Introductory Statement by Klaus Regling to the Joint Committee of Inquiry into the Banking Crisis

January 21, 2015

I am very pleased to be here today and I appear in a voluntary capacity as one of the co-authors of the Regling/Watson report.

In his invitation, the Chairman, Deputy Ciaran Lynch made it clear my appearance was not connected to my current role leading the ESM/EFSF. Therefore, the scope of my contribution today will not be touching on more recent events connected to my current position.

The report was prepared as a diagnostic, not a forensic, study and it did not look at the role of individuals. It was written from a "top-down" perspective to complement the report of Governor Patrick Honohan, who gave evidence to this Committee last Thursday. Sadly, my co-author, Max Watson passed away in December, 2014, so I will have to speak for both of us.

Our 2010 report, titled "A preliminary Report on The Sources of Ireland's Banking Crisis", though usually referred to as the Regling/Watson report, sought to draw policy lessons and identify follow-up areas for investigation looking at the period up to the end of September 2008. This excluded all policy decisions taken from the end of September 2008, including the merits of the bank guarantee at the end of September 2008.

In our report, we found numerous factors - global, domestic, macro-economic and structural that contributed to the crisis. Taken together, these factors acted in a mutually reinforcing way and followed a decade of strong and extended economic expansion when Ireland's living standards first caught up, then surpassed the average EU standard of living.

As we all know, Ireland was one of the countries most badly affected by the financial crisis through a combination of "home-made" problems and global factors. A succession of bubbles in equities, bonds, housing, commodity and credit markets, were the key factors behind the global financial crisis that unfolded from 2007, originating in the United States.

The roots of the problem in Ireland began earlier. Following the creation of the single currency, Ireland's domestic financial services enjoyed a strong and extended boom. This was facilitated by an influx of foreign savings as access to cross border funding for Irish banks increased strongly. It came at a time of very high global liquidity and a low risk premia.

This fuelled the existing strong Irish preference for property investment and developed into a blind-spot, which was ominous in a country that had never experienced a property crash. It was very striking to us, when we were researching our report, how many people we met told us their own personal anecdotes about property investment. Unfortunately, it's hard

not to overstate the impact of this cultural attitude. Property acquisition, as a topic, was almost a national obsession, though not something we could easily quantify in hard data.

This cultural issue is by no means the sole cause. On the economic front, relative to the domestic growth and inflation rates, monetary conditions were very easy and in retrospect, we can see that this reinforced economic vulnerabilities. Statistical tools also failed to capture underlying fiscal deficits. The IMF later calculated that in 2007, although the headline budget was balanced, the underlying, or structural deficit was 8.75%.

Euro area financial integration was also underway during this period when, following the creation of the euro, interest rates were permanently lowered. Irish banks were enjoying unprecedented access to cross-border funds, while foreign banks entered the domestic market, intensifying competition. At the time, cross-border regulatory and supervisory structures had not kept up with this process, though since then, many of these points have been addressed through Banking Union.

Back in 2007, when the crisis first really struck, the benefits of the single currency initially protected Ireland and other euro area member states from the currency turmoil they would have otherwise faced. Unfortunately, it was not enough as pressures built over the following year.

Our report also found a clear lack of budgetary discipline, with pro-cyclical policies and a gradual shift in the tax base that left it fragile and increasingly dependent on the property sector. It shifted from stable to cyclical sources, like capital gains tax, corporation tax, stamp duty on property and consumer taxes. It was also unusual that Ireland did not have a property tax and yet, mortgage tax deductions were offered, creating subsidies that distorted commercial real estate development.

We also noted that there was insufficient surveillance from external bodies such as the EU institutions or the IMF. The IMF was not strong or consistent in its criticism of underlying dynamics of fiscal policy. European Council opinions were favourable, even if the Commission, as early as 2001 was concerned at pro-cyclical policies. However, Stability and Growth Pact commitments were not seen in doubt during the period up to 2008, partly due to an insufficient methodology for calculating structural fiscal balances.

Across the banking sector, there was weak governance and risk management – sometimes disastrously weak. Within the banks, internal procedures were often over-ridden, sometimes systematically and the banks themselves were highly exposed to specific individual borrowers and property lending, especially commercial property. Incentives were also badly structured – it was not just bonuses for top banking executives, but also for middle-management and loan officers

Throughout this period, in the run-up to 2008, counter-cyclical fiscal or macro-prudential policies would instead have moderated the boom and cushioned the recession. With a different official policy mix, perhaps a "soft landing" would have been possible, but instead official policies and banking practices merely "added fuel to the fire". For example, the

government could have mitigated the bubble by initiating fiscal policies that could have dampened, not stimulated, the economy.

Supervisors could have imposed tighter loan-to-value ratios. Supervisors were neither hands-on, nor pre-emptive. They were also not used to technically complex problems. There was also an absence of forceful warnings from the Central Bank on macro financial risks.

In summary, weak financial supervision and bank governance combined with official policies to leave the economy vulnerable to a deep crisis.

In our view, the true burden of responsibility was quite broad and we concluded with a number of follow-up areas for consideration, such as:

- Why was there not a stronger reaction within the banks to this concentrated loan overexposure?
- How were such governance failures initiated?
- Why was the response of supervisors not more forceful?
- Were there failures by auditors?

Investigating the very serious breaches of corporate governance that were identified was also needed. Finally, our report stated that it was important to identify lessons for future policy.

The report concludes that these interlinked factors culminated to create, what in many ways was a plain vanilla property bubble that ultimately burst, with very painful social fallout.

Taken together, we found many inter-connected factors that contributed to the crisis, including insufficient critical external surveillance institutions. Ireland was a country where it seems no one was really in charge to prevent such a bubble from emerging over the previous 4-5 years.