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JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Déardaoin, 5 Feabhra 2015

Thursday, 5 February 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 William Black

Chairman: The committee is in public session. In session 1 we have a discussion with Professor William Black on banking policy, systems and practices. I welcome Professor William Black to the seventh public hearing of the Joint Committee of Inquiry into the Banking Crisis. Later this morning we will hear from European Commissioner, Mr. Mario Nava.

At our first session we will hear from Professor William Black, University of Missouri-Kansas City school of law, on the subject of banking policy, systems and practices. I welcome Professor Black to the meeting and to Ireland. I am aware he is a regular visitor and I hope his stay is pleasant. Professor Black is an associate professor of economics and law at the University of Missouri-Kansas City. Previously he was executive director of the Institute of Fraud Prevention. He has taught previously at the Lyndon B. Johnson School of Public Affairs at the University of Texas at Austin and at Santa Clara University. He was litigation director of the Federal Home Loan Bank board, general counsel of the Federal Home Loan Bank of San Francisco and senior deputy chief counsel, Office of Thrift Supervision, and recently helped the World Bank develop anti-corruption initiatives and served as an expert for the Office of Federal Housing Enterprise Oversight in its enforcement against US financial institution Fannie Mae's former management. Professor Black is also author of the book *The Best Way to Rob a Bank is to Own One*.

I advise that by virtue of section 17(2)(*l*) of Defamation Act 2009, the witness is protected by absolute privilege in respect of his evidence to the committee. If he is directed by the Chairman to cease giving evidence on a particular matter and continues to do so, he is entitled thereafter only to a qualified privilege in respect of his evidence. The witness is directed that only evidence connected with the subject matter of these proceedings is to be given and, as he has been informed previously, the committee is asking him to refrain from discussing named individuals in this phase of the inquiry. I remind members of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the House or an official by name or in such a way as to make him or her identifiable.

Again, I welcome Professor Black and invite him to make his opening statement.

Professor William Black: I thank the Chairman and members of the committee. My statement will be forward-looking as to what one can do to prevent a future crisis. There are a number of restrictions as to what one is able to do currently in terms of the existing crisis so my focus will be on the future. My message is one of hope, in large part, that we can succeed at this. We cannot succeed in stopping all bank failures and we cannot even succeed in preventing all future crises but we can prevent many of them and we can dramatically reduce the severity and length of the crises as well. That is because the great bulk of the worst crises and the great bulk of the worst individual bank failures will follow a characteristic pattern that can be identified well before a crisis stage and can be the subject of successful regulatory intervention.

I am coming to the committee with four hats today, as we would say in US parlance. My primary appointment is in economics. I have a joint appointment in law. I am a recovering litigator but I also have a doctorate in criminality. My specialty is in elite white collar criminals, particularly in the financial area and I think I will be the only successful regulator the committee is like to have appearing before it. We not only write about regulation, as members will see from other parts of the statement we are cited as the exemplars of how to make regulations succeed by public administration scholars. We were the only people to come out of a crisis with our reputation enhanced, which is difficult to find in the current crisis. We made many mistakes and the committee can take advantage of what we did wrong and what we eventually figured out worked well. The first thing that needs to be done is to identify where the future institutions which will cause massive losses will be found, and how they can be identified when they are still reporting record profits so action can be taken while they are still doing so.

The committee has asked me to speak about principles-based regulation, which can mean many different things. The gloss put upon it throughout Europe and the United States was one which ensured it would fail against precisely the kinds of schemes I will talk about. This is not necessarily inherent in principles-based regulation. It is such a vague phrase it can mean different things to different people. Throughout Europe and the United States it came to have the same gloss, which was, basically, BFFs, which means best friends forever and is a cliché for American teenagers. This was the idea the banker could be the BFF and we could all have a Kumbaya moment and strum folk songs together, and if we were just nice to the bankers who were oppressed by regulation and removed this terrible hand of government they would work with us and we would all sit around the campfire and it would go very well. This has no basis in human history, or anything we know about human beings, but it was mighty convenient if you were a non-regulator because you did not have to do much of anything, and the world would be better because you did not do much of anything.

Here is the recipe which leads to something distinctive. It is the recipe that the institutions follow which produces the worst losses, is most likely to cause hyperinflated bubbles, is most likely to cause catastrophic individual losses, and is most likely to cause future crises. I am speaking about the past throughout the world, but my focus is going forward in Ireland with regard to policies the committee might consider recommending. The recipe has four ingredients: grow like crazy, make terrible quality loans - not kind of bad but absolutely terrible and obvious on their face loans; while employing extreme leverage, which means a whole lot of debt compared to equity, and while setting aside no meaningful loss reserves for the inevitable catastrophic losses which will follow.

If these four ingredients are followed, it is mathematically guaranteed - and let me emphasise it is not hypothetical but mathematically guaranteed, given how the accounting works - there will be three sure things. The bank will report, almost immediately, record profits. Under modern executive compensation the senior leadership will promptly be made wealthy but many other people in the food chain will also be made wealthy because the same perverse incentive structures are used to ensure they make those really crappy loans I talked about. The third sure thing is that down the road there will be catastrophic losses.

Thinking about it from the flipside, if you tried to devise a strategy that would cause catastrophic losses it would be with these four ingredients. Using them, you will cause huge losses and you will have no loss reserves. You are particularly vulnerable outside the United States in terms of the accounting rules, as you follow the international accounting rules, which also purport to be principles-based. The principle they purport to follow is an anti-fraud principle that is concerned with what we call the trade cookie jar reserves. These are loss reserves that can be established in good times and taken out in a bad quarter to allow officers to meet their targets and maximise their bonuses. This was the principle that the rule was designed to prevent, but it is being interpreted in a way which creates the perfect crime. It is being interpreted as saying loss reserves cannot be established currently for future losses, even in institutions which follow the recipe where it is absolutely guaranteed that because of their terrible underwriting they will have catastrophic losses.

Right now the anti-fraud principle is being interpreted as the most pro-fraud principle we can possibly imagine. As we speak today, six and a half years after the crisis hit, we still have the same international accounting rule. There have been all kinds of efforts to change it, but none of them has come to fruition. This is an area that could be addressed through regulatory policy. We could have regulatory accounting principles that require appropriate loss reserves. If we did that we would block the recipe I have been talking about and that would be a very good thing. It makes perfect sense that if you are doing things that are very risky you should establish loss reserves today. Otherwise you will create fictional income and you will get everything we have done. As I said, in a poker sense, this creates a tell. The tell is that in order to follow the strategy there has to be pathetic underwriting. What you will find when you look at all of the crises in the past and in other places is precisely this destruction of underwriting.

Underwriting is a process that a bank goes through to ensure it is likely to be repaid, and that if it does loan it will do so at an appropriate interest rate that reflects the risk. The committee can see that this was not done all through the world. I will talk about other places because of pending issues in Ireland and the Constitution. This is precisely what we did in the United States in the savings and loans crisis. We saw terrible underwriting, very low reported losses and record reported income, and we said this is too good to be true and it is. We all teach our children about things that are too good to be true, but we do not, in fact, follow this policy in reality in financial regulation. If we had, there would be none of these current crises, but we did in the past, which allowed us in the savings and loans crisis to identify when institutions were reporting record earnings, and literally reporting they were the most profitable savings and loans in America, and when they did so we targeted them for closure. In fact, we took the list of the allegedly most profitable and made it a priority to investigate each of the institutions in the top list.

To do this you have to understand the accounting and the econometrics. Econometrics is a fancy word for economic statistics. Here is the key: if a regulator examines with a standard econometric analysis - and cost-benefit analyses using this kind of econometric test are mandated throughout Ireland - they will give the worst possible result if an institution is following the recipe. Any characteristic or practice such as ultra-concentration in commercial lending to 25 families during the run up when the bubble is still inflating will show the highest positive correlation with reported profits. It has to do so. If we do standard econometric analysis we will say we should encourage everybody in Ireland, England and the United States to loan to only 25 people who should put virtually all of their money in commercial lending. That mathematically has to follow, so you have to not rely on those kinds of test. You have to understand that if you do not underwrite, as we have known for centuries, it will produce adverse selection. This selection means you get the worst possible borrowers, and the expected value - in order words, what will normally happen - is that you will lose money. It is like gambling against the house in Las Vegas. Statistically, you are going to lose money in these circumstances.

I will leave you with the most important thing, which is a phrase that you probably have not even heard to date - Gresham's dynamic, which is the opposite of that hypothetical Kumbaya dynamic - "All will be well." There is this guy named Swift who identified it in 1726 and put it in *Gulliver's Travels*, but it has also been dealt with by Nobel laureates in economics. It says "What happens if cheaters gain a competitive advantage in the markets?" Then bad ethics will drive good ethics out of the marketplace. This will happen in the professions as well. All of those supposed controls - credit rating agencies, outside auditors, what we call appraisers but you may call valuers - can be hired and fired by the senior management of the banks. That is why, worldwide, in this crisis you see them deliberately going to top-tier audit firms and always getting insane financial statements blessed with clean opinions - because that reputation is valuable and easily manipulated by creating a Gresham's dynamic. You can block that Gresham's dynamic. You can block these crises. We intervened to stop 300 of these frauds that were expanding at over 50% a year in terms of growth, typically while they were still reporting high profits. We adopted a rule restricting growth which attacks the Achilles heel - the need to grow very rapidly. We deliberately intervened to pop the real estate bubble - particularly commercial real estate - in Dallas-Fort Worth. We intervened to stop loans that were in those days simply called low-documentation loans but now in the American parlance are called liar loans. This was in 1990 and 1991. We drove them completely out of the savings and loan industry and prevented a crisis.

Our current crisis is sometimes called the sub-prime crisis, but it is far more of a liar loans crisis in the United States, and even in the United Kingdom. We successfully prosecuted more than a thousand elite people from the banking industry with felony convictions. Even with the best criminal defence lawyers in the world, there was a 90% conviction rate. So you can succeed. We would be very happy to help. If it would be useful, in terms of training, I will provide a week of free training on how we did whatever we did for your regulators or prosecutors, or anything you find helpful, without charge.

Chairman: I thank Professor Black for his opening statement. The order of questioners this morning is as follows: Deputy Joe Higgins will have 15 minutes and Deputy John Paul Phelan will have 15 minutes, and from then there will be six-minute rotations for the following: Deputy Eoghan Murphy, Senator Marc MacSharry, Deputy Kieran O'Donnell, Senator Sean Barrett, Senator Michael D'Arcy, Senator Susan O'Keeffe, Deputy Pearse Doherty and Deputy Michael McGrath.

Before I bring in Deputy Higgins, I wish to comment. I thank Professor Black for his opening address. He described in detail the problems associated with rapid growth in banks' balance sheets. Can he give us some specific indications on how regulators could apply rules to limit the growth rate? Is he suggesting that regulators should stop a growth rate that is excessive by his reckoning?

Professor William Black: Yes. You are probably particularly aware of what I am going to say. This is a federal agency that had three presidential appointees, so you get the best you can. You have to reach agreements. The best we could get was a restriction on 25% growth annually. The rule of thumb in banking for many decades has been that if you grow more than 25% a year you will likely fail, so this is a very weak limit. But here is the good news. It was still a cutback from growth of over 50% a year, which proved fatal to all 300 of these institutions. When I say "fatal", remember - they are dead but they are reporting that they have record profits. So you are not causing the failure, but you force recognition of the failure. In essence, these are Ponzi schemes. Ponzi schemes must grow extremely rapidly to appear to succeed for a while.

Chairman: Later today, in our second session, we will discuss the regulations set out in Basel I, II and III and the credit directives and so forth which are post-crisis measures established at the European level, particularly in regard to the eurozone. Does the professor think those measures are robust enough to protect us against a future crisis, going with his own metric of what he considers the sure things that would create a crisis into the future?

Professor William Black: Basel II was a very substantial contributor to the crisis, particularly in Europe. In the United States, because of heroic resistance by the Federal Deposit Insurance Corporation against the Federal Reserve economists, who are very much in favour of Basel II, we established a minimum leverage ratio. Therefore, leverage is roughly on average twice in Europe what it is in the United States in terms of the crisis. Leverage will magnify either gains or losses. If the FDIC had not done that, US losses would have been roughly twice as large. In fact, that is an understatement, because losses do not grow linearly but tend to grow exponentially in these circumstances. Yes, Basel II was a disaster, because it facilitated the recipe that I have just gone through - grow like crazy. It allowed massive growth. With extreme leverage, it allowed extreme leverage.

Is Basel III better? Yes, but Basel III is horrifically complicated. It would be vastly better to go back to much simpler rules. The position I am taking is, frankly, the majority position among people who are involved in regulation and economics.

Deputy Joe Higgins: I thank Professor Black for coming across the wide Atlantic to assist us with the banking inquiry. I had intended to ask him to give a short résumé of his experiences that have led him to be an expert on bad practices in the banks but he gave some of it in his introduction, which was quite interesting.

He referred to the prosecutions and the investigation into the savings and loan crisis. I remember it was a huge scandal in the United States back in the 1990s. It was a high profile case and was national news in the United States. With that success and what was shown, why was that not brought into legislation or regulation? Why, 17 years later in the United States and internationally, were the same bad practices allowed to create mayhem?

Professor William Black: That is a superb question, not just a good question.

At the moment of our greatest success in 1993 - there is this period that basically ended in 1993 - a new government came in. It brought with it, as its primary domestic priority involving government, the re-invention of government which is, essentially, principles-based regulation. They absolutely adored the lessons of the savings and loan crisis. I personally witnessed the following. We were instructed that we were to refer to the banks as our “customers”. I said, “Surely you mean the people of the United States of America?”. They said, “No, the banks.” I left government at this point, as you would imagine. I do not say it was a conspiracy, but it was a deliberate choice to move to a very different strategy without looking at the successes of the response to the savings and loan debacle. In order to produce over 1,000 felony convictions, we created a criminal referral process that provided the key information from the regulators. I remind the committee that we have vastly more expertise in the industry on accounting issues, etc., than the FBI white-collar folks. We made over 30,000 criminal referrals. That criminal referral process was eliminated. In the current crisis, there were no criminal referrals in the United States, as far as anyone can tell.

Deputy Joe Higgins: That was the Clinton Administration. Is that correct?

Professor William Black: Yes. That was Clinton and Gore. The Vice President was tasked by the President with being the principal person in reinventing government. It was actually worse than I said. The person who was in day-to-day charge - Bob Stone, who was picked by Vice President Gore - has an autobiography out at the moment. He says he was selected by Vice President Gore at a meeting. They had never met before. At their first meeting, Mr. Stone said one substantive thing to Mr. Gore, which was that he should not waste one second worrying about fraud.

Deputy Joe Higgins: Okay. Was it a wilful decision to move towards deregulation, rather than encompassing the lessons that had been learned?

Professor William Black: Yes. It was expressly "the government is a failure, the private sector is an enormous success, we need to bring in private market principles to reinvent government".

Deputy Joe Higgins: Okay.

Professor William Black: We needed to think of ourselves as a partnership with the banks - that was the explicit language they used.

Deputy Joe Higgins: Professor Black said something that might worry some people out there following on from that. He said a few minutes ago, if I understood him correctly, that nothing has "come to fruition" in effective regulation in the six and a half years since the most recent crisis started. Why does he think that is the case?

Professor William Black: When I used that language, I was actually testifying explicitly about the accounting rule on loss reserves. It is true that in general, financial regulation has not been transformed. We are still vulnerable to precisely the things I have laid out. That is because we have not focused on the Gresham's dynamic and we have not focused on the concept that is referred to in the economics literature as "looting". The key document in this regard was written by Professor George Akerlof, who is a Nobel laureate in economics, and Professor Paul Romer in 1993. The article in question, Looting: The Economic Underworld of Bankruptcy for Profit, lays out precisely the strategy I have discussed. They chose to conclude that article with a paragraph emphasising that because economists had no concept of looting, they were unable to aid "the regulators in the field who understood what was happening from the beginning" and suggesting that "now we know better". In other words, if we learn the lessons of this crisis, we need not experience this again. That very concept is forgotten. If the committee checks all the articles and all the testimony it is given, I bet it will find I am the only person who has cited Professor Akerlof, who is a Nobel laureate in economics in the heart of this specialty.

Deputy Joe Higgins: Could it be a factor in the United States or even in Europe that the financial markets and the massively powerful financial institutions have exerted pressure through lobbying, etc., to try to slow down or halt the type of radical regulation about which Professor Black speaks?

Professor William Black: By the way, "radical" in this context simply means regulation that proved incredibly effective for 50 years.

Deputy Joe Higgins: Yes.

Professor William Black: It was adopted on a bipartisan basis by conservatives, liberals and moderates. It is interesting that what was absolutely centrist in banking for half a century has now become "radical". The race to the bottom is another key example of a Gresham's dynamic. The regulatory race to the bottom was a real thing. If the members of the committee look at their counterparts in the United Kingdom - the parliamentary inquiries there - they will see it was absolutely explicit in the regulatory statute of the UK Financial Services Authority at that time that there was a need to win the competition. The aim was to keep the City of London as a top centre by deliberately weakening regulation.

Deputy Joe Higgins: Okay.

Professor William Black: Of course Wall Street always pointed to the City of London to say it needed to weaken or get rid of the Glass-Steagall law in the United States. It thought financial derivatives should not be regulated because that would result in all such activity being moved to the city of London.

Deputy Joe Higgins: Yes.

Professor William Black: Everybody loses during this race. The city of London won the race to the bottom. It is the absolute worst in the world. Wall Street is a close second in terms of the worst in the world.

Deputy Joe Higgins: We will put this question to the Commission representative who will be here later. We will ask whether there was such a race to the bottom in Europe. We await a response in regard to that. I would like to ask Professor Black briefly about the recipe he has laid out for bank failure, the drive for very rapid growth and the types of loans, etc. He said that one of the sure things is that this leads to immediate and vast profits.

Professor William Black: Reported profits.

Deputy Joe Higgins: Reporting profits.

Professor William Black: Fictional.

Deputy Joe Higgins: Could he explain very briefly to our people how that is possible? How do they make such profits in such a short time?

Professor William Black: They do not, but they report enormous profits. If I make a very bad loan at 9% and my funding cost is 4%, the difference, which is known as the spread in finance, is 5% or 500 basis points. If I make much worse loans, I will report a much bigger spread. That is not real profit, obviously, because I am taking vastly more risk.

Deputy Joe Higgins: Yes.

Professor William Black: In fact, I am taking so much risk that on every loan I make, I lose money in real economic terms. I should have an established loss reserve, perhaps of 600 basis points, which would make it clear that I was losing money every time I made one of these loans. The international accounting rules essentially provide for the establishment of a loss reserve of zero.

Deputy Joe Higgins: Okay.

Professor William Black: To put it simply, the riskier or crazier the loan I make, the more fictional profits I will report, the bigger the losses and the bigger the compensation.

Deputy Joe Higgins: How does that work for the person taking the loan, who is paying higher interest rates?

Professor William Black: They are sometimes paying that rate, but frequently of course they are not paying that rate. The saying in the trade is "a rolling loan gathers no loss". To roll a loan is to refinance it. As long as the bubble is expanding, I can simply play this game by refinancing or giving what is due. It is really easy in commercial real estate. Someone who has €60 million in projects already funded is given another €100 million for a new project and told to use the cashflow to keep himself or herself alive.

Deputy Joe Higgins: Okay. I would like to ask Professor Black a question about Ireland. According to the Nyberg report, lending by the six banks covered by the bank guarantee of 2008 increased "from a stock of €120 billion in 2000 to almost €400 billion by 2007". The report points out that "the three years ending in 2006 marked the highest sub-period of sustained growth, with loan assets more than doubling overall, growing at a compound rate of almost 28% per annum". Would that kind of practice fit in with the bad practice or type of practice outlined by Professor Black at the beginning?

Professor William Black: It is the first ingredient in the recipe, obviously. It is also a question of concentration of risk. We also looked at concentration of risk. This is a sure tell that something is absolutely imprudent. The really good news is that there is no need to predict whether there is going to be a bubble or a crisis. Really bad underwriting is unambiguously bad for the world. When it is stopped, that makes everybody better off, except for the bad people, by blocking a Gresham's dynamic and allowing the honest bankers to succeed in the marketplace.

Deputy Joe Higgins: I will move on. As part of a discussion on the Nyberg report, Professor Black said that the Irish economic environment before 2007 was not benign and that it was the largest bubble proportional to GDP of any developed nation. He further said that what happened in the banks was exceptionally profitable to the senior officers leading the banks.

Professor William Black: Yes.

Deputy Joe Higgins: Professor Black is probably familiar with Professor David Harvey. I do not have time to quote from his book, *The Enigma of Capital and the Crises of Capitalism*, but he referred to senior hedge fund managers getting bonuses of as much as $1 billion a year as a result of their activities in the financial markets. One can understand how that extreme level, as many people would regard it, of compensation could lead to recklessness but in the Irish case where we would not have figures of that dimension, would Professor Black say that the same type of incentive would prevail, with perhaps smaller levels of compensation?

Professor William Black: You do not need $1 billion to incentivise disastrous behaviour. Seriously, in the lower ranks, the bonuses would often be in the $500 range. It must be remembered that we are talking about people who are pretty close to the minimum wage. If we look at the United Kingdom and the payment protection insurance, PPI, abuses, this is often incentivising people who are pretty much the working poor, and that can be done with just a few hundred dollars. By the way, they do not always do it just with money. In some places, if someone did not sell enough, they literally put a cabbage on their desk. It is the insult in the UK context of being considered a cabbage head.

Chairman: This is the Deputy's last question for the moment.

Deputy Joe Higgins: Mr. Nyberg ascribed most of the problems to bad judgment rather than bad faith. Without going into specific cases, at which point does Professor Black think our people should judge the activities of the bankers as failed banks crossing the line from bad judgment to bad faith?

This is my last question. In view of the type of excesses we have seen and that Professor Black has devoted his life to countering, and what was found in the United States to be criminality etc., rather than having these huge financial resources swilling around the world in private hands, what would be his view of a publicly owned banking system subject to democratic ownership, control and accountability?

Professor William Black: In terms of the last one, postal savings banks have been very successful throughout large parts of the world, not just in Europe. Japan had them for a very long time. There is a concept in economics of Nero banks, and that fits well into that category.

As to the Deputy's other question, one of the critical things this recipe does is allow us to differentiate between behaviour that is "reckless" or "optimistic" and behaviour which is deliberate. We get deliberate behaviour when we deliberately create adverse selection. We must remember that underwriting looks like a cost centre but it is really the primary profit centre of an honestly-run bank. I have not mentioned this, as a banker sitting on credit committees and such, that you make money by doing good underwriting. When you deliberately do bad underwriting and when you push out the people - this is in the Nyberg report - who object and who try to have good underwriting, that is deliberate behaviour. It allows you to distinguish. I have an entire article in the literature on criminology about how to distinguish between criminal behaviour and not; the Deputy can read that article. That is what allowed us to cut through these defences. We must remember these are the best criminal defence lawyers in the world. They are people in elite positions who could hire the best defence and get those convictions with a 90% conviction rate. It is possible to distinguish which of these things is really happening. There is literature available, and there is an experience.

Deputy Joe Higgins: I thank Professor Black.

Chairman: Before I call Deputy Phelan, will Professor Black tell us the role external auditors have to play in what he has been discussing with Deputy Higgins? There is an agency that comes in and examines the bank's balance sheet in terms of risk concentrations and everything else. Surely it has some responsibility or is in a position to make a judgment on it.

Professor William Black: This is in the context where there has just been a very large settlement against a credit rating agency, in the United States context, Standard & Poor's. That is another example of the Gresham's dynamic. There is explicit stuff in our equivalent. I was the deputy staff director of this equivalent in the United States that looked at the US crisis in the savings and loan debacle. The Chairman will see in that that it explicitly states there was a Gresham's dynamic among top-tier audit firms. In that context they were the big eight; we are down now to the big four.

Chairman: What does that mean in layman's language?

Professor William Black: That means I hire the audit partner. The senior banker hires the audit partner. We have a dog and pony show in which they pitch for the business. This is how one becomes a "biggie" in a top-tier audit firm. One brings in a whale of a client, as the phrase goes, and signals in the course of that, and we could have a complete video tape and it would not matter, that one is the right kind of auditor. That is who gets hired, and that is why we will find throughout Europe and throughout the United States preposterous financial statements that got clean audit opinions from top-tier auditors. They deliberately go to top-tier auditors because that reputation enhances both looting and the fraud. Places that are massively insolvent with terrible underwriting invariably get clean opinions from top-tier auditors.

Chairman: I thank Professor Black for that because we will be speaking to Mr. Nava later this morning and I understand that under the Basel III framework auditing companies can still concentrate 80% of their business within one company, so we will certainly be dealing with that. I thank Professor Black for that answer. I call Deputy John Paul Phelan.

Deputy John Paul Phelan: I welcome Professor Black. To continue the point the Chairman just asked him about auditors, he said in his opening statement that we are still operating under the same accountancy rules today as we were six or seven years ago. Will he outline for the committee the changes to those rules with regard to external auditors that could be made?

Professor William Black: The straightforward answer is to not allow the bankers to pick the auditors. There should instead be a panel of qualified auditors that are assigned to them, and we should track the performance of those auditors. It would be like relegation. If someone had a record of screwing up, they get yanked from the panel, assuming what they did was not criminal. If it was criminal, they are driven out of business, but if it was just inept, they get relegated. They do smaller accounts and prove over the five years that they can do it right, and then get back up to the "bigs".

Deputy John Paul Phelan: Who should operate the relegation?

Professor William Black: The United States Government, or the Irish Government in this context.

Deputy John Paul Phelan: I refer to the answer Professor Black gave earlier to the first question asked by the Chairman about the growth rate in banks' balance sheets. Professor Black spoke about the 25% cap in the United States. Wearing two of his four caps that he mentioned at the start in terms of economics and regulator, what does he believe is the optimal sustainable growth rate for a bank?

Professor William Black: There is no such thing. It depends on the growth of the economy. The more sensible answer is to look at the real growth of the economy and the relevant sectors being loaned to. If you are greatly out of line with that and if you did so by lending cheap relative to risk, then you are a disaster waiting to happen. Actually, you are a disaster that has happened that needs a solution immediately.

Deputy John Paul Phelan: Professor Black has written extensively, and it was touched on earlier, about this perverse compensation and employment incentives within banks. Does Professor Black have a view as to how the remuneration systems within financial institutions should be run differently from the way they have been?

Professor William Black: Yes, it should be run consistent with all the literature on how it should be done. All the literature from people of all ideological persuasions says it should be ultra long term so you get in off a living wage and then in the US context you can send one's kid to university. Ours are expensive. However, beyond that, the big kill comes not two years, but ten years down the line. You show sustained performance that is real for at least a decade. That is what all the literature, again by Nobel laureates, on this subject says. We simply do not run executive compensation in accordance with what we purport. We purport that we align the interests with the shareholders but we distinctly do the opposite. That is at the high end. At the lower end, never ever set banker compensation for, say, loan officers based on volume. We have known for centuries that this will produce a disaster. There is no upside to that. It should always be weighted with quality and people's bonuses should be deferred to establish that they were making quality loans, not simply volume loans.

In particular, the PPI is an unbelievable disgrace. This was a product, again according to the testimony in the parliamentary inquiry in the UK, that had an 80% mark up. They talk about unsuitable and while some people could never recover under the policy, it was unsuitable for everyone. It was a pure, rip-off product and they created incentive structures that ensured that it was not just money, but it was also about the humiliation of people who refused to do the wrong thing. That should never be allowed at all. The dollar amount does not matter.

Deputy John Paul Phelan: With regard to financial reporting by banks and other financial institutions, does Professor Black believe they should be treated the same as other businesses in providing quarterly stock market reports and results or can a case be made to treat them differently?

Professor William Black: It is true that there is a generic problem with executive compensation that is not limited to banking. I have literature that I have written about how things should be cleaned up more directly but banking is the worst of the worst and it is the one that has been shown to have the most intensive fault. In the US context, for example, we are back where we were before the crisis with 40% of total corporate profits in finance. Finance is simply supposed to be an intermediary, a middleman, and the efficiency condition for a middleman is clear - lean and mean. Instead it has become a parasite that is the leading enemy in the US context of Main Street. The Brits would call it High Street; I do not know whether there is a phrase in Ireland for this. It is bad for regular people and small businesses now. Banking, therefore, needs to be fundamentally changed to make it an engine of what it claims to be - economic growth and strength.

Deputy John Paul Phelan: Does Professor Black feel six or seven years on from the major difficulties financial institutions got into that current regulation is fit for purpose?

Professor William Black: No, it is clearly not fit for purpose. That does not mean there have not been improvements in some areas but you can see that they are still talking in very much similar terms, for example, cost-benefit analyses and econometric studies. If such studies are followed, you guarantee that you will do things that most facilitate the looting recipe I outlined. That would be an absolute disaster. You will still see that they do not understand the concept. I guess I am the first person that even used the phrase, “Gresham’s dynamic” here. That dynamic is used. The testimony at the parliamentary inquiry in the UK highlighted that dynamic and the US has consistently sued institutions such as Standard & Poor’s where the allegation after investigation is they engaged in fraud as part of a Gresham’s dynamic. We have done that not just to those ratings agencies, but we have strong proof that this happened in the appraisal context. The then New York attorney general, now governor, Andrew Cuomo, found this in investigations. We found it in the top tier audit firm the Chairman asked me about. This is a pervasive problem and there is no Basel-type action to break this dynamic.

Deputy John Paul Phelan: Professor Black gave a number of interviews to Irish media outlets at the end of 2010. In one newspaper interview, he said the Lehman Brothers crisis had saved Ireland from an existential threat. What did he mean by that? Did international factors have an impact on what happened in Ireland?

Professor William Black: Yes. Back in the time machine, as the Deputy will recall, when the crisis originally broke out, in Europe the meme was that it is all the stupid Americans. Europe was clean and it was all about those idiot Americans and sub-prime lending and so on. That has changed a fair bit. My point was that Lehman Brothers precipitated the crisis stage but it would have been far worse if the crisis had continued to build for another two years. In the Irish context, the worst banks had losses well in excess of GDP. They were simply becoming big banks, vastly bigger than the economy. If that bubble expansion had gone on for another two years, think what the losses would have been. For example, in the Icelandic context when Lehman Brothers precipitated the failure, the bank had ten times the GDP of Iceland and it was growing at more than 50% a year. With compounding, when something grows at 50% a year, it doubles in size approximately every nine months. If the expansion had gone on for another two years, it would been more than 40 times the GDP of Iceland. The losses per person in Iceland would have been hundreds of thousands of euro. Everybody there has an EU passport and, therefore, pensioners would have been the only folks left.

Deputy John Paul Phelan: At the end of 2010, in a Irish television interview, Professor Black said, "Nobody has responded to the crisis as stupidly as the Irish Government have responded". Will he elaborate on what he meant at the time?

Professor William Black: It was, in soccer parlance, the most destructive own goal in history. The Government, as everyone knows, guaranteed. This is the consequence in large part of truly terrible anti-regulation. If the regulators tell the Government, there is no problem here, there are no losses and it is a temporary liquidity problem but if it does not act within the next 12 ours, the entire system will melt down, what is it likely to do? If those are the facts as presented to you, it becomes very likely that you will do a guarantee. Giving an unlimited guarantee with no reliable facts turned a banking crisis into a fiscal crisis - not just any fiscal crisis, but clearly one that would crush Ireland. On top of that, Ireland guaranteed not just unsecured claims, it guaranteed subordinated debt. Subordinated debt is subordinated so that it will constitute capital, so that it will be at loss. The entire theory of why, under Basel II, it was tier-2 capital is because it would be lost. Those concerned made a deal, a contract deal. The deal was that if this bank cannot pay because it is insolvent, we get wiped out entirely, so in recompense we get a much higher interest rate. They got their interest rate. They are supposed to die and are supposed to be concerned with risk capital, and they got bailed out. I never understood this. Even with all the bad information they got from the regulators, and obviously from the banks because the banks had to file statements - all of those statements for the covered banks were hopelessly false - and even if you relied on that falsity and on the regulators, who were disasters, you would never, ever bail out the subordinated debt holders. They did not bail out every subordinated debt holder but bailed out the great bulk of them. To my knowledge, nobody else does that. That is why I said "the worst in history".

Chairman: I thank Professor Black. I noticed in his discourse that he differentiated between "banks" and "bankers". I know that in our earlier discussion, he just wanted that point noted.

Professor William Black: Yes, particularly for the folks who are going to be reporting on these issues and hearings, almost always when we use the word "banks", we actually mean "bankers". It is really important to distinguish which is really being referred to. Banks do not feel; they are not real and they operate through bankers. When you hear "the banks became optimistic", you should say "No" and always focus on the bankers. The bankers are not the best friend of the banks. Throughout history, the greatest risk to a bank has always been the bank's CEO. The CEOs are the ones who caused the catastrophic losses throughout history. That does not mean that most bank CEOs are crooks. Do not go from that. Really catastrophic failures are very unusual in banking. When they occur, it is most commonly because of the banks' CEOs. That is what I was referring to when Deputy John Paul Phelan asked me about the auditors. If a bank could choose, it would choose very conservative and very reliable auditors, but banks do not choose auditors. Bankers do, and bankers want a clean opinion that shows they have record profits and, therefore, should get really big bonuses. Bankers will choose, and characteristically did throughout this entire system.

When there is a Gresham's dynamic, you will no longer get just episodic problems with bankers. You can get very widespread problems with bankers, which is why in the United Kingdom, for example, claimants on these products are winning over 80% of their claims. It became absolutely the norm. In fact, the testimony in front of your counterparts is that virtually all the profits that UK banks were reporting came from PPI.

Deputy Eoghan Murphy: To come back to the recipe Professor Black was outlining to us earlier, the second step is the making of bad or terrible loans. What is the motivation behind the making of those loans?

Professor William Black: That is a wonderful question. Let us look at the counter-factual. What if you try to grow very rapidly and charge a premium nominal interest rate by making good loans in a relatively competitive industry such as banking with a mature product? In other words, it is not like the invention of the iPad for the first time, when you could sell it to billions of people. If you wanted to grow 50% a year by making really good loans, what would you have to do? You would have to buy market share and reduce your interest rate to be able to get really good borrowers and their business. Good borrowers find it very easy to buy and get loans in normal times. What would your competitors do when you chopped your interest rates?

Deputy Eoghan Murphy: They would follow suit.

Professor William Black: They would respond. At the end of the day, do we make more money? We would all make a lot less money. However, in any society there is a significant proportion of people who are not creditworthy, and they will agree to pay a higher interest rate. That higher nominal rate, if you do not establish loss reserves, has to show up as a spread — a very big positive spread. It is just mathematics and accounting at that point, although in this regard I would emphasise something I have not emphasised: the really pernicious part that gets added on is when a lot of this income is non-cash. You have to understand the basics of accrual accounting. Is the difference between accrual and cash accounting familiar? With non-amortising or, at least, non-fully amortising loans — Ireland has had these — banks are booking as income things that they have never received in cash. That is how accrual accounting works. I can agree to do lots of things where I am not actually paying in cash. That is why people make bad loans or why bankers make deliberately bad loans. They will create this phoney income whereas trying to make good loans would produce real losses.

Deputy Eoghan Murphy: The point I am trying to come to concerns making bad loans deliberately, with the knowledge they are bad.

Professor William Black: Absolutely.

Deputy Eoghan Murphy: What about where people are investing themselves in what their own bank, or banker, is investing in, as we have seen in certain cases? They are losing money in that scenario also.

Professor William Black: Some of this occurs but vastly less than people think. Let us talk about it. One thing is that compensation is often paid in shares. Those concerned say, "Look, how much I lost when the bank failed", because the share price fell. However, the share price was never real. The only reason the share price reached those kinds of numbers was precisely because of the strategies of the recipe. Therefore, they never lost money because it was not there. Also, even the bankers who are running these schemes do not know when the bubble is going to end; nobody knows. Sometimes people stay too long in the game but frequently, even in those circumstances, you will find it was not really their money but the banks' money. I would be far less impressed with the line of logic that states those concerned must not have been doing anything deliberately wrong because they, too, suffered some losses in these circumstances. That does not follow logically.

Deputy Eoghan Murphy: Let me go back to the prior step in terms of this extreme growth and the role commercial property lending plays for a bank in managing to make that extreme growth, and the relationship with the regulator in that context.

Professor William Black: Again, extreme growth is itself something that should not be allowed by a regulator. We have centuries of experience that tell us that is true. The concentration of risk is something that is insane for a large institution. In other words, small players that cannot reach economies of scale have to have niche strategies, so they will concentrate. That is riskier but they have no great choices. All their choices involve material risk but you do not want a very large financial institution concentrating its risk in a product line like commercial lending. Even if you were going to concentrate on commercial lending, you would never prudently concentrate in a small number of borrowers. The old joke they tell about banking is absolutely true. If you borrow $10,000 from a bank, the bank owns you but if you borrow $100 million from the bank, you own the bank. The banks will extend even bigger loans to you and, as long as new money is coming in, you can keep the thing alive a bit. That is always a bubble disaster. We have known this for many past crises. This was something that was easy for the bankers and for the regulators to figure out. The Irish crisis was one of the most easily preventable crises by either competent bankers or competent regulators.

Deputy Eoghan Murphy: I thank Professor Black.

Chairman: I call Senator MacSharry.

Senator Marc MacSharry: Has the Chairman nothing to add himself on this occasion?

I thank Professor Black for joining us and for making the trip over. Just to start things off, he described the guarantee as an insane decision. We have had Governor Honohan from the Central Bank in and we have had Peter Nyberg, as Professor Black is aware. They have said that these were the best of all bad decisions. In Professor Black's own experience and without the benefit of hindsight, what would he have done?

Professor William Black: That is what I am saying. We are actually saying very similar things. It ends up being an insane decision. It was the worst possible decision that could be made, but in the circumstances one finds oneself - if the bankers are lying to you and the regulators are utterly incapable of seeing reality and, on top of that, are telling you that, tomorrow, the world ends unless you take this action - you are likely to take terrible actions. I think that our testimonies are consistent.

Senator Marc MacSharry: Professor Black may have done the same thing in the same circumstances.

Professor William Black: No.

Senator Marc MacSharry: That is what I am asking. What would he have done?

Professor William Black: Personally, no, because I know banks and I would not have relied on the regulators, but-----

Senator Marc MacSharry: If Professor Black was a politician as opposed to an expert-----

Professor William Black: Yes. A politician is not someone who spent his or her life doing these things and knows that it is too good to be true.

Senator Marc MacSharry: For sure. When I asked Professor Edward Kane, who we had in lately, in the context of Europe's response to the crisis, he said that, in many ways, Ireland got a hard deal from its European partners in relation to bank debt. In the subsequent reforms that we have seen, does Professor Black think that there has been sufficient reform so far in the eurozone to make sure that a scenario like this does not happen again and to account for the need for a fiscal union?

Professor William Black: No.

Senator Marc MacSharry: Okay. In terms of the likelihood of a repeat, does Professor Black think that the set of parameters that currently exist make it quite likely that it will all happen again?

Professor William Black: Yes, and it will be worse. This is not just Ireland and Europe - this is the United States. There has been no accountability for the bankers and no accountability for the regulators. So, it will take the next boom before this happens again. In the savings and loan crisis, as the committee heard we got over these 1,000 felony convictions. None of those people, to my knowledge, participated in the current crisis precisely because they had criminal records. That is what we call specific deterrence. There will be no specific deterrence out of this crisis. The worst actors who know exactly how to use these four ingredients of the recipe that I told the committee are out there, and what they have learned from this crisis is that it is a sure thing and not much of anything happens to one. That is a really perverse incentive structure. It is critical that one reverses that.

Senator Marc MacSharry: We heard from the Governor of the Central Bank in previous testimony. As to the Governor's role on the ECB's Governing Council, does Professor Black believe that this is a flawed construct in the eurozone, where the fiduciary duties of the governor of a state is to the bank and the institution rather than, for want of a better expression, wearing one's nation's jersey?

Professor William Black: The Chairman said that everyone should take off one's jersey. I never had a jersey; I am not from here. Structure matters. Creating conflicts of interest is a bad idea, but all of these structures failed. I spend less time worrying about if it is an FSA consolidated approach or is it from the Central Bank or not from the Central Bank, and far more about whether the people in charge understand the concept. As Professor George Akerlof, the Nobel laureate in economics, said, not understanding the concept, they were helpless to deal with it. If you do not understand the concept, what can you do? It will happen again and you will never even see it.

I focus on leadership. How did it work in the savings and loan crisis? It worked because the chairman of the agency listened to the people in the field, who in business school terms are the closest to the facts. Each month he got 1,000 pages. He actually read and he said that the people in the field were right, and then he went out and he hired the two people in America who had the reputation for being the toughest regulators in America and put them in charge of our two worst areas.

Senator Marc MacSharry: Just very finally-----

Professor William Black: That is just how you do business. Right? If you are a business person, what do you do? You go out and hire some people.

Chairman: I would like to bring Senator MacSharry in for his last question, please.

Senator Marc MacSharry: Last question, and I thank the Chairman. Professor Black's writings, to me, would seem to suggest that Ireland took the hit for the European banking crisis.

Professor William Black: Absolutely.

Senator Marc MacSharry: Professor Black would agree with that statement.

Professor William Black: Ireland tried to bail out the German banks, basically, and that was never going to work.

Senator Marc MacSharry: Would Professor Black feel that the euro, therefore, is arguably unfit for purpose because of the smaller economies on the periphery like Ireland, which are less than 1% of the eurozone?

Professor William Black: The euro is a disaster. It never made sense in terms of the economic literature on an optimal currency area. My colleague, Professor Stephanie Kelton, who is now the chief economist on the US Senate budget committee, is one of a number of scholars who wrote this in advance and their predictions have proven absolutely correct.

Senator Marc MacSharry: I thank Professor Black.

Deputy Kieran O'Donnell: I welcome Professor Black. I will just go back. He wrote a blog on 13 November 2013: "Irish fish, and banks, rot from the head". I want to give him a quote. He said: "The Irish people are distinct, however, in blaming themselves for the crisis." Can he elaborate on that? What does he mean?

Professor William Black: Yes. I come here frequently for the Kilkenomics festival, in particular, in Kilkenny, Ireland. You get stopped on the street by people, just regular Irish people, who want to talk about economics and such.

Chairman: Does Professor Black charge for it? I know he is coming here for free, but are we-----

Deputy Kieran O'Donnell: I am assuming-----

Professor William Black: We are not paid.

Deputy Kieran O'Donnell: I assume it is as an economist rather than as a comedian.

Professor William Black: The Deputy can actually check the literature where that has been confused at times. The point is, we get feedback from hundreds of Irish folk over time. I am brought to many other places, like Iceland and such, for the crisis. Ireland is distinctive in the degree to which the average people on the street blame themselves for the crisis.

Deputy Kieran O'Donnell: When Professor Black says "blame themselves", what does he mean?

Professor William Black: "We were too oriented towards home ownership" and "we did not just buy a home - we bought a second, speculative property".

Deputy Kieran O'Donnell: As an objective observer from outside these shores, what is Professor Black's view as to the view that the Irish people should-----

Professor William Black: In the schema of responsibility, the Irish people are so low on the list that they do not much matter. It is a serious thing. The research on behavioural economics is very, very strong and it is completely ignored by regulatory agencies. Going into this crisis and even afterwards in the United Kingdom, there is all this stuff on consumer education. One cannot try to get everybody in Ireland or the United Kingdom to be able to understand a collared swap, which is what was being pushed for small businesses. I teach courses in this. At the end of a semester-long course for graduate students, if they understand a collared swap I go out and treat myself. The concept that an average person-----

Deputy Kieran O'Donnell: It does raise an important question.

Professor William Black: -----would ever understand this is absurd. This attempt to apply the concept of *caveat emptor*-----

Deputy Kieran O'Donnell: Buyer beware.

Professor William Black: That is right-----and *laissez-faire* in this context produces situations in which one gets an 80% mark-up - a product that no one should ever buy and that should never be authorised, and on which claimants win more than 80% of their challenges saying it is inappropriate.

Deputy Kieran O'Donnell: Professor Black made a comment that the Irish crisis could have been prevented. How could it have been prevented?

Professor William Black: Because it followed absolutely the characteristic recipe according to Nyberg. If one looks through the Nyberg report, it states that the banks grew like crazy. In fact, you just read the statistics about it.

Deputy Kieran O'Donnell: The former Anglo Irish Bank, one of our banks, grew by nearly 30% per annum over an eight-year period.

Professor William Black: It is not limited that. If you look at the covered banks, which is what his report is on, the growth number is there. You can look at it. The fact that it was extreme leverage is there. The fact that the underwriting was terrible is there.

Deputy Kieran O'Donnell: On the four key points Professor Black speaks of, what would have been the antidote to that lethal cocktail to ensure that the Irish banking crisis did not happen?

Professor William Black: When we saw that in the United States, we acted immediately. Within a year of a deregulation law, in our context, which was 1982, there was a full-scale re-regulation of the industry, over the opposition of the Reagan Administration, over the opposition of a majority of our House of Representatives, who co-sponsored a resolution telling us not to re-regulate the industry, and over the opposition of the Speaker of the House, who is the second most powerful elected-----

Deputy Kieran O'Donnell: Let us get to the point. What should have been done? What would have prevented it?

Professor William Black: You would have done what we did. You would have restricted growth. You would have said, “You cannot do this terrible underwriting.” You would have investigated the places that were doing it and you would have closed them down.

Deputy Kieran O’Donnell: From what year would we have done that?

Chairman: This is the Deputy’s last question.

Professor William Black: Within a year of being appointed, which is when we did it.

Deputy Kieran O’Donnell: No, in the Irish context.

Professor William Black: That is what I am saying. You are asking what year, and I am saying we did it as soon as we were appointed.

Deputy Kieran O’Donnell: So you would have moved in straight away?

Professor William Black: We would moved straight away.

Deputy Kieran O’Donnell: I have a final question. There was lower tier 2 subordinated debt as part of the bank guarantee. To the ordinary person, what is lower tier 2 subordinated debt? It is one feature of our bank guarantee that was very unusual and has never really been properly explained. What is lower tier 2 subordinated debt?

Professor William Black: “Subordinated” means that you come later in bankruptcy priority, and as a practical matter, it means you will essentially never recover if a bank fails. That is what it is supposed to mean. Because of that, the banking regulators actually encouraged the issuance of subordinated debt - because this was supposed to create ideal private market discipline.

It is bought, typically, from a minimum size of $10,000 up to multi-multi-million-dollar slugs, so it pays to exert private market discipline. It is bought by elites - allegedly financially sophisticated people - and because of the subordinated feature, if the bank fails, the argument goes, they will lose their money. You are supposed to get ideal private market discipline and because of that, it is treated as part of your capital to meet your capital requirement. It is expressly defined, therefore, as risk capital. That means it is supposed to be lost if the institution fails - otherwise, all that theory stuff goes out the window. So the one thing you would never, ever bail out or guarantee is subordinated debt.

Deputy Kieran O’Donnell: It would make no sense.

Professor William Black: From any perspective, based on even what they knew then, you would never bail out subordinated debt.

Senator Sean D. Barrett: I welcome Professor Black. There are approximately 12 references in Professor Black’s ten-page paper to Gresham’s dynamic. Could he explain that to people watching on television, bearing in mind that here, the Gresham is a very eminent hotel? Even the folks in the hotel may be looking in. Could he explain what he means when he refers to the Gresham?

Professor William Black: It is named after an English economist whose dad was the originator of the idea of creating stock exchanges. It is referred to as “Gresham’s law” in the economic literature, and it says that bad money drives good money out of circulation in hyperinflation.

Professor George Akerlof, the Nobel laureate in economics, in his most famous article, "The Market for Lemons," in 1970, used it as a metaphor to describe a Gresham's dynamic in which bad ethics drives good ethics out of the marketplace. This is because, if you gain a competitive advantage by cheating, markets will become perverse and the cheaters will prevail. It also applies to professions, such as appraisers. This is dealt with in the report published by our analogue to you folks, the Financial Crisis Inquiry Commission, and you can read it.

Senator Sean D. Barrett: I thank Professor Black for that.

Professor William Black: Basically, they extorted appraisers. When I say "they", I mean the lenders. If you were not willing to inflate the appraisal, they blacklisted you and you could not get a job. No honest banker would ever inflate an appraisal. That is an example of a Gresham's dynamic. As I say, Swift actually identifies this with the Lilliputians in 1726.

Senator Sean D. Barrett: I expect the people in the hotel will feel much better after that. Could Professor Black explain the concept of PPI abuses - payment protection insurance - and the 80% mark-up for those watching on television?

Professor William Black: PPI is an insurance policy that is sold along with a loan as an allied product. It tries to take advantage of people's fear of unemployment. It basically says that if you lose your job after a certain period - and only for a very limited period - it will pay some or all of the loan. It is, in United States terms, sort of like a credit life policy. As an undergraduate 40 years ago, I was taught never to buy a product like this. We have known for a very long time that it is a complete rip-off product. On top of that, it was sold to people who were self-employed - who literally could not collect under the terms of the policy.

Senator Sean D. Barrett: One of the things we will be discussing when all the witnesses have gone away is an important recommendation Professor Black makes - that Ireland should not have junked GAAP for IAS 39. It is important for us to understand that change in accounting standards and how Professor Black thinks it contributed to our problems.

Professor William Black: The generally accepted accounting principles, GAAP, rule is that at the time you are making the loans - immediately, in other words - you have to establish loss reserves that are appropriate for the risk you are taking. If you are not underwriting a loan and making it to people with ultra-concentration and such, you have to immediately establish much larger loss reserves. If you had established appropriate loss reserves, the accounting would have shown from day one that the loan was actually a loss.

Senator Sean D. Barrett: I am sure that is something we will come back to. Is there any literature Professor Black has come across that states "No bank should fail"?

Professor William Black: No. Banks should fail. Indeed, our function as regulators is to force them to recognise that they failed a year and a half ago and close them through receivership.

Senator Sean D. Barrett: I have a final question before the Chairman calls this to a halt. Professor Black's presentation states: "I do not believe any of the purported horrors of increased capital requirements for banks." What would Professor Black have in mind? What percentage of equity should they bring to the scene?

Professor William Black: I think the proposals to push it up into the 20% range are eminently sensible. I think there is no chance that Basel will do that.

Senator Sean D. Barrett: I thank Professor Black.

Senator Michael D'Arcy: I welcome Professor Black.

With regard to the bank guarantee, Professor Black used the analogy "the worst own goal in history" when referring to subordinated bonds being paid. Was the game fixed against the Irish nation by external players?

Chairman: That is a leading question. The Senator needs to frame his question in a manner that allows the witness to give his own testimony, not to be led by a member of the committee.

Senator Michael D'Arcy: How did the own goal happen? Specifically, I ask Professor Black to address the external factors of the own goal for subordinated bonds.

Professor William Black: There have been subsequent disclosures of the documentation involved stating that there was, in fact, express pressure from the European Central Bank to do these things. I think I have answered the question. The banks provided statements to the Irish Government and the regulators that had no relationship to reality. They were grotesquely inflated in terms of reported capital at a time when the banks were in fact massively insolvent. That is fact one. Fact two is that the banks came and said if you do not give us this guarantee, we will fail and we will fail within hours. Fact three is that the regulators were asked and, by all reports, said something to the effect of "there is no asset problem here, it is just a short-term liquidity". Fact four is that, for some reason, subordinated debt was not broken out of this explanation. We have gone through that as well in my testimony. Fact five is that, with pressure from the ECB as well, collectively, they said that if there is not an asset problem but there is an imminent liquidity crisis that is going to bring down the banking system tomorrow, we had better give the guarantee. That is how the decision was made.

Senator Michael D'Arcy: What is Professor Black's opinion on the intervention of the then US Secretary of the Treasury, Timothy Geithner, in regard to subordinated bonds being paid as well?

Professor William Black: I am not personally aware of him taking a role in whether the subordinated debt should be paid in Ireland. I can tell the Senator that I have never run into anyone in any context who thought that this was appropriate. There is unanimity among all the financial experts that this part was simply insane.

Senator Michael D'Arcy: Am I correct in saying that savings and loan institutions in the US equated to the building societies here?

Professor William Black: Yes.

Senator Michael D'Arcy: Can Professor Black expand upon the parallels between savings and loan and what happened in Ireland and how they affected the overall banking scenario in Ireland?

Professor William Black: The most parallel crisis to the Irish crisis, of which I am aware, is the savings and loan debacle. There are many differences, obviously, but it is the closest in that it was same in both cases and it was a bit different from building societies. Because of deregulation in 1982, savings and loan institutions were allowed to be essentially universal banks, as the Senator used that parlance, and so they could take equity positions, and unlimited equity positions in the case of the California institutions. They followed the recipe that I talked about and did so not only in residential lending but in commercial lending, and they produced a very large bubble. Our bubbles were regional but we are a much larger country geographically, and those bubbles were of similar magnitude to Ireland, but regional, and compared to our national economy, it was never anywhere near as large.

Chairman: A final question, Senator D'Arcy.

Senator Michael D'Arcy: We are discussing traditional banking and how the traditional banking sector ended up where it has ended up in Ireland. Can I ask about the newer models because Professor Black said he wants to look to the future, and we also want to look to the future? I refer to the newer models of banking such as equity funds which operate in all but name as a bank with their investment in commercial property, and in particular the new disruptive technologies that are disrupting the banking system, as we currently know it, in terms of the tech platforms that have been made available. I refer to what Ana Botín, the chair of Banco Santander has said. These are new challenges that are coming down the tracks rapidly and that are unregulated. What is Professor Black's opinion on those entirely, or substantially, unregulated sectors that could give rise to catastrophic problems in the future?

Professor William Black: It is a complex mix. The Senator is correct that many technological changes have created rivals to traditional banks and that these rivalries have reduced the profit margins in banks and are likely to do so in the future. There is testimony in the Senator's counterpart, about which I would be a bit sceptical, of banks claiming that they lose money in traditional activities. Whether or not they are correct, if they have that mindset, it is going to create pressures to find higher yield. There are two ways to create higher yield, one of which I have talked about at length, which is the recipe, but the other one produces large profits and it is basically fleecing one's customers. That is the PPI model. Both of those are very, very bad things that one would want to prevent. I do not think we are going to be able to prevent technology from changing. It does not particularly upset me that there are private entities that take equity risks as long as they are not bailed out and do not create a systemic risk to the system. If their shareholders want to have an equity fund and win or lose, that is okay by me, but it brings me to the subject we have not mentioned yet, the other grave danger, which is the systemically dangerous institutions, the ones that are so-called too big to fail. One simply should not ever have an Irish champion like that. That is nuts. You cannot bail out Europe in that sense. If one puts oneself hostage to a champion, it is not a champion anymore. As soon as it fails, and it is a question of when and not if, Ireland would be back in a crisis. Do not hitch your star to an institution too big to fail. It will create absolutely perverse incentives.

Chairman: I call Senator O'Keeffe.

Senator Susan O'Keeffe: To return to politicians, faced with a great crisis that is happening all around them, what role could, should or would due diligence play in that scenario?

Professor William Black: Due diligence is underwriting. If one insists on good underwriting, one will find these problems years before, maybe as much as a decade before, as we did with liar loans, and it can be dealt with when it will not cause-----

Chairman: In terms of what Professor Black means by liar loans, are they loans on which people more or less self-assess themselves?

Professor William Black: Yes. It is US business parlance, which was-----

Chairman: When the borrowers self-assess themselves.

Professor William Black: This is how the industry in the United States referred to these loans behind closed doors. In the United Kingdom they are referred to as self-certified loans so-----

Senator Susan O'Keeffe: Should politicians have sought due diligence?

Professor William Black: Right. One of the great stories of the savings and loan crisis is the reason we succeeded in those criminal prosecutions is that Congressman Doug Barnard held a hearing, as part of the regular oversight function, and embarrassed the heck out of our agency, the FBI and the Department of Justice. He exposed the fact - this is around 1983 - that there was no effective system for making criminal referrals and for prosecuting people. Yes, vigorous oversight hearings by the Legislature, to use a generic phrase, are critical.

Senator Susan O'Keeffe: No, I am talking about the moment of a crisis when everything is going wrong.

Professor William Black: I am saying before a crisis. The crisis is too late. At that point if a committee started getting involved-----

Senator Susan O'Keeffe: If a decision is going to be made about guaranteeing something, would Professor Black seek at that moment to do some diligence on what he was about to guarantee?

Professor William Black: Absolutely. I would be in a different situation with regard to the ability to do that due diligence even quickly, in terms of it being too god to be true-----

Senator Susan O'Keeffe: Yes.

Professor William Black: -----but politicians are generally not going to be in a position to do that then. But I am saying-----

Senator Susan O'Keeffe: But should they seek it?

Professor William Black: -----well before the crisis, you can be an important part of preventing future crises by holding hearings and bringing in the regulators and asking the tough questions when there is ample time to deal with it, literally years before if you keep in mind the underwriting tell, the Gresham's dynamic, this recipe, the concept of too good to be true.

Senator Susan O'Keeffe: Could any bank have embarked on this recipe Professor Black has described by accident, or would they know that they were doing what they were doing?

Professor William Black: Again, if I might chide Senator O'Keeffe, that is where we should use the word "banker" as opposed to "bank".

Senator Susan O'Keeffe: Please do.

Professor William Black: That is my professorial response. No, that is how you distinguish. No honest banker is going to gut underwriting because we have known for centuries if you do that you will lose money. But bankers who want to follow this recipe will do it because it will produce these three sure things, and that is how we got convictions even against top criminal defence lawyers by explaining that to juries. I was the expert witness in a number of these cases. I trained the FBI agents and the assistant US attorneys in precisely how to distinguish. That was among my functions.

Senator Susan O'Keeffe: Would bankers in that recipe scenario know that their own bank was insolvent? Could they have confused it in any way?

Professor William Black: No, they knew and took lots of actions to ensure that did not become public, including the ones in which I have testified at some length in terms of accountants and the creation of the Gresham's dynamic.

Senator Susan O'Keeffe: Would it be fair to use the term that they were actually creating personal profit centres – that that is what they were at?

Professor William Black: Well, the term used by a Nobel laureate in economics is that this recipe is all about looting. That is a pretty strong term.

Senator Susan O'Keeffe: It is a very strong term. I am very interested to know how the bankers make the money. Professor Black talked about cashing out, the extra shares, the golden handshakes and all of that. How do they actually make the money? Were they taking it out when no one was looking or was it just in their salary? Did they have deals going on?

Chairman: Those questions are leading.

Senator Susan O'Keeffe: What was happening in Professor Black's experience?

Professor William Black: I can answer a generic question.

Senator Susan O'Keeffe: Based on his experience.

Professor William Black: In my experience and I am answering the question generically not with regard to Irish banks-----

Senator Susan O'Keeffe: Absolutely.

Professor William Black: There are myriad ways to take it out. In fact, if the Senator reads my broad testimony, the national commission that investigated the savings and loan crisis referred to every way possible being used, but the primary way, the cleanest way that reduces the risk of prosecution is to simply take it out through modern executive compensation in which one's bonus is tied to performance. For the reasons I have stated, it creates a sure thing of high reported profits. That makes one wealthy within months or a year, depending on the situation.

Senator Susan O'Keeffe: What is the myriad of other ways? Can we find them?

Professor William Black: There are all kinds of other ways you can do it. There are many institutions that lend to the senior officer. There are others where they never repay it. There are others where they use that and they take projects. The usurpation of corporate opportunity is the jargon in the United States and probably in Ireland as well.

Senator Susan O'Keeffe: So it is easy.

Chairman: I am sorry, but that is a leading question.

Senator Susan O'Keeffe: I am sorry.

Deputy Pearse Doherty: Cuirim fáilte roimh an tOllamh Black chun an coiste. I welcome Professor Black. We are short on time and, as he can see, we have a very strict Chair. I will delve straight into an article Professor Black wrote in 2009 entitled "Those Who Forget the Regulatory Successes of the Past are Condemned to Failure". He presents in it a model of how to build an effective financial regulatory body. He talks about an analysis of data to look for patterns of emerging risks, including patterns of incomes that are too good to be true. He discussed what that means earlier in his testimony. The final point of his six-point plan calls for the prosecution of "elite control frauds" regardless of their political patrons. That is the issue I would like Professor Black to discuss. What does he mean by "political patrons"? Based on his knowledge in terms of his vast experience in the United States, could he tell the committee what political patrons mean in this context and the effect such a relationship would have on the financial crisis?

Professor William Black: We have not set this up but I thank Deputy Doherty. My answer is not in response to Ireland. I am not talking about Ireland. I am responding to the generic question. Here is an example of that dated 15 July 1987 from Charles Keating, our most notorious fraud in the savings and loan crisis to his chief political fixer. "Highest priority - get Black. Good grief - if you can't get Wright [the Speaker of the House] and Congress to get Black - kill him dead - you ought to retire." That is the kind of thing I am talking about. Our joke in the savings and loan crisis was the highest return on assets was always a political contribution for any banker. In our context, the Speaker of the House held hostage our Bill to get funding to close the institutions, to extort special favours for several fraudulent Texas savings and loan branches. Five US Senators who became known as the Keating Five sought to keep us from taking enforcement action against the worst fraud. The President of the United States attempted to appoint two members, chosen by Charles Keating, to run the agency. I told the committee it was a three presidential appointee agency that ran it. A Mr. Phelan, doubtless a distant cousin, was hired by the House ethics committee to investigate the ethics complaints against the Speaker of the House, James Wright. He did resign at the end of this process, but three of the recommended charges by Mr. Phelan after his investigation were that an ethics case should be brought against the Speaker of the House for his effort to fire William Black, his effort to fire Joe Selby, who was one of those two top regulators I told the committee about, and because he held hostage our funding to extort favours on behalf of folks.

In the United States context, these people do not go quietly. If you bring cases against powerful bankers, they will enlist their political allies and they will give very large political contributions to do that. In our context, Alan Greenspan was used to recruit the Keating Five, the five US Senators. He was hired as a lobbyist initially by Charles Keating to recruit those Senators. The United States is not unusual in those terms. If you take on really powerful bankers you will find that you get political push-back. If you do not pick regulators who will stand up to that – this is what I referred to as the Mike Patriarca level - Mike Patriarca was asked by a US Senator, one of the five who was meeting with us, whether he was saying that Arthur Young & Company, then one of the top tier audit firms, would prostitute itself for a client. Committee members, as legislators, know that if they ask that of a bureaucrat what the only possible answer is. When there are five Senators the only possible answer is, "Oh no sir, I would never say that." The actual answer from Mike Patriarca was "Absolutely, it happens all the time."

Deputy Pearse Doherty: I need to move on to another question as my time will run out. In his opening statement Professor Black talked about the ultra concentration of commercial lending is a tell to use poker analogy. He said that is a characteristic in the rapid model of growth. In relation to the ultra concentration of assets of other witnesses, we have had various reports done on behalf of the Irish Parliament on the concentration of lending in two specific banks. A total of 50% of the loan book of Anglo Irish Bank was in the hands of 20 individuals and Irish Nationwide Building Society had 51% of its loan book in the hands of 25 individuals. In Professor Black's experience in the United States, would that type of concentration of commercial lending be unique or common? If one came across such a concentration, what should one do? Should one ignore it or should it raise alarm bells? What should be the response?

Professor William Black: I have never seen a concentration that high at any financial institution of any size anywhere in the world at any time in history. It is absolutely - no questions and no ifs, ands or buts - utterly unsafe and unsound and I would have begun efforts to stop it immediately. At those levels we would have been gearing up for receivership.

Deputy Pearse Doherty: Professor Black said a rolling loan gathers no loss.

Professor William Black: And you thought bankers could not be lyrical.

Deputy Pearse Doherty: You have proven that you are more than a banker. With regard to rolling loans and a stagnant commercial property market, where there is a downturn in commercial property sales and investment but a bank's loan book to commercial developers keeps growing, is that a tell? Whether it is or not, what should the reaction be?

Professor William Black: It is absolutely a tell, and it is why the recipe is so dangerous in hyper-inflated bubbles. The first ingredient of the recipe is "Grow like crazy," and this is met if rents are already declining and there is an abundance of what we call see-through buildings, which are those that have been constructed have no occupants, but the bank keeps on lending. That was exactly the experience in the savings and loan debacle, which is one of the parallels. This is a superb device for hyper-inflating the bubble. It was absolutely done in the United States in the current crisis. We have excellent numbers showing that it was liar loans that grew by over 500% from 2003 to 2006. They became 40% of all residential loans in the United States while conventional lending was falling sharply. We know the marginal loans that hyper-inflated the bubble were these fraudulent loans. We have data showing that 90% of liar loans are fraudulent in the United States. They will be the worst loans, and the lenders will continue to lend even when the stagnation is obvious. Akerlof and Romer talk about that explicitly in their paper. It is a sure tell.

Deputy Michael McGrath: I welcome Professor Black. I want to ask about the inclusion of subordinated debt in the guarantee. He is highly critical of it and makes the point that the Irish response was the worst in history because of the inclusion of subordinated debt. What possible justification could there have been for including subordinated debt? I want to put the figures in context. The guarantee was €375 billion. The amount of subordinated debt included was €12.2 billion and, of this, €1.4 billion was actually redeemed during the guarantee, which expired in September 2010. It is a very important but relatively small proportion of the overall amount. Why does Professor Black say because of this it was the worst response in history? Why, possibly, was it included?

Professor William Black: I do not say it is because of this that it was the worst. It was the worst because it sank an entire nation. It produced a gratuitous fiscal crisis, as it turned out. I distinguish by what you know and when you know it when you make decisions. The inclusion of subordinated debt is simply indefensible and it tells you that you need to look at whoever would have included it. Every regulator in the world should have instinctively said "No" to that. It is contrary to everything we do to include the entire concept of subordinated debt. Remember, precisely because subordinated debt is owned exclusively by people who are considered to be highly sophisticated, they are the ones least likely to run due to liquidity - if it is a liquidity event only and not an asset event - and they cannot run because subordinated debt has a term. It is not like they can take out like a depositor, which is why the number is so low in terms of redemptions at those levels, and you do not have to redeem it after all if you will be paid in full. I add these clarifications to the Deputy's numbers.

Deputy Michael McGrath: What is Professor Black's view on what happened two years later when the guarantee ended? Approximately €20 billion in senior bonds, which were unsecured, came out of guarantee and there were efforts to impose losses on them but those efforts did not work. We will explore that issue and the role of the ECB will come into question. Should losses have been imposed at that stage when the guarantee ended?

Professor William Black: Yes, but under a good bank and bad bank structure we would normally have put all of that in the bad bank and it would have been wiped out. From everything we can tell, this was designed to do exactly the opposite. They were trying to prevent subordinated debt from doing exactly what it is supposed to do, which is-----

Deputy Michael McGrath: I asked about senior debt.

Professor William Black: Senior debt got a smaller additional yield, but it still got a high yield because it is supposed to be subject to loss. While in some ways the subordinated debt is most egregious, as you say, it is the rest of the bailout of people who were not supposed to be bailed out that is a terrible shame and is risky going forward in terms of moral hazard.

Deputy Michael McGrath: In terms of an alternative strategy in the teeth of the crisis in 2008, would it possibly have been to let banks fail or to take them into receivership, as Professor Black put it, separating good assets from bad assets, protecting depositors and burning bondholders? What is his alternative model?

Professor William Black: That is precisely what we did in the savings and loan crisis. We would put them into receivership, the subordinated debt would be wiped out and the shareholders would be wiped out. That is what is supposed to happen to risk capital. The insured depositors would be paid in full and the other folks would get a haircut appropriate to what they signed onto - that is, in bankruptcy they take in proportion to whatever is left in those situations. What is different about Ireland is the enormous extent of non-depositor liabilities. That should have been a huge warning flag to your regulators.

Deputy Michael McGrath: You are saying that in Ireland deposit insurance was up to €100,000 and when the crash hit in September 2008 anyone with deposits in excess of that, such as corporate deposits, institutional investors or those with personal savings in excess of €100,000, should have been burned.

Professor William Black: They should have been under your own system. That was your rule as to what was supposed to happen. They got a higher interest rate because of that. That is how economics works.

Deputy Michael McGrath: What is curious is that you say with absolute certainty that the worst possible decision was made, but can you say with certainty that it was better than letting the banks fail and letting €170 billion of deposits included in the guarantee fail? How can you say with certainty that that would not have been worse or better? I do not know.

Professor William Black: You are asking me in retrospect?

Deputy Michael McGrath: Yes.

Professor William Black: In retrospect we can tell because receivership would have been a vastly better solution. The banks were in fact deeply insolvent. That is the reality. The claim by the banks that they were not was false and the assurance by regulators to the politicians that there were no asset problems was preposterous based on the facts they knew.

Chairman: We will need to substantiate that. I take Professor Black's presentation on that, but we will need to substantiate it as we go through the inquiry.

Professor William Black: Which element? That the assurance was preposterous?

Chairman: Yes.

Professor William Black: The assurance was preposterous given what the regulators knew, because, for example, the regulators knew all of the things that are summarised in the Nyberg report. They knew about the stagnation that people have asked me about. They knew the difference with rents. They knew that the asset book was terrible and had pathetic underwriting. They knew very large numbers of things. Your regulators did an enormous disservice to the nation. I do not put primary blame on them. I certainly agree it is the banks - more precisely the bankers - to follow my own chiding and I will chide myself. I meant bankers, not banks. The bankers knew these things and the senior regulators assuredly had the facts to be able to do vastly better analytics.

Deputy Michael McGrath: I wish to ask a last question. Professor Black said one of the reasons it could all happen again is because there was no accountability for bankers and regulators. What does that mean?

Professor William Black: At this juncture worldwide, and I will talk about the United States, instead of 1,000 plus felony convictions in a crisis that was less than 1/100th the size of our current crisis we have zero people convicted who actually were in charge of running the places that made these loans. In a US context, we have scores of lawsuits in which the United States of America and various agencies say, after investigation, that these were caused by fraud but they have failed to bring criminal charges in every case in which they say it was caused by fraud. That is what I mean by the death of accountability in the current system.

Chairman: I shall bring this section of the meeting to a conclusion by inviting Deputies Higgins and Phelan to conclude. Before doing so, I have a few questions on the final point made by the professor. Is he aware of the Sarbanes-Oxley Act 2002 which was passed by the United States Congress?

Professor William Black: Yes, I am well aware of the Sarbanes-Oxley Act.

Chairman: My Cork accent does not travel well across the Atlantic. The Act was passed in 2002. As Deputy Higgins said earlier, the US had an early crisis in the 1990s, lessons were learned and legislative Acts were put in place but another crisis happened. Can the professor give us his opinion on the Act?

Professor William Black: Yes.

Chairman: It was introduced in 2002.

Professor William Black: Two very different Bills became law as this single Act. Oxley, in our context, was a very conservative member of the Republican Party and he was not a very big believer in regulation. His Bill was weak. I do not mean that as a criticism but it did not have very much in it. Sarbanes, a member of the Democratic Party, was more in favour of regulation. The Sarbanes Bill was considered dead-on-arrival when it happened. Then the Enron scandal was followed by the WorldCom scandal so suddenly politically the Administration had to respond and the Sarbanes Bill was the only thing on the plate that was credible. Therefore, this dead-on-arrival Bill suddenly became law. As a result, it is not well thought out and logical but is a weird pastiche compromise. I am sure everyone here understands better than I how these things become law. The Act contains a useful provision and concept. The thing it does is say that the senior people must actually sign off on the financial statements. The concept is that internal controls have to be tested, not just fictionalised.

Chairman: That is exactly what I want to talk to the professor about. The long title of the Act reads: "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." That means senior officials, as bankers in banks, must put their name to the assurances being given to the wider world with regard to the bank's credibility, operational structures, etc. That is what it does in a nutshell. Am I right?

Professor William Black: Yes.

Chairman: Professor Ed Kane attended the committee last week. He gave a number of recommendations to this committee for the future, very much as Professor Black indicated in his opening statement, on how to avoid this type of crisis in the future and the necessary levels of accountability at senior banker level. I shall outline one of the figures he gave us. He said that the fines to date of US and European banks since 2008 are worth €180 billion. These are just fines and not prosecutions, bailouts or anything else. That sum will be paid in fines and is many multiples of the cost of the Irish guarantee. How should we deal with this matter into the future? Do we continue to fine institutions? Do we need to increase the tariff or penalty imposed on bankers along the lines of what was indicated in the Sarbanes-Oxley Act?

Professor William Black: When I was an enforcement and litigation director I negotiated these things all the time and here is the key that you need to understand. Bankers make the decision and their priorities are not to go to jail, not to lose their job and not to have their bonuses clawed back. To accomplish those three things they also have a fourth priority to not throw anybody junior to the wolves. In the United States we have much broader plea bargaining powers than exists in most of Europe. If you throw the junior person to the wolves we will flip him which means we will get him to plead and to testify about the more senior people. The committee will note that in all of these major deals in the United States nobody got named, loses their bonus, loses their job or goes to jail and they are happy to trade off fines.

The fines sound large. They are large in absolute terms but relative to JP Morgan Chase, to pick a non-random example, they are literally a few weeks' revenue so they do not care. Also, bankers do not pay the fines; it is the shareholders. This is the third in a triple whammy hit if you follow the recipe to the extent that the banks have followed this recipe. First, they have caused huge losses to the shareholders directly by making bad loans intentionally. Second, they have taken a whole lot of money that should have gone to the shareholders in the form of bonuses for destroying the institution or at least causing huge losses. Third, they come along and are happy to sign an agreement in which the shareholders pay the fines to make sure that they have no accountability. Therefore, this is an utterly useless exercise in terms of deterrence.

Chairman: I want to clarify the bottom line before I bring in Deputy Higgins. In the next session we will discuss Basel III and the credit directives. The latter talk about increasing and enhancing sanctions but we do not know what the sanctions are. Do we need to re-examine the basis of the fines approach? Do we need to move, as in the Sarbanes-Oxley Act, to more identifiable, individualised sanctions that increase tariffs such as jail terms and other matters, rather than just fines?

Professor William Black: Yes, one only gets deterrence when one affects the senior individuals who make the decisions.

Deputy Joe Higgins: Does that mean that when, in a court of law, there are convictions against senior financiers for very serious financial crimes, fines should be personally levied against their wealth and-or they should go to jail? Does the professor say that is more a deterrence than the massive fines that we have routinely heard get paid, from the banks, by shareholders to the US Government?

Professor William Black: Yes, it is not only more. It is the only potential effective deterrent and, yes, it has to involve jail sentences for criminality. In addition to the jail sentences for the 1,000 plus convictions, we had over 3,000 enforcement actions and roughly 600 civil suits. Our goal was that we would make sure no fraud proceeds remained with any senior official. We were not always successful obviously but we were broadly successful in those efforts.

Deputy Joe Higgins: The professor said that 40% of total corporate profit globally-----

Professor William Black: In the United States.

Deputy Joe Higgins: --- comes from the financial sector. If I am correct, the professor referred to the financial sector as a parasite.

Professor William Black: At those levels it becomes parasitical and actually weakens mainstream ---

Deputy Joe Higgins: Yes, because a parasite sucks the lifeblood of its usually unwilling host. The international financial press has reported that major private corporations in Europe have about €3 trillion, or \$3.5 trillion, sitting in banks and presumably in other financial institutions, which they will not invest, while 25 million people are unemployed. Looking into the future, what could or should be done, in Professor Black's view, to make those funds, which he describes as parasitical, work for people, society and social regeneration?

Professor William Black: There is really good evidence on this in the United Kingdom context. We have talked about payment protection insurance, PPI, but when they made small business loans, they characteristically sold swaps - often very complex swaps - to small business people, which is an utter outrage. This is the whole theory of financial intermediation, where they always claim to be engines of growth and such but they became the opposite in many contexts. What should you do? You should crack down on this recipe because it systematically leads to funding bad projects as opposed to good projects that are going to lead a country into development.

In the figures that the Deputy gave for Europe, in particular, what we are seeing is austerity. This is one of the costs of austerity. Banks are going to lend to businesses when businesses want to hire more people. That is demand. When there is not a whole lot of demand from the business community for purchasing, banks sit on the cash. They will particularly sit on the cash in circumstances where we have massive bailouts of the banks, not through the formal bailout that we have been talking about today, but through this incredibly ultra-low interest rate regime. Basically, the banks are not just sitting on the money; they are arbitraging. If they buy a bond, often a foreign bond, the supposed productive is not to Ireland, Greece, Italy, Spain or even Germany; that money is going out to somebody else, probably in China.

It is beyond this committee's remit, but the austerity principles that Europe is following are just nonsensical to economists because they have managed to create a gratuitous depression. Greece, Spain and Italy are not in great recessions; they are in great depressions.

Chairman: I will have to bring proceedings to a conclusion so I will invite Deputy Phelan to make a contribution and then we will have to conclude.

Deputy John Paul Phelan: I have a number of quick questions for Professor Black, the first of which relates to auditors. Did his own investigations in the 1990s in the US lead to the prosecution or fining of auditors for their activities?

Professor William Black: We made criminal referrals against the major audit firms including Arthur Andersen - which no longer exists and so can be named here - for far more egregious things than what it did at Enron. That was a bridge too far for the justice Department but we did get over $1 billion in recoveries, in a much smaller crisis, from the big eight firms. We also removed and prohibited particular audit partners and kept them from doing things in the future.

Deputy John Paul Phelan: In answer to an earlier question, the professor poured some cold water on Basel III. Does he think that the Basel process is capable of working or delivering results?

Professor William Black: No. The Basel process, with Basel II, was opened up to industry but not to public interests or consumers. This is where bankers and banks are at their absolute greatest comparative advantage. It is ultra sophisticated, supposedly, econometric analysis modelling and normal human beings cannot fight against this. We have seen what Basel II produced, which was not ultra-sophisticated results but preposterous results. Under US law, you would have been considered critically under-capitalised under the Basel II standard and be shut down immediately. Under Basel II you would have had three times your requirement. That is how ridiculous the Basel II process became. As I said, the only thing that saved us in the United States, even partially, was resistance by the Federal Deposit Insurance Corporation to the economists at the Federal Reserve who were the principal proponents of this insanely low marginal capital requirement.

Chairman: I will bring this session to a conclusion now. I thank Professor Black for making the journey to Ireland and for sharing his extensive knowledge and experience with this inquiry. We will be bringing forward a number of recommendations for the future. We are not just looking at the past, but at what we can learn from it for the future. On behalf of this inquiry, I thank you for the time you have given us, for the experience you have shared with us and the added value that you have given to this inquiry. In terms of the drafting of our final report, we thank you for the matters you have brought to our attention for our consideration at that time. I now propose that we suspend the meeting for 15 minutes until just after 12 p.m., when we will resume with Mr. Nava.

Professor William Black: I have an Irish mother who would kick me if I did not thank the Chairman, members and staff for their assistance.

Deputy Kieran O'Donnell: Where is your mother from?

Chairman: Thank you very much Professor Black. We can discuss that over coffee.

Sitting suspended at 11.50 a.m. and resumed at 12.05 p.m.

Mr. Mario Nava

Chairman: I welcome Mr. Mario Nava from the European Commission to discuss banking regulation, supervision and financial stability. Mr. Nava is currently the director of the regulation and prudential supervision of financial institutions directorate in the Financial Stability, Financial Services and Capital Markets Union Directorate General, formerly the Internal Markets and Services Directorate General. Mr. Nava has been in the European Commission since 1994. His previous posts include acting director for financial services policy and financial markets, member of the group of policy advisers to Commission President Romano Prodi and a member of Mario Monti's cabinet. He studied economics at Bocconi University and at Louvain and has a PhD in public finance from the London School of Economics. Alongside his work at the Commission, he is active in research and teaching. He is a visiting professor at Milan's Bocconi University and occasional lecturer in many universities across Europe.

I wish to advise the witness that by virtue of section 17(2)(*l*) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to this committee. If the witness is directed by the Chairman to cease giving evidence on a particular matter and the witness continues to do so, the witness is entitled thereafter only to a qualified privilege in respect of his evidence. The witness is directed that only evidence connected with the subject matter of these proceedings is to be given and, as he has been informed previously, the committee is asking witnesses to refrain from discussing named individuals in this space of the inquiry. Members are reminded of the long-standing ruling of the Chair to the effect that members shall not comment on, criticise or make charges against a person outside the House or an official by name or in such a way as to make him or her identifiable.

I welcome Mr. Nava again and ask him to make his opening remarks.

Mr. Mario Nava: I wish the Chairman, Deputies and the Senator a good afternoon. I am very pleased and honoured to have been invited to the Oireachtas to assist this committee in its inquiry into the banking crisis. I have been asked to provide the European Commission's perspective on the fitness of the European Union regulatory framework for banks and the supervisory policies, systems and practices in the run-up to the financial crisis, the lessons learned and improvements made in the past two years.

The regulatory framework for banks in the EU has evolved considerably over the past 15 years. A number of factors have driven this evolution. These include the need for the EU Single Market, international developments, rapid changes in the banking sector and shortcomings in bank risk management and the regulatory and supervisory framework. The EU regulatory framework takes into account the global standards for prudential regulation and supervision set by the Basel committee on banking supervision. These standards have been updated several times since 1988, most recently in December 2010 when the Basel III standards were adopted. Each of these updates has been implemented in EU law.

In 2000, the EU regulatory framework followed the principle-based approach which was