of the deal of being a boss.

- The Irish crisis was essentially the result of the sudden deflation of a widespread domestic real estate bubble implying that domestic policies, decisions and processes should remain central:
    - this mania was not a unique phenomenon and can be compared to recent developments in the US and Spain as well as in Scandinavia in the 1990's.
    - the triggering factor was a tightening of liquidity originating in the US market which affected Irish banks particularly through
        - dependence on market financing;
        - over-concentration of extensive amounts of lending to the real estate and related sectors.

- Even in the absence of the US crisis as a trigger, it is unlikely that the domestic Irish bubble episode would have ended well (in other words, it is unlikely that the hoped for "soft landing" would have been the outcome):
    - over the long duration of the pre-crisis phase, governance, lending criteria, internal oversight and risk management processes gradually weakened in almost all covered banks to make room for faster growth and higher profits;
    - the business models of Anglo and Nationwide remained unchanged until the very end, they were even looked on by investors and commentators as examples to be followed and other banks showed clear tendencies to emulate them;
    - trust in bank solvency and the viability of their business models continued right up to the moment of crisis;
    - little public-sector activity to rein in the mania was discernible until after the US crisis in 2007;
    - whether the Irish crisis then would have been more or less costly is not easy to assess.

- While a number of doubters and contrarians could be identified in banks and public authorities, they were very few and had little effect on decisions which remains somewhat of a conundrum:
    - this may have been a result of the long boom eroding both the confidence and credibility of critics;
    - internal willingness to seriously consider alternative or contrarian scenarios was very low both in banks and within public authorities;
    - persisent doubts were judged to pose risks to further employment, remuneration and professional reputations;
    - it appears this was true also in other countries and in international bodies and not a unique Irish feature of the crisis.

- There appears to have been a global consensus view that financial markets are stable and efficient to which also Irish private and public-sector decision makers adhered:

    - this belief, amounting to group-think, may partly explain the simultaneous occurrence of risky bank behavior and passivity of public supervisors and central banks;
    - increasing competition among banks and public cooperation across borders tended to spread the consensus because diverging policies created short-term costs;
    - importantly, these tendencies were not challenged by international organisations, academics, media or consultants and were in the EU hailed as proof of the success of financial integration.

- The rapid expansion in borrowing and bank lending provided temporary benefits to many, which may have contributed to the general lack of action:
    - the Government benefited greatly from taxes and fees directly and indirectly generated by the real estate boom;
    - many companies and ordinary people also benefited through higher remuneration, public expenditure or services earnings;
    - such benefits may have contributed to the unwillingness to address or reduce the increasingly risky business models of the banks (both in Ireland and elsewhere);
    - the common beliefs referred to earlier made large scale and rapid credit growth seem the norm while the related imprudence seemed vibrant and dynamic.

- There seems to have been fairly little outright criminality in the run-up to the Irish crisis:
    - the excessive risks taken, and the subsequent losses, appear to have been the result of ignorance or lack of understanding;
    - this corresponds to experiences elsewhere (as well as to the experiences from Finland in the 1990s);
    - decision makers who were interviewed appeared shocked and surprised by the onset and nature of the problems;
    - many financial professionals appear to have believed in their own strategies and views which in many cases resulted in large personal financial and reputational costs. Many such professionals had borrowed heavily from banks to invest in property directly or via bank-organized funds.

- Problems were not created by a lack of regulation or supervisory powers but by inability or unwillingness to notice or prevent growing financial risks:
    - people tended to see only what they were looking for and what the overall consensus view determined as relevant;
    - private and public-sector institutions agreed that only banks were able to appropriately judge the validity of their own business model and decisions;
    - the general belief in light-touch regulation meant that even when risks were identified, corrective action was mild and protracted;
    - particularly in Ireland, cooperation between the Financial Supervisor and the Central Bank was weak, making it difficult to combine observations of weak bank governance with those of unusual strong credit growth;
    - the likely ”dampening” effect on the economomy of strong public action may have reduced the willingness of public-sector authorities to rein in the credit boom (this is a personal guess and is not supported by clear documentary or interview evidence).

- External auditors did not have a sufficient mitigating effect on banks' risk management in Ireland (same as in other countries):
    - later identified problems did not figure prominently in auditors' communications to bank leadership or the public;
    - some banks had received clean audit statements less than a year before having to be rescued by public intervention;
    - overall, external bank-specialist auditors were no better or worse than other professionals who ideally all should have known better, both in Ireland and in other countries where the same large international auditing firms audited banks.

- The decision of the Government to guarantee most liabilities of Irish-owned banks on September 29, 2008 is not surrounded by a lot of documentation. This willingness to guarantee the banks' liabilities appears consistent with a lack of serious concern by public authorities about the solvency of Irish banks at that point in time:

  - it seems to have been based on the belief that the Irish banks were solvent and their liquidity problems therefore were temporary;
  - this view had been and up to then was supported by the Financial Regulator and the Central Bank and a few months later by the PwC;
  - the Government did not have access to alternative credible systemic risk assessments which would have required long preparation (should have started before the US crisis);
  - since problems of this severity had not been foreseen there were no detailed contingency plans or preparations available;
  - time pressure was considerable since orderly market conditions had to be ensured when banks opened.

- Given this situation the Commission does understand that the Government saw no workable alternative to the guarantee (which in the immediate aftermath was in fact viewed as a success by the Government). This does not imply that it was objectively the best decision possible under any set of circumstances. However, a decision had to be made with only the knowledge and preparations available at the time; and had to be made fast.

Issues not included in the Commission Order but which could, in my personal view, be useful for a further evaluation of the causes of the crises:

- Closer scrutiny of the role of some other major contributors to the real estate mania that gripped Irish society for some years before the crisis could prove illuminating:
  - many of them are referred to only in passing in the Commission report;
  - such contributors included:
    - other banks not needing Irish public support (i.e. those foreign-owned banks that received overseas Government support via their parent banks);
    - real estate market actors, including appraisers;
    - the media;
    - academic economists;
    - financial advisers, including strategy advisers to the Irish banks;
    - political institutions like political parties and the Parliament.

- Evaluating how future contrarian thinkers and analysts could be listened to inside their work places better than before:
  - such persons were at the time not considered credible by their peers and supervisors, particularly as the long duration of the boom appeared to render their concerns as incorrect;
  - they were occasionally subject to direct or indirect sanctioning;
  - still, they often maintained their contrary views;
  - any evaluation should take into account that all contrary views do not turn out to be as spectacularly right as in this instance.

- Assessing why historical and foreign experiences were not sufficiently incorporated in prudential planning and practice:
  - an appreciable number of countries outside Ireland also contained banks that proved to be less robust than lenders or domestic authorities assumed;
  - since the 1980's there have been several systemic banking crises in developed countries despite simultaneous comprehensive regulation and often well resourced supervisory structures;
  - clearly this was, for unclear reasons, not fully taken into account before the crisis by the banks themselves nor, in particular, by external bank-specialist auditors, and by the public authorities tasked with regulating and supervising this key industry.

- Assessing whether the Commission conclusion is valid, that the problem was the lack of implementation of existing regulations, and assessing the implications of this:
  - it seems difficult to argue that the series of crises in recent decades and in several countries are the result of insufficient regulation or too few resources provided to supervisors;
  - the Irish financial crisis was not caused by a blow up in derivatives or other complex financial instruments, but was a credit-induced property bubble and burst with many overseas precedents,
  - rather, it appears that the problem may be a widespread tendency to, repeatedly, gradually weaken implementation of existing regulations (including for example Ireland's historic sector concentration lending guidelines);
  - if this is so, there are three main alternative remedies:
    - stressing simple lending limits and substantially higher solvency requirements rather than quite complicated risk modeling techniques;
    - markedly reducing the size of banks relative to Government budgets/the size of national economies, and
    - stringently enforcing bail-in rather than bail-out crisis resolution regimes.

Thank you for your patience. If there are any questions to be answered, I will do my best.