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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉIREACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 28 Eanáir 2015

Wednesday, 28 January 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D'Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O'Keeffe.
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

Context Phase

Professor Edward Kane

Chairman: I welcome Professor Edward Kane to the meeting. He managed to escape from the United States of America notwithstanding the inclement weather.

Professor Edward Kane: I did. I went through San Francisco which is a lot safer in the winter.

Chairman: We hope we can guarantee the professor's safety here this morning also.

Senator Sean D. Barrett: Nobody needs an excuse to go to San Francisco.

Professor Edward Kane: Unfortunately, I did not go to San Francisco, just through it.

Chairman: With members' agreement, I now bring the Joint Committee of Inquiry into the Banking Crisis into public session. We commence this morning with public hearings with Professor Edward Kane of Boston College on banking and banking regulation. I welcome everyone to the sixth public hearing of the joint committee. We will hear from Professor Kane on banking and bank regulation. Professor Kane is very welcome before the committee this morning.

Professor Edward J. Kane is a professor of finance at Boston College and holds a PhD from the Massachusetts Institute of Technology. Professor Kane's specific research areas include financial crisis management, deposit insurance, causes and implications of financial change and the changing structure of financial services competition and regulation. Currently, he consults with the World Bank and is a senior fellow in the Federal Deposit Insurance Corporation's Centre for Financial Research. Previously, Professor Kane has consulted for the IMF, components of the Federal Reserve system and three foreign central banks. As well as authoring three books, he has published widely in professional journals and currently serves on six editorial boards. The expression "zombie bank" to describe a bank which is insolvent but is kept alive through government assistance, was first used by Professor Kane in an academic paper published in 1987.

Before we begin, I advise the witness that by virtue of section 17(2)(*l*) of the Defamation Act 2009, he is protected by absolute privilege in respect of his evidence to this committee. However, if he is directed by the committee to cease giving evidence on a particular matter and continues to so do, he will be entitled thereafter only to qualified privilege in respect of his evidence. He is directed that only evidence connected with the subject matter of these proceedings is to be given and - as he has been informed previously - witnesses are asked to refrain from discussing named individuals in this phase of the inquiry. Members are reminded of the longstanding ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the Houses or an official either by name or in such a way as to make him or her identifiable.

I again welcome Professor Kane and invite him to make his opening remarks.

Professor Edward Kane: I thank the Chairman. I appreciate being invited here today and I congratulate the committee for trying to get to the bottom of what made this financial crisis so severe, in Ireland in particular, but also in other countries. It is an honour to have a chance to help the committee in this work.

My testimony is built around the idea that financial markets resemble roads. These roads are used simultaneously by individuals and businesses and their purpose is to allow ordinary citizens and corporations to create wealth and divide it up. Banking is regulated for the same reason as road traffic, which is where the power of this metaphor comes from. One issue is to co-ordinate potentially chaotic activity. Members can imagine how hard it would be to cross a city like Dublin if we did not have street lights and stop signs. There is also the need to make all drivers behave more safely.

In banking supervision, norms that foster deception and abuse of the public trust have become embedded in banks' and regulators' organisational structures. It might help if I take a minute to explain how people think about organisational culture in sociology. The most widely cited model suggests that every organisation has a mission and set of goals and then has a set of visible procedures, buildings, staff and equipment that are presumably devoted to those goals. However, the third thing an organisation has is a bunch of unobserved norms of behaviour regarding what one has to do to get ahead in the organisation and what is expected of those within it. These norms often conflict seriously with the goals and mission. I will try to develop that idea as I go along.

The banking crisis occurred because bankers routinely abused the financial rules of the road without suffering meaningful personal penalties. Why is that? It is because of these norms. The heart of the problem is professional ethics in banking and in regulatory agencies. If systems for supervising traffic flows were as distorted and as elitist and slow to respond as those for supervising banks in Europe and the US, ordinary citizens would be afraid to venture out of their homes.

The central problem is straightforward. Safety nets encourage unhealthy relationships between banks and their regulators and distort the incentives of both groups. In good times and in bad, regulatory and banking cultures encourage their countries' largest banks to take on too high a risk of ruin. We call this "tail risk", thinking of the probability of the distribution of outcomes. People take risks in banking all the time, but to risk the ruin of their firm is something one would think they would not ordinarily be eager to do. The way the safety net subsidises risk-taking, it only pays off if we are taking tail risks.

Financial accounting systems fail to identify and record the economic value these incentives transfer from taxpayers to stockholders and banks. I propose two straightforward solutions. First, regulators must explicitly measure and manage the cost of safety net guarantees. Currently, they do not calculate it and certainly do not manage it. Second, regulators should impose a series of graduated penalties on individuals who violate important rules of the road. In the United States and in Europe, most of the penalties have been focused on the corporations. Fines have been charged, which penalise shareholders, but not much has been done about the individuals who put the bank at risk. These two steps would help force too big to fail, TBTF, banks to internalise the costs of safety net guarantees and would negate the elitist norms that continue to corrupt the culture of regulation in the US and Europe. These solutions come from a handful of propositions from lessons we have learned from the most recent crises around the world.

The first point is that safety nets can and often do cause financial instability. To stop this, society needs to make the extraction of these subsidies to risk taking a source of disdain rather than pride. Currently, bankers pride themselves on this kind of abuse of the safety net. However, this will not happen until regulators and supervisors strip out from reported profit flows the embedded value of the taxpayer credit support a too big to fail bank receives. So, if one is a manager of a too big to fail bank and one increases the tail risk, when one takes that risk, the increasing value of the stock price will increase one's compensation and make one appear a wonderful manager. However, when one takes long shot risks, the odds are that some of them will turn sour.

Although analysts agree that regulators should control systemic risk, most definitions of systemic risk leave out the role that regulators' propensity to assist troubled and insolvent firms rather than to resolve their insolvency plays in generating it. One of the norms that conflict with the goal of financial stability is the norm of helpfulness. It leads policy makers to act as cheerleaders for innovative forms of contracting. There is also a norm of mercy, where if an institution gets in trouble, there is a presumption that it happened through bad luck, rather than through deliberate and aggressive risk taking. Banks are given the benefit of the doubt about their solvency, until it is too amply demonstrated. The deference these norms create encourages incentive conflict within the supervisory culture. That is to say, an examiner may find a lot of problems with a bank, but as this is reported up the line, the regulatory officials will often ask the examiners to use softer words and to find ways of painting the thing. This ties to the norm of "non-escalation". Regulators are very afraid they will be accused of escalating a bad situation and instead try to cover it up. This essentially leads to the idea that it is alright to deceive, as long as one's heart is in the right place. This kind of deception allows more of this tail risk to be taken and increases the bill that ultimately must be paid.

Fragility is rooted in conflicted incentives. Dangerous incentives could be reduced if safety net subsidies were measured conscientiously and compensation schemes paid managers and taxpayers in better ways. Although officials claim otherwise, it is no accident that they repeatedly fail to foresee the emergence of crisis pressures and that they respond to them in elitist fashion, helping the banks at the expense of taxpayers. These conflicts lead to regulatory capture and that expands implicit and explicit government guarantees that become part of the equity funding structure of any bank that is too big to fail.

It is important to rethink this point, and I will mention this again and again in my testimony. It is wrong to think of bailout funds as loans or insurance payments. I will say this again and again. They are loss absorbing equity, but they are very badly structured. The taxpayer cannot sell his position. He cannot hedge it. The taxpayer is coerced into this position. It is not a voluntary action and his position has unlimited losses. If the regulators never close these firms, there are unlimited losses, whereas ordinary stockholders have limited liability. There are several other issues, but we do not need to go into them as the committee can already see how bad it is the way we have structured the incentives for government to protect. What I think is that we should think of it as a trust fund for taxpayers that is invested in this barely structured equity contracts in banking organisations. Contingent taxpayer support deserves to be recognised as an equity claim. I am not saying it is recognised as an equity claim, but it deserves to be recognised as such. Parliaments around Europe and Congress of the United States ought to address this so that in company law and in financial accounting, we recognise taxpayers as having an ongoing position in any firm that is *de facto* too big to fail.

The rest of my statement develops this point. Financial safety nets coerce taxpayers into these positions and taxpayers should receive legal protections parallel to those that explicit shareholders enjoy, particularly minority shareholders. Essentially, we as taxpayers are minority shareholders in too big to fail banking organisations in our country and we are being abused. The formal establishment of this position, of owners' equity, leads to thinking of the too big to fail institutions as creating a portfolio of trust funds in which taxpayers are forced to invest. This casts regulators as trustees and creates, automatically, a different view of what their goals should be. The formal establishment of such trusteeships would lead officials to judge regulatory performance in terms of effects on the value of taxpayers' equity position. These positions can be valued using what we call "contingent claim analysis". This would also require regulators in protected institutions to rework their norms, information systems and incentive frameworks to support this effort. This is a big change in the duties of regulators and of top managers and officials of too big to fail firms.

The lesson is clear on these conflicts of interest. Governments need to do two things. They need to rethink the informational obligations that insured financial institutions and their regulators owe to taxpayers as *de facto* equity investors and change the way that information and industry balance sheets and risk exposures are reported, verified and used by supervisors. Lots of information is collected on industry balance sheets, but not enough on risk exposures. It is not reported publicly or verified, or it is only verified by periodic examination, and is not used by supervisors in the most effective way for taxpayers. Without these reforms of the practical duties imposed on industry and government officials and the way these duties are enforced, financial safety nets will continue to expand and their expansion will undermine financial stability.

The last lesson I want to get across concerns the nature of guarantees. Guarantees are misunderstood, even by some of the top economists in the world. They have a two-part structure. The main idea of a guarantee is to allow the guaranteed party to put responsibility for covering losses that exceed the value of the assets the bank owns to the government that guarantees it. However, the put is not the whole contract. No guarantor wants to voluntarily expose itself to unlimited losses, which happens if one writes only the put. For this reason, all guaranteed contracts incorporate a stop loss provision that gives the guarantor a call on the assets of the firm. When we talk about closing an insolvent bank, it is a call on the assets of the firm. Ordinarily, the stop loss kicks in just as insolvency is approached or breached. However in the US, efforts to exercise the Government's call are termed "prompt corrective action". In the US and Europe, we did not see much timely corrective action for "too big to fail", TBTF, institutions during the great financial crisis. The policy actions we did see have helped the world's TBTF banks to become bigger and more politically powerful than before. It is a perverse result.

With the helpfulness and mercy norms, the Government's call on the assets could not be exercised. Guarantees then shift risk losses away from creditors and stockholders. It is as if these TBTF banks have a flow of profits that goes through a pipeline with a Y junction in it. Insolvency exists when the institution is unable to cover its debts from its own resources, but when a TBTF firm such as AIB becomes insolvent, a political switch is thrown that channels further losses to the taxpayers until and unless the firm manages to recover solvency. Deeply insolvent institutions are zombie institutions. They can operate only because they are backed by the black magic of implicit government guarantees. A government does not need to come forward and announce that it guarantees the bank. The fact that it leaves the bank open, that the bank has a safety net and political power, leads creditors in this and other countries to lend to the bank. This passive policy of forbearance allows the institutions to roll over and even expand their debts, which the private markets without the guarantees would never allow.

In the US, the American Insurance Group, AIG, case closely parallels what has happened with AIB here, except that it was never nationalised. In the lead up to the crisis moments, the company underwent a long-term decline on the stock market but bounced around depending on whether or not there was serious consideration being given to nationalising the institution. A graph included in my presentation shows that the stock price never got to zero. Much of the value of the firm during the crisis months of 2008 and 2009 came from the Government guarantee. The equity claim from the taxpayers had very little upside but continued to have a great deal of downside.

Another figure from some work I have done with Armen Hovakimian and Luc Laeven shows the value of the quarterly dividend the US taxpayer ought to have been paid by large banking firms between 1974 and 2010. While the value of this dividend shows a cyclical pattern, it is most instructive to look across cycles. With each cycle from 1974 onwards the value of this unpaid dividend to taxpayers increased. My fear is that this is still going on, that people are still figuring out how better to fleece taxpayers, unless we do something to reverse it. I have already sketched my solutions and will sketch them further. We should be able to see the same patterns in the Irish scene and I fear that greater and more dangerous subsidy flows will reveal themselves in the next crisis. We will have crises, and while I hope we will have a few years of respite, a lot of clouds are gathering in Europe today.

It is important to understand the difference between guarantees, insurance and loan contracts because each of them imposes different ethical duties. Insurance around the world does not protect so much the insurance company but the insured. It allows the insured to take additional risks because they have insurance. This is called moral hazard. In a loan contract, one expects to be repaid and this is the difference between insurance and the bailout. An insurance company does not redouble the coverage of drivers who have revealed themselves to act as recklessly as the TBTF firms did during the last economic boom, especially after they have had the losses. Similarly, lifelines provided to an underwater firm cannot be thought of as low-interest loans because nobody will lend even a nickel to firms that are in zombie condition.

To solve this problem, something must be done to sanction the reckless pursuit of subsidies by TBTF firms. Exhortations and promises are not enough. The type of sanctions I would propose are outlined in the last part of my statement. The key point is to recognise the deliberate exploitation of TBTF guarantees as a form of criminal theft and develop ways to punish individuals who engage in it directly and higher officials who encourage it without pulling the trigger.

The way we frame problems is critically important in policy making. Although it is not true today, in the future legal systems must make it crystal clear that recklessly increasing a guaranteed firm's risk of ruin is a form of theft. I am not saying it is a form of theft *de jure* but *de facto*. Whether it is *de jure* theft depends on the laws of a country. The theft is from what I call the taxpayer trust fund. The taxpayer has stocks that should be managed by government officials as trustees. Rules of the financial game must acknowledge that it is wrong for individual managers to adopt these ruinous risks and wilfully conceal and abuse taxpayers' equity stake. Such behaviour deserves to be sanctioned explicitly by corporate and criminal law and not excused by insurance law as if it were inevitable moral hazard.

Banking supervisors have let society down in two ways. First, they did not set up the equivalent of the most modern radar systems and helicopter surveillance to track excessive speed and aggressive driving. Second, they did not develop a penalty structure to punish unruly behaviour in a meaningful and timely fashion. Effective regulation and supervision must establish disincentives that can dissuade bankers who are tempted to drive at perilous speeds and undertake dangerous manoeuvres. While we have incentives, we also need disincentives so they know they will be punished. Today, they are very confident they will not be punished. The analogy between regulating banks and regulating vehicular traffic suggests that, country by country, the penalty structure and burdens of proof in cases of safety net theft could be designed to parallel those used in traffic courts. Here and in the US, we already have administrative procedures for enforcing regulatory findings whose jurisdictions resemble those of traffic courts. Most of these schemes combine fines for minor violations, a points system which hikes the penalty for repeated and more serious violations and procedures for transferring particularly consequential cases such as vehicular homicide or extreme drunken driving to ordinary criminal and civil courts. No matter what regulators finally do with their traditional tools, such as capital and liquidity requirements, if they do not set up sanctions which punish individuals for acts of wilful or complicit safety net theft, we are bound to get more wrongdoing in the future. There is great value in prosecuting violators in open court. The public needs to understand how much managers benefit when the burdens of the corporate fines and admissions they negotiate serve principally to punish shareholders instead of naming and sanctioning individual managers.

I thank those present for listening and look forward to any questions.

Chairman: I thank Professor Kane for his opening comments. The order of members engaging today will be Deputy Michael McGrath leading with 15 minutes, followed by Deputy Eoghan Murphy for 15 minutes, and then, in six minute slots, Senator Seán D. Barrett, Deputy Kieran O'Donnell, Senator Marc MacSharry, Senator Susan O'Keeffe, Deputy Joe O'Higgins, Deputy Pearse Doherty, Deputy John Paul Phelan and Senator Michael D'Arcy.

I will deal briefly with a couple of matters before I invite Deputy McGrath to speak. Professor Kane suggests in his broader paper that £157 billion sterling has been paid in fines levied between 2008 and 2013. Is it Professor Kane's proposal to the committee this morning that fines of this magnitude will continue if a more stringent and more determined regulatory structure is not put in place?

Professor Edward Kane: No. The whole idea is to stop the behaviour, not to collect money. This is part of the incentive conflict. In the US, we collect a lot of money, especially from foreign banks. The US Government welcomes this. Also, it does not necessarily stay with the agencies so that they can get stronger and do a better job. The whole purpose of a disincentive is to stop the behaviour.

Chairman: As opposed to an income rating scheme.

Professor Edward Kane: Yes.

Chairman: These proceedings are broadcast live and members of the public will not be as familiar with financial discourse as are witnesses such as Professor Kane. Therefore, could he describe to the inquiry what is meant by equity capital in banking terms and what is meant by capital adequacy requirements?

Professor Edward Kane: Equity capital is ownership capital and it is capital that can absorb losses immediately without any manipulations. Without raising additional money, it is there. It is the owner stake. The taxpayers have been made owners by the norms of the financial safety net management.

The Chairman's other question was about capital requirements. Equity capital is *de facto* the amount of resources that owners have supplied, including or not including taxpayers, depending on how one wants to break it down. Capital requirements are looking to stockholder capital. This is capital that has been put up by stockholders. These are measured by accounting principles and rules. There are three sets of accounting rules that allow troubled banks to hide the losses that should go through to their capital. One has to do with itemisation rules. They might not itemise, for instance, loans that are going sour and that everyone in the bank knows are worth, say, 50 cent, 25 cent or 10 cent in the dollar. They keep them at par by accounting manipulation. As far as capital requirements are concerned, it looks fine, even though, from an economic point of view, it is a lot of losses. Another has to do with when one realises losses - which is very closely related to this - or realises gains. A troubled bank tends to bring its gains - its good results - forward and to push the recognition of the losses into the future. Finally, the values they assign will also be biased, if they are troubled banks, to try to overstate the values of things, that is to use touchstones that overstate it. The problem is that by the time the violation in what you want capital requirements to capture is identified and a firm is recognised by accountants as insolvent, it has been deeply insolvent for a long time. The incentives to take these end-game gambles, to go for broke, just loads more losses, on average, on the taxpayer, even though some of these firms win their bets.

Chairman: In his research paper, Professor Kane stressed how the amount of equity capital recorded on a bank's balance sheet is not necessarily a good indicator of its health. Professor Kane indicates this in his most recent comment. In a recent paper of his, he states that the idea that capital requirements can serve as a stabilisation tool is based on the presumption that, other things being equal, the strength of an institution's hold on economic solvency can be adequately approximated to the size of a capital position and that this way of crunching the numbers, as shown on a firm's balance sheet, seems simple and reliable, but it is neither. Can Professor Kane expand on this? Is he saying the balance sheet of a bank is not a great indicator of its health?

Professor Edward Kane: That is right. The issue is that all these rules or principles for recognition, itemisation and valuation which I was talking about are discretionary. If a firm is strong, it may not engage in any exploitation of these loopholes. However, if it is a troubled firm, it will and, in many cases, it will push it beyond the legal limits of what can be done to hide losses and it will turn out to be a criminal representation or fraud.

Chairman: In terms of gate-keeping, one gate-keeping measure is the role of auditors and, particularly so, external auditors. What role would Professor Kane assign to external auditors when considering his opinion that equity capital accounting systems are not simple or reliable?

Professor Edward Kane: Unless auditors also try to audit and establish the value of the taxpayers' position, they are not doing the whole job. All of these tricks, when there is a troubled firm, transfer losses to taxpayers. This transfer should be measured. Auditors have not yet come to grips with this view of potential taxpayer bailouts providing equity. However, if one thinks of it as equity, auditors have to change their job and information systems have to change to adapt to this.

Deputy Michael McGrath: I welcome warmly Professor Kane and thank him for making the effort to come and see us and share his expertise with us. I will try to keep my questioning within the confines of his opening remarks and the areas he has set out, but I do need to ask him how familiar he is with the Irish banking crisis.

Professor Edward Kane: Only a little bit. I am not a student of the banking crisis in Ireland.

Deputy Michael McGrath: Professor Kane is broadly aware-----

Professor Edward Kane: I am broadly aware that, say, Allied Irish Banks had made a number of speculative loans in real estate, in particular, and had received a lot of financing from foreign creditors.

Deputy Michael McGrath: There is no point in any of us going into questions with Professor Kane about the Irish banking crisis *per se*. It is more the broader issues-----

Professor Edward Kane: I understand what I was asked to address was why banks are regulated, what the consequences are of this, how this leads to crisis, and what we can do to improve incentives going forward.

Deputy Michael McGrath: It was important to clarify this. Professor Kane made an interesting remark which was that by the time accountants report a firm as being insolvent, the firm has been insolvent for a very long time. Can he explain what he means by this? Does it come down to the recognition of an asset value and if the asset is impaired? Is it because of the accounting standards that there is a significant delay in making a provision for that asset or is it due to the lax application of standards by professional firms?

Professor Edward Kane: It is more a matter of the incentive for the manager to hide losses. It is not as if auditors can see anything. When a bank makes thousands of loans, the auditor can only sample them. In sampling them, it is in the interest of the bank to make it difficult for the auditor to find the loans with the biggest losses. They can take the files out of the bank for a while, if they are clever enough. That would, of course, be fraud but if it cannot be proved it might be worth the risk to keep their jobs going for another year.

Deputy Michael McGrath: One of the issues we will be examining is the question which arose in 2008 of solvency versus liquidity in the banks in Ireland. The balance sheets at the time were clearly reporting that the banks were solvent but the question arises of whether adequate provision was made against potential losses or impairments in respect of the assets on the balance sheets. Professor Kane spoke about the incentive to prevent too much recognition of potential losses. Is that an issue of accounting standards or of auditors not having sufficient information or knowledge of the detailed composition of the bank's assets?

Professor Edward Kane: In many cases these are not potential losses, they are actual losses. If one tried to sell these assets in the marketplace and the other side did due diligence, one would immediately mark them down. The question arises of how one can hide information, soft information in particular, from the auditors. One may know that the firm is in grave trouble but the auditors may not have sufficient information to allow them to determine that. The basic problem pertains to the regulatory culture. Banks that have trouble turning over their debt or raising new stock are always going to claim it is due to a problem of liquidity. Somehow the markets are drying up and people are not ready to invest. However, this is also a good indication of insolvency. The culture has the attitude of giving the banks the benefit of the doubt. If they say it is just a liquidity problem, supervisors will let them ride with that for a while even though the bankers know it is an insolvency problem. They will take action to restore their insolvency, which means taking more risks.

Deputy Michael McGrath: One of the central points that Professor Kane made is that there is an implicit safety net for banks. They know, if they get into trouble and are too big to fail, that the State will come to their rescue. Does he think that was a real consideration in the lead-up of the crisis in the back of the minds of executives running large and systemically important institutions around the world? Does he believe they might have been taking risks they knew they should not be taking but the backdrop of the safety net allowed them to proceed?

Professor Edward Kane: That is my position. It is not that they should not have been doing it. If their only responsibility was to their explicit shareholders, they would be doing their duty by maximising the value of the stock. However, that is a defective ethical norm when tax payers are standing by with a guarantee. The norm of profit maximisation in these too big to fail firms around the world is misconceived.

Deputy Michael McGrath: Is the lesson that we should not allow firms to become too big to fail or is it that we should regulate them differently?

Professor Edward Kane: There are two ways of doing it. If there is great economic value in being big, one would have to say that it is wasteful to break them up. However, if the only value in being as big as they have become is a better ability to exploit the taxpayer, then breaking them up is a good solution. My approach would finesse the problem because if one establishes duties to taxpayers, one will not see the same kind of behaviour. It would not be rewarded or even regarded as clever. It would be perceived as criminal behaviour.

Deputy Michael McGrath: Professor Kane is not necessarily saying institutions should not be allowed to become too big to fail.

Professor Edward Kane: I have to stop the Deputy there. I do not want them to be too big to fail. We should be able to fail them. It is preferable, however, to change the incentive structure so they do not take the risk of ruin and bringing us to deep crisis.

Deputy Michael McGrath: Is it Professor Kane's view that by 2008 some institutions had become too big to fail across Europe and the US?

Professor Edward Kane: Absolutely. They were too big to fail because of these regulatory norms. From the little I know about the Irish case, AIB clearly was deserving of nationalisation a long time before it happened. If one considers the guarantee as including a call on the assets of the firm, it was in the taxpayer's interest to call that position earlier.

Deputy Michael McGrath: Does Professor Kane wish to express a view on Anglo Irish Bank?

Professor Edward Kane: I just did.

Deputy Michael McGrath: I apologise, he was referring to Anglo Irish Bank.

Chairman: Professor Kane was referring to AIB not Anglo Irish Bank.

Deputy Kieran O'Donnell: When he referred to "AIB" did he mean Anglo Irish Bank or Allied Irish Bank?

Professor Edward Kane: Anglo Irish Bank, I think.

Deputy Michael McGrath: When Professor Kane said "AIB" he was referring to Anglo Irish Bank, is that correct?

Professor Edward Kane: Yes, I think so.

Deputy Michael McGrath: Just so we are clear for the record.

Professor Edward Kane: Members have confused me. I thought that was the name of the bank.

Deputy Michael McGrath: We get confused ourselves. Professor Kane suggested two ways of dealing with the issue of banks that are too big to fail. The first is that one strips out from the reported profit flows some measure of the benefit of being too big to fail in terms of an implicit safety net or guarantee.

Professor Edward Kane: Get rid of the safety net. Even if a bank is literally too big to fail, it might still get a benefit from the State.

Deputy Michael McGrath: How does one measure that benefit?

Professor Edward Kane: It can be measured using the option pricing theory. There are two options, and the value is the difference between the two.

Deputy Michael McGrath: Professor Kane was strong on the issue of penalties and punishment in his opening statement.

Professor Edward Kane: Yes.

Deputy Michael McGrath: We cannot deal with the area of criminal law but I ask him about regulatory breaches. Where clear breaches are identified by the regulator what kind of penalties should be imposed on the institutions and individuals concerned, depending on the severity of the offence?

Professor Edward Kane: Let us take the individuals first because ultimately it is individuals who do these things. That is where the point system analogy works well. One clocks the fact that people have violated these rules and one assesses some cumulative measure of violation. If people violate too often, they are banned for various periods. That is how the system of driver licensing operates. If a driver gets seven points, for example, his or her licence is suspended for six months and if he or she is reckless enough the licence is eventually taken away forever. We would identify people working in the industry who are outlaws in some sense and we would decide these are not the kind of people we need in banks.

Deputy Michael McGrath: Professor Kane is suggesting such people should not be allowed to hold senior positions in institutions.

Professor Edward Kane: Or positions in banking at all.

Deputy Michael McGrath: Did that happen in the US?

Professor Edward Kane: Yes. People were banned after the savings and loan mess of many years ago. That issue was resolved in 1989 and a number of criminal prosecutions were eventually brought, as well as the penalty of being banned.

Deputy Michael McGrath: Does he think there is reluctance in Europe and the US to address that issue properly by imposing sufficient sanctions where breaches are identified?

Professor Edward Kane: This is why I say the system is elitist. It treats bankers as some kind of high priest and gives them the idea that they have been punished enough by the embarrassment of leading a firm to failure. They may have a great pension, lots of property and a portfolio of stock but we cannot take that away because they have already been shamed enough. However, we cannot take that away because they have already been ashamed enough. It is not just about shame. It is a matter of redress.

Deputy Michael McGrath: Does Professor Kane believe the lessons have been learned from the crisis?

Professor Edward Kane: I do not. I always like to draw the distinction between information and disinformation. There is a lot of disinformation, no matter what one tries to say to clarify the matter. Some say it was all just bad luck, some ask who could have guessed that all this building in Ireland would turn out to be so shoddy or how could we guess the people who were borrowing 120% of the value of their homes would not be able to pay back the debt. Of course we can guess that.

We see ourselves moving more and more back to high-leverage loans on real estate. Real estate values fluctuate a great deal. Sure, there will be periods when they go up, and then they will collapse. Banks have to make loans prudently in terms of whether the people who are borrowing have the money to be able to support the loan. People bought more houses than they could afford and borrowed more money than the house was worth. The value of the house went down and they were lost.

Deputy Michael McGrath: Is it an offence in US law to manage a bank recklessly?

Professor Edward Kane: It is a regulatory offence but I do not think it is a criminal offence. This has to do with what we call a negligence standard. There can be gross negligence. How do we define "reckless"?

Deputy Michael McGrath: Did the US Administration make the right decision, in Professor Kane's view, in allowing Lehman Brothers to collapse in September 2008?

Professor Edward Kane: The committee should look at the Lehman decision by itself. Preceding it was the rescue of Fannie Mae and Freddie Mac, vast government-sponsored mortgage lending enterprises. Then, two days after the Government let Lehman go into bankruptcy, it rescued American International Group, AIG, which was not even covered formally by the safety net. I call that a double U-turn in policy. It was extremely upsetting to the public in that it suggested the officials did not know what they were doing at that critical time.

Chairman: I will bring in Deputy Murphy presently. Professor Kane, by your estimation, how many too-big-to-fail banks exist at present? How many of them are located in Europe and the US?

Professor Edward Kane: You probably know that there is something called a G-SIFI, a globally significant financial institution. These are designated and there are approximately 28 or 29 of them. It is a little misleading to treat too-big-to-fail as if it is an on-off condition. Institutions try to make it harder for them to fail politically, economically and administratively. A firm can be made more complex such that it scares would-be regulators from taking it over. Clearly, the top ten US banks are too big to fail.

Deputy Eoghan Murphy: I thank Professor Kane for joining us today. Let us consider his opening statement, the paper he provided to us and some of his work. Much of it is directed towards how we incentivise banks to take less risk or how to reduce the public's exposure to the risks they take. In the US is there such a concept as public interest directors on the boards of banks?

Professor Edward Kane: I do not think there is any requirement to have public interest directors on the boards of banks in the US.

Deputy Eoghan Murphy: Professor Kane is not aware of it existing as a role in any of the banks. Is that the case?

Professor Edward Kane: No, the idea is that the supervisory system is supposed to protect the public. The board is constructed for the stockholders and the stockholders vote.

Deputy Eoghan Murphy: Given his knowledge of banking and how the board structure works in bank, does Professor Kane believe that, as a concept, it is possible to have someone with a dual obligation on the board of a bank? Can such a person have responsibility to the shareholders and also to the public?

Professor Edward Kane: The government-sponsored enterprises, Fannie Mae and Freddie Mac, had such public directors but the way in which they were chosen involved a lot of patronage. There was a lot of political influence, potentially, exerted on them.

Deputy Eoghan Murphy: Does Professor Kane know whether they had a formal reporting role to the US Government when they were on those boards? How did they-----

Professor Edward Kane: Did they report separately as independent directors? Is that the question?

Deputy Eoghan Murphy: Yes.

Professor Edward Kane: I do not know that they had any separate obligations. They were supposed to join the board and represent the public interest rather than being appointed by the top management of the firms.

Deputy Eoghan Murphy: Was there any public knowledge of how they discharged their duties as public interest directors?

Professor Edward Kane: I do not think they specified that their duties were any different from those of any other director. They did not have that obligation. Although, one would think that a board member who was a public interest trustee would feel the conflict if something was being done that was against the public interest. The danger of expressing such conflict at board-----

Chairman: I wish to make an intervention for a moment. These Houses examined the role of public interest directors some years ago at the finance committee. There is no such thing in Irish law, whatever about US law, as a public interest director. The State can appoint someone to a bank in the title of a public interest director, but under the law and the Companies Act that person, as a director, owes his fiduciary duties to the institution not the State.

Professor Edward Kane: That is right. That is my understanding. It is the idea that since they are appointed in the same way they would not feel the obligation to the management to keep them actively reappointed.

Deputy Eoghan Murphy: Was it simply a US Government public relations exercise? How does Professor Kane view the concept being applied or put in place? Is it simply a PR exercise on the part of the US Government?

Professor Edward Kane: I was on a board of a big pension fund for 12 years. I was elected from the beneficiaries. It was basically for college employees. For a while we had a separate track to being on the board. I could see the difference between the people that the managers had appointed and how they dealt with, shall we say, messy situations and how those of us who came out of the other appointment process dealt with them. Again, once a person is on the board, he is on the board. There is no distinction as an active board member in the duties.

Deputy Eoghan Murphy: I want to look at Professor Kane's work on blanket guarantees. When a government institutes a blanket guarantee I suppose it implies that all the covered institutions that come under it are too big to fail. Hence, the government steps in with the guarantee. At that point, Professor Kane is right in that the institution in question is already too big. When there is a systemic crisis with a number of banks, what is the alternative to a blanket guarantee?

Professor Edward Kane: We have to begin somewhere. At some point a government has to clean up the mess. I try to distinguish three elements: the crisis, the restructuring and the aftermath. The trouble with blanket guarantees is that they give away a lot of resources at the start and very much constrain what can be done in the later restructuring phase and in the aftermath. I believe that it makes sense to call for a banking holiday of a short period to sort out which are the really insolvent banks. The idea is to take them over temporarily, stop their loss-making and sell them back to the private sector as they are restructured.

The trouble with these various mercy and helpfulness norms is that we let institutions get so far under water that by the time we step in to restructure them or give blanket guarantees, the size of the problem is daunting. It is necessary that we find ways of uncovering these problems earlier. Again, by re-orienting what auditors would have to do and how taxpayers would be treated, we will lessen the chance that many institutions will get into this problem.

Deputy Eoghan Murphy: When Professor Kane speaks of giving away too many resources too early, is he referring to taxpayers' money?

Professor Edward Kane: Yes.

Deputy Eoghan Murphy: Professor Kane spoke of a banking holiday. Will he elaborate on that comment?

Professor Edward Kane: "Holiday" is one of these funny words because it is not a celebratory period or anything. It is the idea that one shuts the bank - the troubled institution - for a few days and sends in valuation experts to get an idea of how deeply insolvent it is.

Deputy Eoghan Murphy: Shutting a bank for a few days would mean there would be no access to its funds.

Professor Edward Kane: That is right.

Deputy Eoghan Murphy: If the crisis is systemic, no one would have access to funds in any of the banks.

Professor Edward Kane: Again, we are talking about what is a systemic crisis. To my mind, a systemic crisis would start well before one gets to the point at which all of the banks would have trouble raising funds. Again, it is the ignoring of the expansion of taxpayers' responsibilities until these responsibilities are sensed in the market to be so big that they test the system. The regulators then feel the problem is that there are too many institutions to deal with it in a reasonable period of time. We should track better what is going on and figure out a taxpayers' stake.

Another idea, which is not in my statement but features in some of my work, is that if we were to establish a formal trusteeship at the very big institutions that are going to be hard to fail, we would give that trusteeship the right to issue treasury stock, with "treasury" meaning "of the corporation". This would dilute shareholders and change very much the incentives of managers and shareholders to tolerate this kind of risk-taking. Risk-taking, as it now stands, is in the interests of shareholders until things go sour. When things go sour the smart shareholders should sell. I am not bragging about this because I did not sell all of my Bank of America stock. However, I sold one third of it at a price of around $50 per share. The price later fell to €3. In my case, the too-big-to-fail proposition worked out all right, although not great.

Deputy Eoghan Murphy: On that point, Professor Kane spoke of tracking better earlier in the context of regulation. In his opening statement, he used the analogy of having helicopter tracking on the road system. Clearly, our regulatory system is not sophisticated enough. Is that what Professor Kane is saying?

Professor Edward Kane: Yes, I am saying it is not sophisticated enough in that it does not recognise the value of guarantees or make an effort to track what is going on with the missing element of the balance sheet, namely, the value of government support. This is not a problem for very small institutions but as institutions get larger and larger, it starts to become a problem and at some point it becomes almost absolute.

Deputy Eoghan Murphy: In Professor Kane's view, it is not only a question of infrastructure but a cultural problem and problem of behavioural norms.

Professor Edward Kane: That is a huge part of the problem but the more general problem is recognition that taxpayers have a position. To take Bank of America, which I know a lot about, it was the biggest bank in the United States at one point. It made a terrible acquisition of a firm called Countrywide that had been making mortgages that were almost insane. Bank of America added this very troubled firm to its position. The only way to justify this is to argue that Bank of America made itself even harder to fail because it was now even messier for authorities to jump in and try to pull everything apart and put it back together again. Did I answer the Deputy's question?

Deputy Eoghan Murphy: In his opening statement, Professor Kane spoke of coming to a better understanding of "how thoroughly behavioural norms that foster deception and abuse of the public trust are embedded in banks' and regulators' organisational cultures." He paints a damning picture of how the banks and regulators view the public.

Professor Edward Kane: Yes, I do so because banks and regulators are not forced to recognise the value of the support, quarter by quarter, that taxpayers provide. This is only recognised when we have this disastrous situation when it is suddenly recognised all at once. The problem then seems too big to do anything about other than, as the Deputy stated, provide blanket guarantees. However, anything that is blanket or without conditions makes no sense. One must impose conditions whatever one does. For example, one can require that a bank cannot grow any more or make new loans or certain types of new loans for a while. The idea of stepping in and guaranteeing everything just worsens the incentives.

Deputy Eoghan Murphy: Commenting on the banking system in Ireland, Professor Kane states, "Here in Ireland, banking appears well on its way to becoming a duopoly with a fearsome ability to pervert and abuse the rules of your financial roads." Will he elaborate on a problem with a small number of banks in a banking system?

Professor Edward Kane: The point is that if two banks are very much larger than all the other banks, it is very hard for the smaller banks to operate, especially if the giant banks enjoy these too-big-to-fail guarantees. There are always some small banks in the system but they will be disadvantaged because they will not have these implicit guarantees.

Deputy Eoghan Murphy: The problem we had here in the build-up to the crisis was competition from other banks moving into the market. What we then had were new lending products and riskier lending strategies. Just to be clear, are we talking about the number of banks in a banking system or their size?

Professor Edward Kane: We are talking about the banks that have political power to extract guarantees to support themselves. In most cases, these are giant banks.

Deputy Eoghan Murphy: Is that political power derived from their size or something else?

Professor Edward Kane: It is derived from the exchange of personnel between themselves and government agencies, campaign contributions that they are able to make either directly or indirectly through encouraging their staffs and basically schmoozing people and building relationships.

Deputy Eoghan Murphy: There may be an unhealthy closeness between those banks and people in regulatory or political positions who could have some influence should a crisis develop.

Professor Edward Kane: Yes.

Deputy Eoghan Murphy: Is that Professor Kane's experience from the United States?

Professor Edward Kane: It is my experience from studying the savings and loan, S&L, mess and it was written even larger in the last crisis.

Deputy Eoghan Murphy: We had a commission of investigation led by Dr. Peter Nyberg. One of the recommendations in Dr. Nyberg's report related to the idea of too-big-to-fail banks. It suggested that measures limiting a bank's size and growth could be implemented. He gave the example of setting a limit on the absolute size of a bank's balance sheet. What is Professor Kane's opinion of that proposal?

Professor Edward Kane: It would be hard to enforce because there are bank holding companies. If something cannot be put on the bank's balance sheet, it can be put on the holding company's balance sheet and the banks can still exploit connections. There would be a lot of trouble writing the law. In the United States, we have some type of requirements like that with respect to the percentage of banking deposits that an individual bank can own. However, every time a bank has approached that limit, it has found ways to get around it pretty much, for example, by selling a few branches here and there or finding ways of redoing its balance sheets to stay within the limits. This proposal would treat something that is a proxy for the problem. Size is a proxy for the problem, not the problem. The problem is the relationships and the ability to force government support. That means eventually that taxpayers will be left to pay for it.

Another practice underlying that is not putting this on the balance sheet of the government until taxes are finally raised.

Chairman: Deputy Murphy was also making a point on which I ask Professor Kane to place some shape before I move on to the next questioner. Professor Kane is a great man for giving an analogy and using metaphors and comparative descriptions. These provide very good imagery for his presentation. He uses the term "regulatory capture". What does he mean by that?

Professor Edward Kane: I did not originate the term "regulatory capture", although I certainly use it. It goes back to an article in 1971 by a University of Chicago professor. The idea of regulatory capture is, one way or another, being able to dictate the policies of enforcement or the rules to the interests of the industry as opposed to the interests of the ordinary public citizen. It was initiated with respect to price-setting for utilities by utility commissions. The notion is that the utility companies dictated what the commission would ultimately adopt as prices. It is very evident in US banking. One of the issues concerns what is called the revolving door between government and regulation. The top regulators in the United States have migrated to one firm in great numbers, Promontory Financial Group, and blatantly advertise on their website that they have influence to deliver. It is about being able to influence or even dictate certain policies.

Chairman: What Professor Kane is naming is a process whereby senior public servants in the regulatory structures are going to work with major players and perhaps too-big-to-fail institutions in the private sector.

Professor Edward Kane: That is correct, and then using their contacts. We can think of this in two ways. The revolving door is the sensible thing to go through as a matter of career management. We can learn things working in both sectors that make people more powerful and more effective in whatever sector people stay in. The issue is whether people try to influence the decisions in an anti-social way.

Senator Sean D. Barrett: I welcome Professor Kane. On page 11 of his submission, he refers to "the risks incurred in backstopping TBTF firms cannot be calculated and priced in the straightforward way that the risks of bond or insurance contracts can". How does he calculate the risk? Can he comment on the estimate of Ms Admati that it is worth approximately $300 billion a year in the United States to have that degree of protection?

Professor Edward Kane: I should have said how bonds and insurance contracts are priced. People try to get a measure of the probability of default, or the probability of some event if it is an insurance contract, and the contingent loss given that event and put them together. It is much richer when we look at options. It should be priced as the difference between the put option, for the institution to be able to put losses on the taxpayer, and the call option, for the taxpayer to be able to take over the firm. In the case of banks that are too big to fail, the call option is never exercised. Not looking at that as a put option and using the bond or insurance approach misses how important is forbearance. I do not remember seeing how the particular calculation is made but some co-authors and I put the figure 2 into the statement. We figured out what it was worth as a quarterly dividend to have guarantees across the banking system. It surged in late 2008 and early 2009 and has come down since. It will never go away and the value will be there until we change the incentives.

Senator Sean D. Barrett: We should have had a number of that kind in our accounts ever since bank regulation began in Ireland.

Professor Edward Kane: Ever since there was a perceived safety net. If there are implicit or explicit guarantees, they lead to a stake like this for taxpayers.

Senator Sean D. Barrett: Professor Kane mentioned on page 3 that there is a role for both regulators and auditors to explicitly monitor loss-shifting activity. We will ask questions of auditors. What should they be doing in properly regulating banks after what has happened in Ireland and the US since 2008?

Professor Edward Kane: They should focus on the notion of taxpayer equity. What is the value of taxpayer equity in a firm? Is it negligible and is it increasing? If is increasing, that is what we want to pick up. That would do a great job of measuring it at first. If whatever they are measuring is increasing, they know they will be flagging a problem before it gets to the severity we saw in 2008 and 2009.

Senator Sean D. Barrett: Professor Kane says that both officials and industry lobbyists resist transparent performance accounting. What do we have in transparent performance accounting?

Professor Edward Kane: For a bank that is too big to fail, it is a matter of pulling out how much of the reported profit is actually an unpaid dividend to the taxpayers. Given that the position of taxpayers is so disadvantaged, they should receive more than the dividend going to stockholders.

Senator Sean D. Barrett: Could two kinds of banks emerge from this, where we guarantee some and the rest have a note on the door informing people that they are not guaranteed by the Government? One is a utility bank and the other is some kind of casino.

Professor Edward Kane: This solution would work for a while but the danger is what we saw in the case of the insurance firm in America, AIG. The firm was not even covered by the safety net but its creditors were. When the firm got into trouble, the creditors pressured the Government to rescue what looked like the firm but it really rescued the creditors and the jobs of the managers. The stockholders benefited because they were not taken over.

Senator Sean D. Barrett: Regulators as trustees brings a new kind of regulation. If we must recommend what new regulators should be doing, trustees presumably have a view of how regulation is performed in the interest of society as a whole. Can Professor Kane develop the point?

Professor Edward Kane: These equity stakes constitute a portfolio of some kind and we can think of the portfolio as a trust fund. There is a trust fund in each bank that contributes an appreciable value to this portfolio and regulators should act in trust on behalf of taxpayers. That requires them to collect information on the value of the stake. There are many ways they can structure it but the most important thing is to give them an explicit responsibility and train them to see it and manage it and extract a dividend.

Deputy Kieran O'Donnell: I welcome Professor Kane and I hope he enjoys his stay in Ireland.

On page 9 of his presentation he states:

> With each successive recession, more benefit is extracted by too-big-to-fail institutions.

These patterns ought to be observable in the Irish scene as well. I fear that far greater and more-dangerous benefit flows will emerge in the next crisis.

Do we need to move towards a system where, rather than banks being too big to fail, they are small enough to fail? Professor Kane states, "Deeply insolvent banks are what I term zombie institutions. They can only operate because they are backed by the black magic of government implicit guarantees". Is our system at the moment too incentivised towards banks that are too big to fail? Is one solution to provide banks that are small enough to fail so that the black magic of the implicit government guarantee does not come into play?

Professor Edward Kane: Surely that would be better than having lots of banks that are too big to fail but the issue is what kind of interference we must make on the market-----

Deputy Kieran O'Donnell: I am asking whether it is practical.

Professor Edward Kane: It has its costs as well. Clearing up the accounting for the taxpayer would be more powerful in changing incentives. Every institution would want to get as close to the maximum as it could since it would be harder to fail. If one tried to ensure that no bank became more than a small bank, one would be giving up lots of economies of scale or scope that might be very good for society as a whole. There is always a trade off. I do not see that there really is a trade off in what I am proposing. I am just saying let us recognise that the taxpayers will bail people out, that they are providing loss absorbing equity at the key moments of a life of a firm. They are equity holders and are being treated badly compared to explicit shareholders.

Deputy Kieran O'Donnell: From what Professor Kane knows of the Irish situation, and he referred earlier to Anglo Irish Bank, which was nationalised on the backs of the Irish taxpayer, in terms of structures, what could have been done to save the Irish taxpayer money and how early should it have been done in terms of knowing when a bank is insolvent?

Professor Edward Kane: I have to answer this hypothetically.

Deputy Kieran O'Donnell: I accept that.

Professor Edward Kane: Any bank that is growing very rapidly should have required -----

Deputy Kieran O'Donnell: When Professor Kane refers to a bank that is growing rapidly, what benchmark would he use to define that growth?

Professor Edward Kane: I do not think one needs a quantitative benchmark, but one uses the industry norms and relative to the industry and to its history. It is like a quality control chart in main factories.

Deputy Kieran O'Donnell: The bank would have fitted into that category.

Professor Edward Kane: Yes. If one sees that somebody is pushing the upper limit of whatever benchmark one is using, then that requires additional attention. Similarly one can say the same thing for certain types of loans. If loans for commercial real estate and residential estate are expanding very rapidly, it is likely that the terms are too generous or there is a certain risk of taking a concentration risk. It is a matter of the norms of regulation, rather than saying that we want to be helpful to these firms that are expanding and bringing value ------

Deputy Kieran O'Donnell: If one has a situation where one sees an institution that is expanding at such a rapid rate, what are the practical means that the regulator and the State should do at that point in time?

Professor Edward Kane: They should send in a special examination force, they should challenge the values reported to make sure they can be justified, they should try to figure out as I have said the value of the taxpayer's stake in the firm and try to collect value for the taxpayer. Ideally, one should just say that much of the so-called profit actually belongs to the taxpayer.

Deputy Kieran O'Donnell: Am I correct when I say that Professor Kane believes that the regulation system should be such that it can step in prior to the bank becoming insolvent to stabilise the situation on behalf of the taxpayer?

Professor Edward Kane: The point is that I would define it as insolvent if the bank is running basically on the equity capital being supplied and not recognised by the taxpayer. A zombie is an institution that can only stay in business because of the guarantees, the implicit or explicit guarantees. As a firm approaches that condition, that is the ideal time to act.

Deputy Kieran O'Donnell: It may not be what would be termed a financial technical measure of insolvency, but Professor Kane's view is that if a bank can only function based on the implicit guarantee from the State-----

Professor Edward Kane: Yes.

Deputy Kieran O'Donnell: It is a zombie bank.

Professor Edward Kane: They are zombie banks and they are owned effectively by the taxpayer.

Deputy Kieran O'Donnell: The taxpayer needs to move in?

Professor Edward Kane: Yes.

Chairman: To conclude this section before we go for a break, Professor Kane has written extensively on banks that are "too big to fail" and "deposit insurance and other safety net methods" in the context of the United States. To draw him into the European context, does he think that executives in European banks prior to 2008 believed they would be rescued by governments if they got into trouble?

Professor Edward Kane: They do. I did some work with some Spanish economists on what the price of the guarantee should have been quarter by quarter. I was not familiar with the European scene but just by our method, I was shocked to discover that the Dutch banks were in a very dangerous condition, which turned out to be the case very quickly. This work could have been done. These calculations are not perfect but they are indicative and one can get at a figure for what should be paid for the safety net support.

Chairman: Would it be Professor Kane's understanding that the difficulties they got into were underpinned by their own belief that they were too big to fail and that there would be government intervention?

Professor Edward Kane: This, of course, is something that the industry denies. I have been told by some bankers that they were fully aware and that they were exploiting taxpayers, but the Chairman will have a hard time finding this on the public record.

Chairman: Thank you, Professor Kane.

I propose that we suspend the sitting and resume at 11.15 a.m. Is that agreed? Agreed.

Sitting suspended at 10.55 a.m. and resumed at 11.15 a.m.

Chairman: We will now resume our discussion with Professor Edward Kane. The next contributor is Senator MacSharry.

Senator Marc MacSharry: I welcome Professor Kane and thank him for making the journey here to help us out. In a paper he wrote in 2006, entitled Inadequacy of Nation-Based and VaR-Based Safety Nets in the European Union, he outlined the European Union's financial safety net and stated, "If confronted with one or more large-bank insolvencies, nationalistic pressures on home and host regulators are bound to aggravate weaknesses in accounting reports and to prevent the losses imbedded in deeply troubled institutions from being allocated quickly, efficiently, or fairly across member states involved." Even though that was in 2006 the report was insightful. With the benefit of hindsight, is this an indictment of the EMU that it is not fit for purpose in a crisis?

Professor Edward Kane: It is certainly an indictment of the failure to completely design the system. The ability, say of the European Central Bank, to absorb losses is limited by the ability to recapitalise itself from the member states. In addition, the fact that they have never established a formal loss allocation mechanism and are just "winging it", to use that term, is part of the problem.

It took the United States a long time before we had the Federal Deposit Insurance Corporation. I think the aspirations of European unity have run ahead of the institutions that are supposed to support and embody it and this is just one example of that. I appreciate the Senator quoting my paper. It was a matter of being an analysis and was not so much a forecast. It had to be that way. If one does things incompletely then one must unravel problems in an *ad hoc* way.

Senator Marc MacSharry: I appreciate the professor's limited knowledge of the domestic situation here. Considering the nature of the EMU, and his research writings in 2006 which were specific to the preparedness, readiness or lack of it for a banking crisis, for a small open economy like Ireland, was it possible to prevent or adequately navigate the crisis once it hit in 2008, considering what the professor wrote of the circumstances?

Professor Edward Kane: First, instead of other states coming to the rescue, Ireland seemed to have been forced to help creditors in these other lands, like Germany. I do not think that would have been the way one would design for a crisis in a small country. Of course, Greece is the absolute poster child for all of this.

Ireland showed a lot of gumption in handling this situation for itself. It should have worked a harder deal with the rest of Europe but it was not in a position to dictate terms, I guess.

Senator Marc MacSharry: Was that because of Ireland's small size?

Professor Edward Kane: Yes.

Senator Marc MacSharry: Was it because Ireland is less than 1% of the eurozone?

Professor Edward Kane: Yes.

Senator Marc MacSharry: That is interesting. In terms of the regulatory situation throughout the world, I shall give a bit of background on the Irish system. Post-2003, we had a regulator and a Central Bank that were separate but connected. Is such a model flawed? Are central banks and regulators best placed to work together on the same mission with shared information?

Professor Edward Kane: It is very dangerous to have prudential regulation in the Central Bank because the Central Bank is pushed in a lot of directions in terms of inflation and unemployment. As I said, the regulator should be thought of as running a trust fund for the equity position of taxpayers. This can be done as a single-minded goal. Central Banks will never have that aim as a single-minded goal. It would be hard enough even to get the regulator to do so. That is why involving private trustees also as co-trustees would be advantageous.

Senator Marc MacSharry: I think I know the professor's answer to my next query but I shall ask it in any event. In terms of international co-operation on banking regulation, and the professor talked about established norms, does it remain completely unfit for purpose?

Professor Edward Kane: Completely unfit is a very strong term. As of where we are today, the cross-country contracts - if one wants to think of them as contracts - are very incomplete. One can really see this in the other area of the swaps regulation because that is where it stands out the most. Every country that has an important swaps market wants to be able to do whatever it wants to do. It wants the other countries to recognise their regulatory authority over the nationals of the foreign countries trading. Then one is trading on their platforms. The dangers of this, especially for countries like the United States, is that the United States will end up having to cover losses incurred in other markets. This is what happened with England. I mentioned a firm called the American Insurance Group or AIG. The losses surfaced in trading in England by a French subsidiary of this firm and this little subsidiary created a large portion of its losses. We are so far from having arranged what I would call an adequate or complete contracting of who will do what in a crisis, across countries, that it is frightening as to what could occur.

I sometimes use a cartoon that shows the ECB, Germany represented by Angela Merkel, and the IMF throwing money first at somebody wearing a Greek toga and then behind that there are hands of five other countries that are in trouble, including Ireland, scrambling to get some of the dollars. Then the IMF turns around to Uncle Sam and says, "Do you realise that if this doesn't work we are going to be calling on you?" That is the way the system is set up.

Senator Susan O'Keeffe: Earlier Professor Kane said there was an incentive for banks to hide their losses and it would be fraud if they did, plus how they would hide soft information from auditors. Is it also the case, from his experience, that banks worked hand-in-glove with auditors to hide it from time to time? Was it simply doing that separately from auditors?

Professor Edward Kane: Absolutely, these are not auditors we would treat as representative of the profession. There is great pressure and there is hard information and fact that sometimes, say bankers, would call up a firm and say, "Take this auditor out of here as he or she is finding out too much trouble". There are certain professions where the pressures to corrupt are enormous and auditing is one of those professions. People will never be satisfied with the work of auditors unless one gives them the number they want to show. People will try to influence an auditor towards that number. If a firm is committing fraud, or at least deliberately misrepresenting one's position, then one has got to fight with the auditors.

Senator Susan O'Keeffe: On page 7 of the professor's original submission it reads, "We did not see much prompt corrective action for Too Big To Fail institutions". He did not say whether that was deliberate on the part of governments to not take corrective action. Was it deliberate that they did not do so? Was it because they were lost and did not know what was doing on? Was it, as the professor said, because bankers were largely treated like what he called high priests?

Professor Edward Kane: It is because of the norms of trying to be helpful and recognising that it will cause a lot of trouble if one gets these big banks angry. It is a matter of giving them the benefit of the doubt and of deferring to them. What if they say, "You don't understand swaps and you don't understand that we have got all this stuff hedged?" What they talk about is over the pay-grade of the examiner. However, the examiner may or may not say, "You should be able to make me understand". One notices that we have all of this stuff hedged. They talk about it and it is about the pay grade of the examiner. The examiner may or may not say, "Well, you should be able to make me understand," but we all know that there are times when we short-cut our work.

Senator Susan O'Keeffe: At a previous hearing Mr. Peter Nyberg who also wrote a report on the banking crisis said one sign of a lack of bad intent, by which he meant bad intent on the part of bankers, was that very many bank executives had taken out loans to buy real estate and shares in their own banks in which they obviously believed. That does not quite square with Professor Kane's broader version that banks know precisely what is going on and are looking to take advantage of things going bump in the night and seeing how they can get things for themselves. What does Professor Kane think of this?

Professor Edward Kane: The issue is: when will the party end? A person can recognise that the party has to end badly and still feel it is not ready to end and that they can make some money. I cannot tell the committee how many people have told me they will get out and will not have losses when interest rates turn around and go up, but it does not usually work that way. It happens and they are stuck. That is not really evidence, but it is evidence that they thought the party would go on longer.

Senator Susan O'Keeffe: Professor Kane talks about the whole scenario of encouraging people to cash out - the creative, aggressive risk takers who are smart enough to cash out. Were shareholders in the banks and bankers, including senior bankers, involved in that game of cashing out also?

Professor Edward Kane: Some of them were. The way really senior people covered themselves in the United States was by having golden parachutes. If the firm replaced them, they would get this very big pension which would absorb whatever losses they had incurred. Going back to the Senator's first question, one could possibly interpret this as wanting, on the one hand, to show their belief the party would go on and, on the other, to have protection so that if it did not, they would not really be impoverished.

Senator Susan O'Keeffe: Professor Kane talks a lot about the relationship between bankers and regulators. He talks less about the relationship with politicians. Is it a three-way relationship? Are they three legs of the stool? Do politicians and the political system constitute a weaker leg of the stool or are they a leg at all?

Professor Edward Kane: I think it is. The way in which regulators in the United States are influenced most is through politicians. Bankers tell politicians that they are unhappy with this or that policy and they then call the regulators in for hearings like this and roast them.

Senator Susan O'Keeffe: Is Professor Kane saying bankers, regulators and politicians have parity in the stool or are politicians stronger?

Professor Edward Kane: I think the biggest bankers are strong. Politicians purport not to understand and rely on this sense of giving top bankers the benefit of the doubt. One can see this in the handling of all the problems J. P. Morgan has had.

Chairman: The Senator can ask one last question.

Senator Susan O'Keeffe: Is it a good idea to offer incentives to sell more product to bank workers who are literally at the coalface in talking to customers? Is this a good system in a bank?

Professor Edward Kane: Let us put it another way. The systems have seldom been good. For example, rewarding somebody for getting a higher interest rate from a customer seems to be against the long-term interests of the bank. When I was in high school and college, I used to work on straight commission. The commission system has some good features, but it has some things one would have to control in banking. Incentive-based compensation can be good if it is tied to the right targets and bad if it is tied to things that end up mistreating customers.

Senator Susan O'Keeffe: Can I finish?

Chairman: The Senator is out of time. Professor Kane touched on the banks positioning themselves to pre-empt or deal with a future crisis. Basel III is one example where greater capital requirements are now required to be met. Some academics like Amante and Helwig argue that capital adequacy regulations would work better if firms were required to have considerably higher equity levels. What is Professor Kane's view?

Professor Edward Kane: My view is that it comes back to measuring capital and the assets which are risk-weighted in many cases. Those authors are very careful to talk about total assets, but even with total assets, there is the question of whether it is of the bank or the banking organisation. My view is that this would be helpful for a while, but one would have innovations and reorganisations designed so that these capital requirements would become increasingly toothless. What I am saying is that this puts a constraint on the behaviour of people just like a speed limit puts on a constraint, but the question concerns how that constraint is enforced and things are measured. The measurement system has so much leeway that I fear that this would not be a long-term solution.

Chairman: The United States has a single federal structure running across all states. In his earlier response Professor Kane indicated that the difference between Europe and the United States was there were individual member states and that the financial infrastructure was not in place because Europe was not a federal political union. However, central banks in each country have the capacity to put their own capital ratios in place; therefore, Ireland could decide in the morning to raise the bar Basel III will set. Is that an advantage that this country could use or does it make any difference?

Professor Edward Kane: Every country can use it. The issue in any situation where one country is trying to be tougher than others is how does this affect the allocation of loans and deposits and other instruments across countries. Customers want the best deal they can get. In the United States every useful reform is challenged on the grounds that it will make it harder for US banks to compete in the world. One of the norms is this mercantilist idea of helping national institutions to compete. If Ireland sets capital requirements at a much higher level, the banks will scream that it is being taken out of the financial All-Stars of the world.

Deputy Joe Higgins: On page 2 of Professor Kane's presentation he says, "the problem is that, in good times and in bad, regulatory and banking cultures continue to encourage their country's largest banks to take on too high a risk of ruin, i.e., too much tail risk." On page 1 of his presentation he says, "then, in times of deep trouble, supervisors extend the safety net to promote the needs of distressed institutions and their creditors - even foreign ones - over the welfare of ordinary citizens." Does he know of any banking crisis where this was turned on its head and the welfare of ordinary citizens and taxpayers was put before the needs of the banks, bondholders, etc?

Professor Edward Kane: Some time ago with a colleague at the IMF I studied 12 crises. I think we found that two of the Scandinavian crises had been handled in a way that was harder on the banks than everybody else. One can see how the norms of the Scandinavian countries are different. Asian countries are varied. The Confucian idea is that if something is wrong, you should not have done it; you do not need to prove you knew you were doing wrong. We do not impose that kind of obligation. We do not have *ex post facto* laws and punishments.

It is a Scandinavian egalitarian spirit that makes it hard for those banks to get in so much trouble.

Deputy Joe Higgins: Professor Kane states on page 3 that "...the distortions that unbridled profit maximisation might cause becomes an additional justification for regulating financial firms". Could he elaborate on the role that the distortion profiteering by financial institutions had in the global financial crisis?

Professor Edward Kane: The issue is not taking risk but taking the risk of ruining the firm - the risk of ruin. People do not often make this distinction. Most firms, whatever their industry, take risks. However, people do not go out of their way to take positions that make it a really observable probability of failing. It is very unusual. Most managers want to keep their jobs and are not willing to run that risk. The only reason that managers of these too-big-to-fail institutions run these risks is they are confident they will be bailed out.

Deputy Joe Higgins: Is it not inevitable, in a situation where private profit maximisation is the ultimate goal, that institutions will take risks for that end?

Professor Edward Kane: I think it is inevitable. That is why I say that what is wrong with the norm of profit maximisation is the leaving out of this important stakeholder which provides equity funding from the calculation of the profits. There could be a firm that is losing money but increasing the value of the guarantee so much that it can report some profits. Maximising that is done by further victimising the taxpayers. This is what I think is wrong. Value maximisation is fine, as long as we count all the suppliers of equity and not just the stockholders.

Deputy Joe Higgins: On page 4, Professor Kane states, "The goal of my testimony is to suggest how - by defining and sanctioning theft by safety net as a felony - governments can better align incentives of private risk managers, accountants, credit-rating firms, and government supervisors with those of ordinary citizens." Is it really possible to align the interests of, for example, hedge funds - which some people will describe as vulture funds looking for quick profits on the financial markets - with the interests of, as Professor Kane put it, ordinary citizens?

Professor Edward Kane: It is all a question of how completely one wants to do things. We have this important supplier of equity capital which is being fleeced. As far as I know, positive law does not call this theft by safety net and we will have to change the laws to do this. Until we change the laws, there will be firms that will be in the shadows, if one likes, or near-banks, if one wants to call them that that, limited banks that are not chartered as banks, that will try to take advantage of various opportunities. However, we do not have to align the incentives of all these people. If these are people who are the equivalent of termites in a house which are eating wood we cannot see, they should be punished by the usual system. No one should be bailing out hedge funds directly. They are not covered by the safety net.

Deputy Joe Higgins: Professor Kane states on page 9, "With each successive recession, more benefit is extracted by too-big-to-fail institutions". I make the remark that this has been observable in Ireland also. Then Professor Kane states, "I fear that far greater and more dangerous benefit flows will emerge in the next crisis". Some people might feel chilled by that prognosis. Is Professor Kane saying that governments will not move to change what brought about the financial crisis and the ripping off of taxpayers?

Chairman: I will give the Deputy time to conclude his two last questions, if he wishes to add anything.

Deputy Joe Higgins: I do, if the Chair would bear that in mind. Professor Kane referred in response to Deputy Murphy to the interconnectedness between the regulators going back into the banks, the interchangeability, campaign contributions to politicians etc. All that is in the mode of private for-profit banking in financial markets. What would Professor Kane say to public ownership banking with democratic control as an alternative?

Professor Edward Kane: I lost the Deputy's first question, which I was ready to answer. However, the idea of public ownership creates its own problems. Temporary public ownership is very important in straightening out incentives, as is exercising the call on the assets that is part of the guarantee. People will find ways to corrupt public institutions. There will be different channels from the ones we have just described. However, we will still see taxpayers exploited through this. This has been the history of government ownership of banks all along. One gets what is called crony capitalism. The governments lend to well-connected parties. In some Asian countries, there will be a family who will get huge amounts of the loans from the public institutions.

Chairman: What was Deputy Higgins' earlier question?

Deputy Joe Higgins: I referred to the next crisis.

Professor Edward Kane: On the next crisis, if one looks at what is happening in the United States, we passed the Dodd-Frank Act. Several of its provisions have been voted back in very slippery ways because they were bothersome to the banks. In the negotiations in Basel, one sees the putting off and the extension of the times for things to come on line. Every delay gives more time for re-fashioning things to be more comfortable. In a boom, everything looks strong and fine. These look like unnecessary precautions.

Deputy Joe Higgins: Is Professor Kane saying it is inevitable that we are going to have more dangerous benefit flows in the next crisis?

Professor Edward Kane: I am not saying it is inevitable. Given the way in which we are proceeding, it is inevitable.

Deputy Pearse Doherty: Cuirim fáilte roimh an tOllamh Kane and welcome him back to

Ireland. He has spoken a lot about the too-big-to-fail concept. There have been studies on what this means. In Professor Kane's view, what does it mean to have a bank too big to fail? How would he, or a member state, assess in a crisis whether a financial institution is too big to fail?

Professor Edward Kane: I like to define it as too difficult to fail and unwind. It is, therefore, not necessarily a question of size, but also the the complication of the firm. It would be big, of course, but it would also be so complex that it would be administratively difficult. Another consideration is a political one. The institution may have such a strong political base - getting back to the question of operating through politics - that it would cause the head of the regulatory agency an awful lot of trouble, and influence, perhaps, the reappointment, or the future employability, of the head. The next question is "how to assess". I believe "how to assess" is trying to tease out, from stock market and other trading information, the value of the taxpayers' stake in the firm. That should be serviced in some way by a dividend, but in any case of that surging, there is a problem. Something has to be done about it. If one is pricing it, it is not likely to surge. To the extent it is being underpriced, then one has to worry about it. Right now, zero is a severe underpricing.

Deputy Pearse Doherty: Professor Kane mentioned that Anglo Irish Bank should have been nationalised earlier. I appreciate, as Professor Kane stated, that he is not a scholar of the banking crisis in Ireland. However, can he explain the difference between nationalising Anglo Irish Bank, which has at this point imposed losses in the region of €30 billion on taxpayers, and guaranteeing it? What difference would this have made?

Professor Edward Kane: It is my understanding that AIB was enjoying implicit guarantees. As it took losses on its more aggressive contracts, it compiled these losses. They compiled these losses and they did not stop taking these risks until they were taken over. Giving them more time to put more taxpayer money at risk is what was wrong with the delay. The delay is rooted in the norms of regulation.

Deputy Pearse Doherty: How does that factor into some of the other evidence provided by Professor Kane in regard to a banking holiday? If we were to nationalise a bank such as Anglo Irish Bank, does it not put the losses on the State automatically as a result of nationalisation? Does Professor Kane still believe that was the best option or is the idea of a bank holiday, where people can go in, look at losses and buy time, the preferable option?

Professor Edward Kane: If we look at a concrete case like this where huge losses were accumulated, it should not take long to see that it is too late from the fact that creditors were trying to collateralise their positions and otherwise shorten the maturity, doing whatever is necessary to get out. Realistically, when we can say that the firm is insolvent, we do not need to have a holiday to assess that.

It took so long that anyone could see from the way informed counterparties were behaving that this was a bank whose loss taking had to be stopped. The best way to do it is to exercise the call. The takeover is not a permanent solution; one is trying to repair and restructure the bank and refloat it as a private institution when it is all over.

Deputy Pearse Doherty: With regard to Professor Kane's 2004 paper examining 12 countries and their guarantees, were any of the guarantees similar to what the Irish State put in place? For example, the Irish bank guarantee covered all past and future deposits, retail and commercial institutions, interbank, covered bonds, senior debt and dated subordinated debt. Were the other guarantees of a similar nature or was this unique?

Professor Edward Kane: A majority gave blanket guarantees. I would have to go back to 2004. The easiest thing politically is a blanket guarantee because there are all these people fearful of losses. If one says the government will pick it up, it is so much easier administratively and politically for the authorities in the short run. That is why the majority of them took that approach but they did not take it proudly. Subsequently, they took a lot of heat for doing so from the populations and the citizenry. That is why I say it is elitist because they make the elites happy but they are punishing the ordinary citizen.

Deputy Pearse Doherty: The 2004 paper says that while policy-making during a crisis may be of the seat of the pants variety, the policy itself is informed by a political and economic struggle over who pays for the losses. How important in the view of Professor Kane is that dynamic, namely, the political and economic struggle of who pays for the crisis in terms of framing the terms of the resolution?

Professor Edward Kane: I think it is terribly important. I define a crisis as a battle over loss allocation. There are firms with losses and no one wants to hold them. People are contracted to take the losses, by writing insurance or lending money or bonds, but they do not want to pay and they have the political power, in many cases, to see that they are paid. My superficial understanding of Ireland is that many foreign creditors were paid off with Irish taxpayers' money and it is astonishing to me how good politics, the way a republic or a democracy is supposed to work, would ever lead to that solution.

Deputy John Paul Phelan: I thank Professor Kane.

Following on from the question of Deputy Doherty, with regard to governments that enter into blanket guarantees, once a guarantee of that nature is entered into, is it virtually inevitable that the guarantee will have to be continued until the immediate crisis passes? To use another driving analogy, of which Professor Kane has used many, is it akin to the no claims bonus? Once it is entered into, not continuing to avail of it means there is a disproportionate penalty for exiting until the immediate crisis has passed.

Professor Edward Kane: During the immediate crisis, the bank guarantee will usually resolve the immediate crisis. The question is how to get out of it and roll it back. It must be rolled back so one should extend haircuts or provide that some things will not be guaranteed. The worst thing would be to say the blanket guarantees were forever. They usually have a short fuse, precisely so that they can be adjusted.

Deputy John Paul Phelan: With regard to the financial reports issued by financial institutions, all businesses in the Irish context tend to post results quarterly. In terms of the unique circumstances surrounding banking, is it appropriate that the reporting terms be extended? Would a different reporting system be useful in terms of how banks report their financial situations?

Professor Edward Kane: I think they should report more frequently. It would help us to figure out the value of taxpayers' positions if we were getting weekly or monthly reports so the Deputy's suggestion is moving in the wrong direction. How frequently businesses report allows certain things to happen in between. We have inspections for cars for safety or emissions and if we were to go from annual inspections to biannual inspections, we would have a lot more unsafe and smoking cars on the road.

Deputy John Paul Phelan: Just to play devil's advocate to previous comments about the size of financial institutions, and bearing in mind that the view is very different from the United

States, do big banks not have advantages for individual customers and corporations in terms of international credit and international trade, provided they are properly regulated? Is the size of the bank not a secondary issue to the level of regulation the banks are subjected to?

Professor Edward Kane: I do not see precisely what Deputy Phelan is getting at but there is a size sufficient that it does not help to get much bigger if it were not for the guarantees that came from getting bigger. Some of the institutions, and we can point to JP Morgan, seem to have become too big to manage. That is okay because the Government is behind them and people do not feel at risk. We must really try to imagine what the world would be like if we did not have these government guarantees. We would not see so many large and complicated institutions.

Deputy John Paul Phelan: The point is that whether they are properly regulated is the primary issue, rather than large or small.

Professor Edward Kane: Let us understand that assuming proper regulation is a huge assumption and it does not advance the argument. The issue is not what would happen if they were properly regulated but how strong the pressures are for improper regulation and supervision of these large and complex firms.

Deputy John Paul Phelan: Professor Kane stated in a lecture given at King's College, Cambridge, a number of years ago that banks outsource and shortcut due diligence. Can he provide a basic description of how they do that?

Professor Edward Kane: The outsourcing is to the credit organisations, which disgraced themselves. The regulators said that if the credit organisations told them the loan was not risky they would not charge much of a capital charge against it. Lots of evidence has emerged in the US about people being fired for being too good, credit A list, and people being promoted because the securitisers were really happy with the work they did. The incentives in those organisations really went bad. When one takes another person's opinion one should be very careful about why one takes that opinion. The same applies to me. When the committee listens to what I say it has to decide for itself because it has the responsibility for deciding how applicable what I say is to the work it has to do.

Chairman: In your earlier comments, Professor Kane, when you talked about nationalisation of an Irish bank, were those remarks made in the context of Anglo Irish Bank?

Professor Edward Kane: Yes.

Senator Michael D'Arcy: Professor Kane is very welcome. The "too big to fail" theory is often used but that comes from the perspective of the bank. I want to reverse that perspective and ask the professor's opinion of a country that is too small to guarantee. Were we too small to guarantee?

Professor Edward Kane: This question can be asked in so many ways I am not sure what the Senator is getting at. There is a sense in which I would say absolutely, the burden placed on taxpayers is enormous. The burdens on people in this country who took out mortgages they cannot pay are enormous. If we ask from the point of view of public policy, looking backwards, should this all have been guaranteed I would find it hard to find people who would say "Yes, that was really great policy". The trouble is people had the authority and the pressures at the time to do those things. What is true is that the fiscal strength, the tax and debt capacity of a country, limits the value of its guarantees domestically and particularly for foreign creditors.

Senator Michael D'Arcy: Is there a metric on that? The Irish national debt was approximately €45 billion, GDP was €160 billion and the metric on the bank guarantee was €440 billion. Is there a standard metric that is used?

Professor Edward Kane: There is no standard but there definitely is an association. To have debt at 50% of GDP is a very big burden. It is not so much today because interest rates are low. When interest rates go up this burden will really shock people.

Senator Michael D'Arcy: At the end of the guarantee a funding cliff was created, which created its own problems. The professor analysed a dozen or so blanket guarantees. Was our exposure to that funding cliff in line with that of other countries or did they reduce that problem in a different manner?

Professor Edward Kane: I do not know enough about Ireland's funding cliff to answer that question.

Senator Michael D'Arcy: The professor uses a lot of traffic and vehicular analogies and the term "extreme drunken driving". Is there an example of that in Irish banking terms that he is aware of?

Professor Edward Kane: I do not think I should opine on that.

Senator Michael D'Arcy: He has touched on Basel I, II and III. Some hold the view that these risk analysis mechanisms are over complicated. Is there a prospect that when the banking sector becomes over-regulated it drives money into the private equity markets that are unregulated?

Professor Edward Kane: First, I do not think the banking sector will ever be over-regulated in my lifetime, which is getting shorter all the time.

Senator Michael D'Arcy: So is all of ours.

Professor Edward Kane: The politics is so strong today that it will take a long time and maybe another crisis or two to really change things in Europe and the United States. They are going to be under-regulated and Basel III and the complexity is all part of the under-regulation. It looks like it is terribly high, when they talk about 16% equity ratios risk-based but the risk weight has already come down to half so they are really talking about 8% and many other industries that are not supported by the government hold much more than 8% stockholder equity capital.

Senator Michael D'Arcy: What is the professor's opinion of the private equity funds which are banks in all but name. They are completely unregulated. We do not know who the investors are, their share capital ratios. Is that an area where we could be gathering up major difficulties for the future?

Professor Edward Kane: We are always going to have a border problem between the regulated sector and the substitute unregulated firms. There is no question if something is almost a bank but does not have a bank charter we have to ask is it going to be protected if a crisis occurs. If these shadow banking institutions get into trouble the question is what authority and what pressure points do they have to be rescued. If they do not have that we could generally just monitor them without putting rules on them as long as it is understood that we will not absolutely rescue them.

The problem is that when the money market fund industry in the United States got into trouble during the crisis it received guarantees that covered it only for the period of the crisis and as that ebbed they tried to argue that it cost nobody anything, it did not cost taxpayers anything to provide these guarantees. Part of it is cutting through and seeing if there is a taxpayer value in the firm that one protects. As a minimum one has to at least collect information from these firms, make them register, so that it is possible to collect the information and make the calculations.

Senator Michael D'Arcy: That is not being done at the moment.

Professor Edward Kane: In the US we are slow to do this too.

Chairman: To use the professor's motorway and traffic analogies, crises have two aspects: the crash and the emergency services that come afterwards. There is the structure of the emergency services and the behaviour, obedience to, or ignoring of, the rules of the road, that caused the crash.

Can he elaborate on what he calls the "seat-of-the-pants" policy making at the height of the crisis?

Professor Edward Kane: The thing that worries me about this, having studied crises for so long, is that the authorities never admit their mistakes, as the guide people. Instead, they try to paint themselves as heroes and say how brilliantly they handled the crisis. That is why the seat-of-the-pants decision-making is so dangerous. They look back and say this country had a lot of success in doing it a certain way, which in fact had many problems. I maintain that the handling of the savings and loan mess in the United States helped to create this last crisis.

Chairman: I would like to draw you out on the consequences of that seat-of-the-pants approach. When a country experiences its own crisis, goes to look at where this happened in the past and how a crisis was managed in another country and starts to model from that, are you saying there are flaws in that modelling that are not then known to the country that may be mirroring it?

Professor Edward Kane: That is right. I am saying that the anxiousness of everybody to avoid blame for mistakes which are inevitable when one is doing seat-of-the-pants decision making means that people glorify what was done, and overstate how it had to be done that way, how brilliant it was that they were there and how lucky we were to have had them in the position. The 12-step programmes always begin with the idea of admitting one has a problem.

Chairman: AA is like that. Recovery is all about 28 days and ten-point programmes.

Can I move that on to the final situation with regard to seat-of-the-pants policy making? Professor Kane has written extensively about banking guarantees and blanket guarantees. Can he cite an example where a guarantee was flawed in its design and where that type of model was used in another jurisdiction repeating the mistake unknowingly or unwittingly?

Professor Edward Kane: To answer that question authoritatively, I have to go back and look more closely at data. We have seen some countries like Argentina which are perennial crisis countries. One would think that they would have learned from each of these crises how to avoid this, but we find them surfacing way more frequently than crises in other countries.

Chairman: This brings me to my final question to the professor. Given that there has been a very extensive global crisis and a huge crisis across the European Union, particularly among members of the eurozone, does the professor think the European institutions at both a macro and a micro level, including the European Central Bank and the Commission down to the individual central banks of the member states and their administrations and governments, have learned enough that we are ready for a future crisis now?

Professor Edward Kane: No, absolutely not.

Chairman: Why not?

Professor Edward Kane: We see the notion that low interest rates are going to cure everything and the buying up of private securities, which seems very dangerous. I see the ECB following what was done in the USA, but it is very different for the Federal Reserve Bank, which is backed by the taxpayers of the United States, and the ECB, whose claim on taxpayers is very imperfect. I can easily see the ECB overextending itself.

Chairman: I will conclude with the two lead questioners, Deputies Michael McGrath and Eoghan Murphy.

Deputy Michael McGrath: Where a bank has to be rescued by a country, and by the people ultimately, is Professor Kane in favour of burden sharing with creditors to reduce the ultimate bill that taxpayers have to incur?

Professor Edward Kane: That is right. I consider that the notion of blanket guarantees which do not have haircuts when one can see there are losses to allocate is essentially to throw things on the taxpayer without considering the incentives going forward. That is why I say that things have gotten worse each time. One rescues the creditors, taxpayers pick up the pieces and it looks like a really good game to play.

Deputy Michael McGrath: What creditors should be on the hook for taking losses?

Professor Edward Kane: Very small depositors are not really essential to this so we should not cause them such a disruption, but somewhere there should be a deposit size where people start to share. What was a shock to me in the last crisis was that deposit insurance schemes that had co-insurance arrangements almost uniformly threw them out in the crisis. They were not enforced. People take risks and get paid for taking them but when the risk comes they use politics to weasel out of their due share. This is the heart of what prolongs a crisis and perverts the government's response.

Deputy Eoghan Murphy: I want to come back to that point which links to the discussion earlier which is that link between politics and banking and how the closeness in that relationship influences the willingness of a government of the day to intervene in a bailout. How do we guard against that? In this country, we have banned corporate donations to which Professor Kane referred in his opening statement. How does one guard against improper access to political elites?

Professor Edward Kane: There are some guards. One is to limit the ability of regulators to take a job in the industry for so many years or to limit what kind of job or contacts they can have with their agencies over the years where they may have some cosy relationships, but none of that will be perfect. What one really must do is get into the incentives system and see that taxpayers deserve to be represented in the governance of the firm and the dividend payment of the firm. Many of these crises would have been much less if we had just put freezes on dividends early. There are things we can do if we understand that taxpayers have been drawn into the capital structures of these firms though the providing of equity capital, but we do not acknowledge that in our company law.

Senator Susan O'Keeffe: I ask for a clarification on an answer Professor Kane gave to the Chairman. Professor Kane said at the end of his remarks to the Chair that the ECB is overextending itself. That is quite a big sentence and I wondered what he means.

Professor Edward Kane: I said it might be overextending itself.

Senator Susan O'Keeffe: In what way?

Professor Edward Kane: If the European Central Bank is tested by an indirect run, who will guarantee it?

Senator Susan O'Keeffe: Is the professor suggesting there could in that circumstance be a run? I am not sure.

Chairman: Professor Kane has answered. I am not going into a speculative discussion on what may or may not happen. The professor has said there is an exposure there if there was a run and that ultimately in terms of his testimony this morning, it is about the taxpayer across Europe picking it up, or in the term I prefer to use "citizens" rather than "taxpayers".

Deputy Kieran O'Donnell: That links in. When does Professor Kane think the next crisis will emerge?

Chairman: That is speculative. I am concluding. I thank Professor Kane for coming before the committee. In his testimony this morning he did something which is useful to the inquiry. It is not just about looking at the past, but also about ensuring there are safeguards into the future as Deputy O'Donnell just alluded to.

In his opening statement, Professor Kane said he was very conscious about coming here and about things that the committee needs to hear in terms of where we go into the future. In his final remarks, he might give advice to the committee on how to ensure that we measure systemic risk to empower citizens into the future. How do citizens benefit from the type of risk exposure they have at the moment? What needs to be done to reduce the likelihood of a future financial crisis coming down the tracks?

Professor Edward Kane: Let me make sure I break this down. One is what we can do to help taxpayers that would reduce the risk of future crises. If we allow taxpayers to be victims and have their pockets picked, we will have more pick-pocketing. We must step in there and change the incentives so that bankers that pick taxpayers' pockets are immediately shamed for doing so and not enriched. In the current system, if one can increase the value of the government guarantee, other things being equal, that will register as profits. That will allow more pay to be paid to top executives and nothing is done about it until it gets to such a large amount that the system has to be tested. The question is when it will happen. I cannot give a timeframe, because I cannot predict how quickly this system will be re-established. The low interest rates change many things, but we will not have low interest rates forever. If, for instance, the ECB were to come under pressure, this would be catastrophic.

Chairman: I thank Professor Kane for coming before the inquiry and for his participation. It has been a very informative and valuable meeting which has added to this committee's understanding of the factors leading to the banking crisis and possible considerations as to how risk could be minimised in the future.

Professor Edward Kane: I thank the committee for giving me the chance to speak to such an influential group.

The joint committee adjourned at 12.20 p.m. until 9.30 a.m. on Thursday, 29 January 2015.