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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉI-REACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 25 Feabhra 2015

Wednesday, 25 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 Gregory Connor

Chairman: The committee is now in public session. I remind members and guests to switch off their mobile telephones before we commence. Session A this morning is a public hearing discussion with Professor Gregory Connor from NUI Maynooth on issues relating to banking policy, systems and practices which may have underpinned the banking crisis in Ireland. I welcome everyone to the tenth public hearing of the Joint Committee of Inquiry into the Banking Crisis. Later this morning, we will hear from Professor Eamonn Walsh from UCD.

I welcome Professor Gregory Connor, who is professor of finance at NUI Maynooth, having previously been part of the finance faculty at the London School of Economics and director of research at MSCI Europe. He specialises in portfolio risk analysis, factoring modelling, financial economics and security market pricing. Professor Connor holds a BA in Economics from Georgetown University and he received his doctorate in economics from Yale University.

Before we begin, 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 they are directed by the Chairman to cease giving evidence in relation to a particular matter and they continue to so do, they are entitled thereafter only to a qualified privilege in respect of their evidence. They are directed that only evidence connected with the subject matter of these proceedings is to be given. As you have been informed previously, the committee is asking witnesses to refrain from discussing named individuals in this phase of the inquiry. Members are reminded 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.

I invite Professor Connor to make his opening remarks.

Professor Gregory Connor: I thank the committee for inviting me. I have your thoughtful list of suggested topics on bank funding and the Irish banking crisis. Let me start with a key point. An enormous uncontrolled flow of foreign debt capital into the Irish domestic banking system is the key cause of the Irish financial crisis. Obviously, there are other secondary causes, but the basic and most fundamental cause of the Irish economic crisis was a poorly controlled very large inflow of foreign debt capital into the commercial banks of Ireland.

This foreign debt capital flow had two effects. One, it created unstable debt levels throughout the economy but, two, it acted as a Keynesian stimulus to the economy - it raised incomes, production costs, wages and tax revenues. That increase in tax revenues then led to an increase in Government spending. When we think about the fiscal calamity that hit Ireland after the banking bust, it was directly and indirectly caused by this foreign debt capital inflow. It was directly caused through the big costs of the bank bailout but also indirectly, because one had a sudden stop to the Keynesian stimulus from foreign debt funding and this fed disastrously into private and Government spending, so there was a sudden stop - basically a Keynesian effect.

From a global perspective, people often say this Irish banking crisis is unprecedented but it is not really unprecedented. Economists talk about what they call “a capital bonanza”, which is a large flow of capital, equity or debt, into a national economy. Often if there is a regulatory

policy or business failure or some combination, capital bonanzas lead to financial bubbles, followed by busts. This is what happened in Ireland. There were policy, business and regulatory failures and there was an enormous capital bonanza, financial bubble and bust, so it is not really unprecedented.

Where did the capital come from? In the early years of this century, there was a global tidal wave of liquidity across developed markets. We were aware of this at the time and people used that phrase "global tidal wave of liquidity". It was a period called the great moderation, which lasted about 20 years. If one looks across countries in the developed world and through time, there was fairly stable economic growth and people said this is a new paradigm, the business cycle is solved, we have new institutions, we have new technologies and there is going to be stable growth. It was just a tidal wave of liquidity across markets.

All developed markets were hit by the great recession which followed the US credit liquidity crisis of 2008 but only a handful, including the USA, Greece, Iceland and Ireland, had identifiably distinct credit bubbles and busts. If one looks at Iceland, its credit bubble and bust has a lot of parallels to Ireland. It too had excessive foreign debt capital into its banking system as the main cause of its credit bubble and bust. Another parallel, which I think has been underappreciated, was the very poor prudential oversight of the Icelandic Central Bank during their credit bubble.

If we turn briefly to Greece, their credit bubble and bust was very different. There, the same global tidal wave of liquidity did not go into the banking system but it went directly into Government borrowing, which was hidden in various ways, including with some complicity by the banking system and the international investment banks, in particular. It was a different source of capital, but again a credit bubble and bust in Greece.

A key objective of Economic and Monetary Union was to allow free capital flows across member states. That was considered one of the great advantages of EMU - that we were going to have funds flowing quickly into high funding cost states, like Ireland, from low funding cost states, like France and Germany. This worked, in fact, one could say one of the big causes of the Irish crisis was that this EMU mechanism worked too well. That was a deep clear flaw in the EMU system, and the economics profession shares some blame for that. We underappreciated the instability which would be caused by allowing very free capital flows across member states. That was an error in the design of EMU by the economics profession. Partly because of the political enthusiasm, which many of us share for EMU, we overlooked the problems - both in the economics and the policy world. JK Galbraith said that one of the advantages of being an economist is that the more one messes up, the more they need one. There has certainly been a great deal of work to try to correct that EMU flaw but I do not think it has been fully corrected.

Let me turn to funding and capital risk at the Irish banks as the committee requested. The source of the funding is straightforward. During this period, German and French banks had more deposits than they could profitably use at home so they moved funds to a growing economy with high rated banks and no exchange rate risk, Ireland in particular, as well as others. Three main vehicles were used for the funding, namely, the interbank borrowing market, bond issuance by Irish banks and direct deposits by foreign financial institutions and corporations into Irish banks. In terms of the size of the funding, I said it was massive. The net foreign liability of the Irish domestic banking sector in early 2003 was €29 billion. This grew over the next five and a half years by 449% to €158 billion in 2008. The net foreign borrowing ratio to GDP was 88% in the third quarter of 2008, which was massive. That was a very large and very risky overhang of foreign debt. In fact, if one thinks about some of the early macroeconomist

discussion and talk about the Irish debt ratio, or Government debt, one has to think about the 88% that the banks owed to foreigners. It was very unstable, hidden borrowing. The risk from this was amplified for property development lending which grew from €21 billion in early 2003 by 524% to €133 billion in late 2008. It was an enormous growth in what is one of the riskiest classes of bank borrowing. It is much riskier than mortgages and much less diversified than SME lending. This is a very narrow concentrated lending growing by 524% over five and a quarter years.

The Irish Central Bank and the Financial Regulator should have blocked the enormous debt capital inflow and should have blocked the too fast growth in property development lending. If they had done either of those things, the Irish banking crisis would not have happened. They should have done both. There was a massive failure by the Irish Central Bank and Financial Regulator in not blocking both of these. I do not blame the crisis entirely on them, however. Economists were mistaken also. Globally, there was an overly complacent attitude toward the risk of a banking crisis in developed markets. We had not had one in 50 years in many countries and were too complacent. There were also big errors in bank risk and liquidity regulation, in particular the level of bank equity capital was much too low. The definition relied too much on tier 2 equity, which is only available when a bank is no longer a going concern. It does not provide a buffer to a going concern bank. It provides a buffer to a bank which is being restructured. Relying on that was a big error. That interacted with a misunderstanding of the big risk of systemic liquidity problems in the banking sector. That was also missed. As such, the economists share some blame.

A solvent commercial bank has a backstop in the case of a serious liquidity problem. It can use its long-term assets as collateral. Central banks stand ready as lenders of last resort to provide funding to banks. In the case of the eurozone, this failed because the ECB had very strict rules. It could only lend for good collateral to solvent banks. This dichotomy between the lender of last resort function and the problem with insolvent bank restructuring was very problematic. The ECB's attitude was that it was in its charter that it would only lend to solvent banks for good collateral and that what happened where a bank was distressed was someone else's problem, namely, a national problem. That was a big issue and a major difficulty. Another problem of course was that, along with many other European countries, Ireland did not have an effective, quick bank resolution mechanism at that point.

The committee has asked me to address how interbank competition increased risk taking. Here I want to differentiate between blame and causes. In terms of risk taking by Irish bank managers, they are to blame for what they knew in many cases was overly risky lending. Many people in the industry knew that what they were doing was too risky. However, in terms of causes, there was a rivalrous environment from the maverick banks, particularly Anglo and Irish Nationwide, which increased risk levels and then pulled in the other banks. Irish shareholders were also leading this. They were forcing the banks to adopt more aggressive strategies. As such, the shareholders also contributed to this pulling of the strategies to be too risky. That is in terms of causation. In terms of blame, the bank managers who knew they were taking too much risk are to blame. In terms of causation, that was deeper. Without the control from the Financial Regulator and the Central Bank, it was very difficult in this environment to avoid the banks being pulled into this ethically wrong strategy.

I turn now to the capital outflows from Irish banks and the liability guarantee. The problems with refunding in the banks really started in August 2007 with the early stages of the crisis. Over the whole next year, the ability of various banks to access the three main vehicles became

increasingly difficult. A global credit liquidity freeze hit after the bankruptcy of Lehman Brothers in mid-September 2008. There also had developed institutional bank runs, particularly in the USA, but spreading to some of the maverick banks in Ireland during October 2008. There were liquidity problems in the system at this point. They played a central role in the 2008 US crisis in that month. The US crisis is correctly termed a credit liquidity crisis. Ireland did not have a liquidity crisis, it had a bank credit crisis. It received €136 billion in liquidity support at peak from the ECB and Irish Central Bank. That was more than enough liquidity support. Ireland did not suffer a liquidity crisis, it suffered a bank insolvency crisis. The ECB began providing liquidity funding to the Irish banks in early 2008 and the funding amount rose sharply. The ECB began to question under its charter whether it was providing liquidity support or risky capital infusion, which it felt it could not do. In my judgment, in fact, some of the liquidity support provided under ELA was risky capital. It did not really meet the ECB claim that it was liquidity support only.

With hindsight, the domestic banking system's aggregate balance sheet was actually insolvent in September 2008. There was a claim at that point of €43 billion tier 1 and tier 2 equity but bank accounting statements even relative to other corporate sectors greatly lagged the reality. They presented a very lagged picture of reality as Professor Honohan noted earlier. The Government in fact injected €64 billion into these banks, after which the banks only had tier 1 equity of €13 billion. That is a minus of €51 billion somewhere. The banking system aggregate balance sheet was insolvent in September 2008. In September 2008, the Irish Government provided a blanket liability guarantee to an insolvent banking sector. It was a very costly error. There are three caveats to muddy the picture. First, the lender of last resort function of the ECB was not working properly. The liability guarantee was partly intended to allow access to this very flawed funding function from the ECB. Second, the guidance provided to the Government by the Irish Central Bank and Financial Regulator was poor. Third, the information provided by some of the banks may have been embellished deliberately to disguise their real capital positions. Those are my comments. I thank the committee for listening.

Chairman: I thank Professor Connor. Before I bring in lead questioners, I will come back to his statement to deal with two matters. As he is aware, these hearings are broadcast to the public. In simplified terms, could he explain to the committee what he means by funding or liquidity risk and also what is meant by capital or solvency risk?

Professor Gregory Connor: The assets of banks tend to be illiquid long-term loans. That is what banks do. On the other side - their liabilities and the money they owe - are short-term liabilities such as, for instance, deposit savings accounts where their liability claimant often has very quick access. If depositors come to the bank and want their cash now against long-term assets, then that is called a liquidity problem. The bank needs to have cash for its long-term valuable assets. An insolvency problem is when the value of the long-term assets has fallen. For instance, many of the property loans may be failed projects and do not have real cash value. The claims made by the savers and bondholders of the bank are larger than the value of the assets of the bank. That is insolvency. It is not that the bank cannot pay cash now as its central bank can always provide. It can never pay the cash. Someone is going to have to take a loss.

Chairman: One of the principle terms of reference of this inquiry is to examine the solvency *vis-à-vis* liquidity of the banks in the lead-up to the crisis period, particularly around the time of the bank guarantee. Will Professor Connor explain to the committee what difficulties governments face when attempting to diagnose whether a bank has a liquidity or a solvency problem?

Professor Gregory Connor: The first thing is to determine solvency. So, we need to value the assets of the bank and make sure they are larger than the non-equity liabilities. There is an equity, which is the residual liability or the buffer of the bank. That is just a residual claim which has to be positive. When that is negative, the bank is insolvent. If one takes the value of the assets and subtracts the value of the liabilities - claims from debt holders, deposits and savers - and gets a negative number, then the bank is insolvent. That is essentially the exercise.

The hard part is valuing the long-term assets of the bank. It has to look at these projects, which in the case of Ireland were mortgages and property development projects, and decide how many of these are not going to pay the bank back. That was the problem. It was difficult. The banks were also in the year-long habit of overstating their solvency because they had been trying to refund themselves, roll over their funding. They had got into a bad habit of embellishing the quality of their books.

Chairman: Taking Professor Connor's evidence to the inquiry so far this morning, at the time of the bank guarantee, what does he believe was the then Government's view with regard to the banks being in need of liquidity or them actually being insolvent?

Professor Gregory Connor: They were insolvent. I know Professor Patrick Honohan spoke on this. In his follow-up testimony, he said two of the banks were insolvent. Most of my work has been to simplify and provide an overview. I use the aggregate balance sheet. I net out the relationships between the banks and look at the overall banking sector. Although Professor Honohan does not say it, the domestic banking sector was insolvent on an aggregate basis. That is clear from the fact that we injected €64 billion into a banking sector which was then worth only €13 billion, plus a little bit of tier 2 capital.

Chairman: Are Professor Connor's remarks inclusive of all banks that were Irish owned?

Professor Gregory Connor: Yes. From their aggregate position, all of the domestic banks were insolvent. This was obviously due to some of the most insolvent. I have not tried to analyse individually which banks were insolvent. The aggregate position, I think importantly, was insolvency.

Senator Seán D. Barrett: Professor Connor states in his submission:

> If one or more senior officials in the Irish Central Bank had shown the wisdom and strength of purpose to block the massive and destabilizing debt capital inflow into the Irish banking sector, or its risky utilization in property development lending, the crisis would not have happened.

As we say in examination questions, will he expand on this?

Professor Gregory Connor: Yes. I think Ireland was actually a strong economy and that was partly one of the reasons it received this capital bonanza. Ireland was a tiger economy. That was part of the reason this enormous capital bonanza came into Ireland. Ireland would have suffered, along with all other developed markets, from the Great Recession. It would not have suffered as much as the French and German economies from the 2008 US credit liquidity crisis because it did not own foreign bank assets. I think in fact the economic crisis is directly tied back to preventable actions and prudential banking regulation. I know that is a strong statement but I will make that claim.

Senator Seán D. Barrett: If the capital inflow had been reduced, would there have been a

less optimistic portrayal of Ireland abroad? Would it have been a case of telling foreign banks not to put capital in Ireland because we have enough of it already?

Professor Gregory Connor: People talk about the too-big-to-fail problem from the bank's perspective. Banks think they are too big to fail or that they have an implicit guarantee from their governments. One of the problems was that the money flowing in had an implicit guarantee from the European Union. The German, French and British savers and pension funds knew they could freely lend to the Irish banking sector and that they were safe because of the euro. There was an implicit belief that was part of the confidence.

The only bodies that had the power to stop it were the Irish Central Bank and the Financial Regulator. They should have said, "Stop". That is the normal function of a central bank. One pulls away the bowl just as the party gets started. That is what they were supposed to do. They did not do that, however.

Senator Seán D. Barrett: In an article with Brian O'Kelly, Professor Connor states the Central Bank could have operated restrictions such as a 20% limit in total lending on property and that foreign borrowing in the domestic banking sector should not have exceeded 10% of the domestic deposit base. How would those rules have operated? Are there precedents in other countries?

Professor Gregory Connor: There are certainly precedents for the Central Bank. The economics profession was also in this overconfident mindset. I do not want to overstate the error of the Central Bank. It was in the overconfident mindset like many other bodies. It should have had somebody, however, to say it should look at the banking system. AIB knew there were problems. It asked Professor John FitzGerald, as the committee has heard in testimony, to undertake a risk analysis to see if there was a problem. The Central Bank should have said it would look at this problem and then follow on it. Professor Honohan, in his document, goes through the many avenues and tools that the Financial Regulator and the Central Bank had. In his document, he states that if one looks at the powers the Central Bank Governor had up to 2008, it is clear the Central Bank and Financial Regulator had plenty of power to both act on concentration ratios. There was too much concentration on property. They should have gone to Anglo Irish Bank and the other banks and said, "No, this is too much property lending and is not allowed. You can lose your banking licence. Stop. No, this is too much liquid and very unstable funding from foreign debt capital. Stop". They had the power to do it.

In the then environment, as it has been said to me and Professor O'Kelly on this paper, there was a general overconfidence and it would not have been in the spirit of the times. I do not want to oversell it in that sense.

Senator Seán D. Barrett: How did Canada, in particular, and Australia manage to achieve the success which Professor Connor has been telling us about this morning?

Professor Gregory Connor: Banking crises and financial bubbles-and-busts, almost by nature, are unpredictable. The US had a terrible 2008 credit liquidity crisis. Why? It was because it was not controlling the reselling of mortgages or the leveraged packaging of mortgages. Why? It was because it had never that phenomenon causing a crisis before. It was not having a savings and loans crisis like it had 20 years earlier. It was certainly not having one of those again. It was not having a Great Depression-type crisis because that was caused by people borrowing from the banks and using it to buy shares. That had been ruled out. One always tries to prevent them. One sets in place good procedures to prevent them. It was partly bad luck that

Ireland had a collection of bad policies. Some of them were good things. For example, the fact that Ireland had growth contributed to the capital bonanza coming to Ireland. However, there were also bad policies, such as light touch regulation. The political environment also contributed.

Senator Sean D. Barrett: Professor Connor stated that we need a modern and practical legal pathway for quick and effective bank resolutions. What would he include in such a pathway?

Professor Gregory Connor: This was a mistake made by many European countries, including the UK, which found that their bank resolution mechanisms were insufficient for the modern world. I think that has been taken care of with the bank resolution and recovery directive, which came into power last month, and the single supervisory mechanism, which includes resolution controls. The US was overconfident partly because its system, which has now been brought to Europe, works well. Liquidity funding and bank restructuring need to be done by the same body. Somebody needs to decide whether it is a liquidity problem or an insolvency problem and, if it is the latter, have the authority to restructure the bank. That was missing but I do not think it is a missing piece now.

Senator Sean D. Barrett: The value of the protection that parliaments give to banks was estimated at approximately €300 billion per year in the United States. That would be equivalent to €5 billion here. Should we move towards a system whereby the banks pay us for the insurance of bailing them out?

Professor Gregory Connor: That certainly was a problem in Ireland. It was not just the banks. The bank managers knew there was implicit insurance. More important in Ireland's case was that the funders to the banks also relied on that insurance. The insurance actually went to the funders. The German, British, Swiss and French funders of the banking system were all paid in full. That was a problem.

Senator Sean D. Barrett: Did any bank managers go to Professor Connor to advise him their banks were about to go down the tube because of what was happening?

Professor Gregory Connor: No. Bear in mind that I was in the London School of Economics, LSE, until mid-2008. I certainly recall people asking whether Greece should be in the euro. The response was "shush, do not talk about that, be politically enthusiastic". That was heard strongly during my time in LSE but we did not worry much about the Irish banks. I have been studying the Irish banks since 2008, however.

Senator Sean D. Barrett: Should the auditors have seen this happening? They were in the banks auditing the accounts.

Professor Gregory Connor: I will pass on that. Professor Eamonn Walsh will be here this afternoon and I hope he can provide a more detailed answer to that question. I do not feel comfortable evaluating it but it certainly seems to be a sensible point.

Senator Sean D. Barrett: Professor Connor's estimate is that the banks were worth minus €51 billion before we put €64 billion into them. Have other people made similar estimates? His is the first I have heard.

Professor Gregory Connor: As I mentioned in the follow-up document from Professor Honohan, that is also his point. He spoke about scenario one hindsight. He broke it down by

bank whereas I preferred the aggregate numbers because I believe that we were uncomfortable about which of the banks, other than Anglo and Irish Nationwide, were solvent. On the aggregate basis they were insolvent. Note that this was done in hindsight and because one has a lag and these are *pro forma*. When I say "insolvency" I do not mean technical insolvency or that the State accounts are insolvent. On a *pro forma* basis, adjusted for predictable losses, they were insolvent.

Senator Sean D. Barrett: The Keynesian stimulus that Professor Connor mentioned in his opening remarks would have required the Irish Government to have run a massive fiscal surplus, which is probably impossible to imagine even now. A huge capital inflow requires the Government to counteract the stimulus by running a surplus.

Professor Gregory Connor: That was Ireland's hidden borrowing. Greece had hidden borrowing. It had worked out ways to rewrite its national income accounts to hide borrowing and it worked with investment bankers to hide the debt issuance. Ireland's hidden borrowing was through its domestic banking system. When macro-economists like Professor John FitzGerald from the ESRI say they missed the problems, they did so because when they worked through the fiscal accounts there did not appear to be a lot of borrowing but they missed the 88% of GDP coming in as hidden borrowing through the banking system. We are on the hook for that. It was difficult politically but it was a mistake.

Senator Sean D. Barrett: Commercial property emerged as a major destabilising sector for all of this capital inflow. We now have rules for residential mortgages. What kind of rules should operate for commercial property given its explosive contribution to instability?

Professor Gregory Connor: With hindsight, it does not take much insight for the Financial Regulator to enforce concentration ratios on commercial property. I suspect that in almost all of the domestic banks some knowledgeable person was saying "yikes, our exposure to property development is enormous and really risky". Property development consists of nothing more than holes in the ground and half built buildings, unlike a mortgage on a residential property that has somebody living it. It is a very risky operation to have all that concentrated risk. I do not think we need new procedures because it is dead obvious with hindsight, and was probably obvious at the time.

Chairman: I ask Professor Connor to outline his views on the concentration limits for the Irish banks prior to the guarantee. Does he believe they were excessive?

Professor Gregory Connor: As can be seen in the graphs, they greatly exceeded appropriate limits for property development.

Chairman: Was that each and every bank?

Professor Gregory Connor: As I noted, I worked with the aggregate balance sheet. Professor Brian O'Kelly and I have not broken it down bank by bank. That is a good question, but I did not address it.

Senator Susan O'Keeffe: Professor Connor indicated that the Central Bank had sufficient powers but it was not in the spirit of the times to intervene. Are we correct to understand that the Central Bank was caught up in the spirit of the times?

Professor Gregory Connor: Yes, more than most. All of the central banks made errors at that time and they all probably regret some of their actions. Across Europe, the second worst

central bank in terms of responses to the credit bubble was Ireland's. Only the Icelandic central bank had worse prudential oversight during that period. The Spanish, Portuguese and Italian central banks obviously did not have the same enthusiasm as Ireland in the Celtic tiger but their behaviour was more modestly risky, whereas Ireland's was excessively risky. It was quite a bit worse than average. This was in the spirit of the times, and more. It took the spirit of the times and ran with it.

Senator Susan O'Keeffe: Are we correct to believe that in the years before it all went down that the Central Bank must have known about some of the things that were happening? It had the power to intervene but it did not do so.

Professor Gregory Connor: Correct.

Senator Susan O'Keeffe: Professor Connor closed his opening contribution by stating "the information provided by some of the banks may have been embellished deliberately to disguise their real capital positions". Can he elaborate on that comment?

Professor Gregory Connor: During the 12 or 13 month period up to the end of September 2008, they had a lot of trouble rolling over their funding. They had gotten into the habit of embellishing how good their accounts really were and how solvent they were. That is a natural activity for the banks. I know there are records of discussions in the banks from the capital desks. The capital desks have to be recorded for regulatory purposes. If one listens to the recorded discussions on the capital desks, some of the bankers knew they were insolvent and they knew they were hiding that insolvency so it is clear that they knew they were solvent. The banks either knew they were insolvent or someone in the bank knew they were taking on too much risk or they had too much concentration in property or they were borrowing too much through very volatile funding sources. The interbank borrowing market is quite volatile. It is normally used just to manage short-term liquidity needs; it is not normally treated as a source of long-term funding. It is for short-term management so they knew they were using volatile sources of funding, they had too concentrated a loan book and property prices had gone up too much. I suspect many bankers knew what was going on in that sense.

Senator Susan O'Keeffe: Professor Connor used the word "embellish" and talked about them doing this deliberately. What were they embellishing?

Professor Gregory Connor: That was in the context of the liability guarantee, which was a very short-term period. Over that period, there is evidence that at least some of the banks were providing information. Some of the banks knew that they were insolvent. Some of the bankers have been recorded stating that they were effectively insolvent.

Senator Susan O'Keeffe: Mr. Nyberg refers to the loan loss provisioning levels in covered banks falling between 2003 and 2007 in page 43 of his report, stating, "As a consequence, increased accounting profits effectively provided additional capital of up to €3.5 billion to the covered banks and this, in turn, increased their capacity to lend by over €30 billion". Can Professor Connor dwell on that for us? Does that make sense?

Professor Gregory Connor: The Senator should bring that up again with Professor Walsh but I will address it. Bank accounts are unusual in how long the lag is between when a bank gets into real trouble and when the trouble is reflected in its accounts. The accounting profession had a strategy of minimising another phenomenon which was earning smoothing. They forced the banks to only take a loss when there were observable actions which could justify it.

If you notice that you have funded a €50 million shopping complex and you know that no one will shop there because the economy has turned, you cannot take a loss. You have to wait until there is a default on loan repayments. Even as things got bad, there was no provisioning for the losses. You have to have a material action generating the provision. That was one of the problems. That is very much an accounting problem, although it touches on my area. There were errors in the way the banks' accounts were handled in terms of the slowness of recognising loan losses in the accounts.

Senator Susan O'Keeffe: If a bank makes a decision to alter its loan loss provision, is that something it knows it is doing or is it done accidentally?

Professor Gregory Connor: That again is a good question for Professor Walsh. There has to be material event generating your addition to your loan loss provisions.

Senator Susan O'Keeffe: Professor Connor said on page 7 that the bank guarantee was a "costly error". When Mr. Donal Donovan appeared before the committee, he said it was difficult to see any alternative that would "have led to a materially different outcome". Governor Honohan said that while he was critical of some elements of the guarantee "something had to be done for at least some of the banks". What is Professor Connor's view, given his description of the guarantee as a "costly error"?

Professor Gregory Connor: The blanket liability guarantee was an error. The two banks that were most obviously insolvent should have been left out and restructured and that should have been obvious. If the information provided by the Central Bank, Financial Regulator and the banks had been appropriate, it would have been obvious to the Government that the two most insolvent banks should not have been included in a liability guarantee. They were very costly errors. I note €35 billion just for those two. I disagree with Donal Donovan on that point. Obviously most of the damage had been done. The economy was going into a long slump but it could have saved a big chunk of that money. Obviously, you would have the problem that if you default, then you lose some access, they say, so there would have been some repercussions from that event. The private banks would have defaulted on their liabilities but that tends to quickly dissipate. It was not a claim by the Irish taxpayer; it was a claim by private banks and they should have defaulted on those claims.

Senator Susan O'Keeffe: I thank Professor Connor. On page 5, he refers to "irresponsible lending policies during the credit bubble". What was he thinking of in this regard?

Professor Gregory Connor: I was thinking mostly on the property development side. On the mortgage side as well, the mortgages were becoming too risky and the loan to value ratios were becoming too high, though compared to the terrible situation in the USA at that time, the mortgage problem was not as bad. It was wrong but not as wrong. Property development was a notably bad problem for the Irish banks. They massively over concentrated in very risky property development loans.

Senator Susan O'Keeffe: Given that bankers anywhere at any time know that property development is riskier than mortgages and SME lending, why then would they have sought to increase their own risk? Why would they do that when they know something less risky is available?

Professor Gregory Connor: One of the reasons the mortgages became more risky is they needed to generate a place to put the funds. They were pulling in this capital bonanza of €158

billion into the economy and then they had to place it profitably so they were looking for opportunities. SMEs were not providing opportunities. They would have preferred SME lending if they could have found it. Many of the banks were probably looking for SME opportunities. They were also looking to issue mortgages. It was very easy. They were encouraging mortgages. Property development was the worst lending but the most available. Many well connected business people wanted to be billionaires and were willing to take the risk, take the money and develop property. They found the channel that was accessible to them.

Senator Susan O'Keeffe: At the Trinity Economic Forum in 2014, Professor Connor said that up until 2010, Irish banking regulation was the world leader in feather light regulation and at the Dublin Economics Workshop in Kenmare in 2010, he described this as the "pivotal Irish policy error". I acknowledge he has discussed some of this but given he has said the Central Bank and the Financial Regulator had the powers, how could they simultaneously be the world leader in feather light regulation?

Professor Gregory Connor: Obviously they did not exercise their powers. I think part of the problem was the success of the IFSC turned, in particular, the financial regulatory authority into a booster for light regulation. That fed into this very light-touch approach of the Financial Regulator. It was way overboard relative to competitors, except Iceland, and was the second worst prudential performance in the world. It was partly induced by the flawed mandate, which has now been split. You should not have your financial regulator simultaneously flying around the world telling people "Bring your financial services to Ireland and we will adopt a very light-touch approach". That contributed to what was a very bad performance.

Senator Susan O'Keeffe: Is Professor Connor confident in his professional capacity that if he were to conduct all the analysis that would be required, Ireland would still emerge as the world leader in feather light regulation?

Professor Gregory Connor: Perhaps after Iceland. Ireland was shocking and Iceland, a very small country, was even more shocking.

Senator Susan O'Keeffe: Professor Connor mentioned the concept of banks being "too big to fail". Is it that no bank should ever be allowed to fail or is it that, at the time, that was the mood? It is an expression that occurs a lot in conversations, not just in this room but more generally but I have never been really sure what it means and where it came from. How did we arrive at a position where a bank can be considered-----

Professor Gregory Connor: When any large corporation or manufacturing facility fails, it causes economic dislocation. It is not just the owner who suffers but also the families of those who work there, local shopkeepers and others. Banks, by their nature, are tied into everything so when a bank fails it causes widespread economic dislocation. There is naturally a big public externality to bank failure. The question then is whether we should offset that with a moral hazard problem and never let them fail. When banks start to fail, do we inject free taxpayer-based funds to keep them in business? It is a very difficult problem. The "too big to fail" problem is not a simple one.

Senator Susan O'Keeffe: Is there a psychological mindset in banks based on a belief that they will not be allowed to fail?

Professor Gregory Connor: Yes, I think so, and also among the funders of banks. In Ireland's case, the funders of the banks were correct in their belief that they had an implicit

guarantee.

Chairman: I wish to round off with an issue raised by Senator O'Keeffe. Does the professor believe that the Government should have made a different decision in 2008, given the information it had to hand and will he outline to us the information he believes the Government had at that time?

Professor Gregory Connor: I do not know exactly what documents the Government was looking at. That is something this committee will have to tease out. We know that the advice from the Financial Regulator was poor and we know that from statements made in October to the effect that this was just a liquidity problem when that clearly was not the case. It was obvious at that point to many analysts that it was not a liquidity problem but a deep insolvency problem. I do not know exactly how bad the information provided to the Government was so that is why I have provided those caveats. That said, a thoughtful Cabinet meeting at that stage should have been able to see that Anglo Irish Bank and Irish Nationwide, at least, were insolvent, even with the poor information provided by the Financial Regulator. Maybe the information was so bad that the Government missed that but that is my opinion. I admit that it is speculative. I do not have the documents that the Cabinet had when it made that wrong decision.

Deputy Joe Higgins: In the written statement submitted by Professor Connor prior to this meeting, he said there was an excessive inflow of debt capital into Irish banks during 2003-07 and that the business, regulatory and policy failure to control this flow was the most fundamental cause of the Irish economic crisis of 2008-12. Why was there so much global liquidity at the time?

Professor Gregory Connor: We now know that this was partly the fault of the USA generating excess monetary expansion. That came out of some worries about the dotcom bubble of 1999-2000, the September 11 incident and low rates of inflation. There was a bit of a new paradigm, as is happening now. The central banks were able to create massive liquidity with low inflation and the US central bank did so. This generated a reach-for-yield. Rates fell and there was a lot of saving coming out of the emerging markets, in particular, from China. There was a wave of liquidity in the markets that was not specifically Irish.

Deputy Joe Higgins: Was it not from Europe that much of the capital came into the Irish system?

Professor Gregory Connor: Yes, it was pushed but debt was being pushed by the USA too. The US generation of capital affected European markets as well.

Deputy Joe Higgins: Why did investors specifically come to Ireland at that time when, for example, there was a major unemployment crisis in Europe? Why did they not invest in infrastructure or the creation of jobs elsewhere instead of piling into the Irish property market?

Professor Gregory Connor: They did not pile into the Irish property market; they piled into high-rated Irish bank liabilities, which they viewed as safe. The liquidity funding was not at the risky equity end in terms of things like new manufacturing facilities. That is risky, equity investment but what was happening was low-risk, liquid investment comprising interbank lending, Irish bank bonds, bank deposits and so forth. It was low risk but with some yield. Yields had fallen at the low-risk end but Ireland provided a safe-----

Deputy Joe Higgins: Did they know that the funding was going into property, largely?

Professor Gregory Connor: Yes, and they did not worry about it because they were correct in thinking that they had an implicit guarantee. Ireland is a euro country after all and they felt that if they put money into a eurozone bank, especially a well rated bank, it would be safe. That is what they felt and they were right. They were correct in that. Despite the money going into very risky investments by insolvent banks, most of their money was safe, except for some undated subordinated bonds which were a very risky, high-yield vehicle.

Deputy Joe Higgins: Why did they feel it was safe? Was it because their money would be guaranteed?

Professor Gregory Connor: Yes, while I cannot go into their mindset, I think they felt that there was some implicit guarantee in a euro area bank, even though this was way beyond any deposit insurance limits.

Deputy Joe Higgins: Professor Connor's submission states that "Economists were aware of these types of macroeconomic feedback effects, but in the widespread political enthusiasm for EMU, the potential macroeconomic instability from EMU-induced capital flows was down played by economists". Is he saying that economists deliberately downplayed the destabilising effects and, if so, why did they do so?

Professor Gregory Connor: Yes, that is what I am saying. There was a strong feeling among the political establishment which was shared by the economics profession, even though it was not strictly their business, that European integration was a good thing and that it should be encouraged. For instance, it was argued that we need Greece to be a fully-fledged member of our club. That was a very strong feeling, so-----

Deputy Joe Higgins: So, for political reasons, economists-----

Professor Gregory Connor: Economists bought into that although they knew that there were some problems, for instance, in the case of Greece. We all knew at the time that Greece would be a problematic member, given that there would be free capital flows into that country. That looked very problematic but we thought that Greece should be brought in, for political reasons. There was a trade off. Many economists kept their mouths shut and kept their doubts to themselves.

Deputy Joe Higgins: Is that not a perversion of what economists are supposed to be about? The professor provides three caveats to his criticism of the bank guarantee, the last of which is that the information provided by some of the banks to the Irish Central Bank may have been "deliberately embellished" to disguise their real capital positions. What does the professor mean by "deliberately embellished"?

Professor Gregory Connor: What I mean by that is that there were bankers who knew, as they were being called into meetings and telephoned prior to the liability guarantee, that the banking system was, in aggregate, insolvent. Some of the bankers in senior positions also knew that their bank, in particular, was insolvent but they were not saying "We are insolvent; it is not a liquidity problem".

Deputy Joe Higgins: Was it not a Government-----

Chairman: I cannot take that question, Deputy because we are out of time. I now call Senator MacSharry.

Deputy Joe Higgins: The professor did not-----

Professor Gregory Connor: On the earlier question about the economists-----

Chairman: I cannot take the judgment question that Deputy Higgins just asked.

Professor Gregory Connor: I accept that, but he had an earlier question about economists. I agree that it was wrong. Economists should have spoken more forthrightly. Despite the fact that they agreed with the political enthusiasm, they should for example have said "Keep in mind, there is some serious economic risk with bringing Greece into the euro". As we now know, it was a massive error. That is related.

Senator Marc MacSharry: I thank the professor for being here. In connection with the National Asset Management Agency, Professor Connor co-authored with Thomas Flavin and Brian O'Kelly "The US and Irish Credit Crises: Their Distinctive Differences and Common Features in 2010". He stated there that the Irish Government set up the National Asset Management Agency with the explicit goal of overpaying for banks' distressed assets in order to keep privately-owned equity capital in the banks from collapsing in value. Can he discuss that in a little more detail? What is his opinion of how the Government used NAMA to take over distressed assets in Ireland and does he consider that a more optimal approach could have been taken?

Professor Gregory Connor: Looked at now, NAMA has been a success. Overall, it is a pretty clear success at this stage. I found as did others that the setting up of NAMA was delayed inordinately, which was a mistake. At the time, I felt there was a political aspect to that. It was delayed to provide an opportunity for borrowers in the property development community to rearrange their affairs in ways that were not optimal for the taxpayer. I think there was a delay in setting up NAMA.

The overpayment goes back to some of the questions about insolvency. Who knows how to value long-term assets? That was deliberate, as was stated in the accounts, and a 30% premium was paid which went through the EU's criteria and was allowed. The US did the same thing. If one looks at the targeted asset relief programme, another success, it also overpaid for the assets. The idea of overpaying to market value to allow the banking system to recover worked in the long run. I do not think I have a problem with that. They could have paid less, but they deliberately overpaid rather than force all the banks into insolvency and then restructure them. It was to allow three of the banks to continue in something that looked like non-bankruptcy. It looked like that. Effectively, two of them are State owned.

Senator Marc MacSharry: In terms of the restricting of capital inflows, some of this was touched on before. Professor Connor said he believed that was possible. How were these policies controlled in other countries? Were there policies in other countries that restricted capital inflow and kept the punchbowl sufficiently at bay at key times? Can he give some examples?

Professor Gregory Connor: That is difficult. Does the Senator mean on the property development side or the net foreign borrowing side?

Senator Marc MacSharry: I refer to net foreign borrowing.

Professor Gregory Connor: I looked at that question as it was in the suggested questions list. It is a difficult question and I find looking globally that there are a lot of links across countries. There might be situations where one could have a large net foreign borrowing. It was

certainly very dangerous in the Irish case and that should have been obvious to the Irish banks. I am not sure whether 88% of GDP is the second worst in the period. It is certainly not as bad as Iceland. It is a good question and I will follow up. Whether that is the second worst globally, I do not know.

In terms of property development lending, it was certainly excessive. The bank managers knew. I rely here on anecdotal discussion with banks. Most of them had someone in a senior position, perhaps even the CEO, who knew that the concentration in property development lending was excessive. That is anecdotal.

Senator Marc MacSharry: Professor Connor spoke about blame and causes earlier. If we were to consider pillars such as the Irish Government, banks, the regulatory position and external factors such as the ECB, can Professor Connor apportion a percentage weighting of blame or cause?

Professor Gregory Connor: That is difficult. The ECB as an institution, which I know the committee is trying to get to attend, is sometimes overly blamed. It had a very flawed situation in that it could only provide liquidity funding and could not get involved in restructuring. That created an intolerable situation for which it had no solution. It did not offer much. It broke its charter and provided funding through ELA that was, in effect, risky funding. I put less blame on the ECB. I certainly blame business analysts and economists on our over-enthusiasm and over-confidence around banking crises that we know we did wrong. Our Financial Regulator, as I have already mentioned, was notably poor. In terms of the business community, our banking community other than the maverick banks, namely, Anglo and Nationwide, was drawn into it. While they are to blame and a lot of them knew that what they were doing involved poor business ethics, causally they were pulled in.

Deputy Kieran O'Donnell: I take up that point. Professor Connor provided a table on page 14 of his document which sets out the share of the aggregate balance sheet of the local banks. It is fair looking at it that the only institution that had an increase in the share of the aggregate balance sheet was Anglo. Taking up Professor Connor's point there about the banks, is it fair to say looking at that figure that the shares of all the other banks went down? Did that particular bank's way of doing business lead the others astray, or not?

Chairman: That is a leading question.

Deputy Kieran O'Donnell: I said "Or not".

Chairman: The Deputy could just ask how the banks behaved.

Deputy Kieran O'Donnell: Can Professor Connor comment?

Professor Gregory Connor: I said specifically that it led the others astray.

Chairman: Professor Connor is the witness and can say whatever he likes.

Deputy Kieran O'Donnell: I note Professor Connor's testimony. Can he comment on the profile of the schedule he has given which shows that Anglo Irish Bank was the only bank to increase its share of the aggregate balance sheet between 2000 and 2008?

Professor Gregory Connor: If one looks at the figures, one notes that the domestic banking sector was growing excessively fast. They were all growing too much. Anglo Irish Bank, as Professor Honohan has stated in several papers, was growing massively too fast, as was Irish

Nationwide. Professor Honohan gives some numbers and says this should have been obvious to any trained regulator. They were all growing. The figure that Professor Lane produced is the proportion of market share. There was a growing pie but Anglo was growing so fast that it was taking a larger slice of that growing pie.

Deputy Kieran O'Donnell: All the others were reducing.

Professor Gregory Connor: Their proportion was shrinking. Let us pick on AIB for example. AIB was saying, and this is why it went to John FitzGerald, "We are growing too fast but our shareholders and senior managers are saying we are not growing fast enough". It is both of those. They were being pulled but they should have known they were going too fast. It is both of those. They were being pulled but they should have realised. Even the laggards should have realised that this was too much.

Deputy Kieran O'Donnell: Were the banks following the bank Professor Connor identified, namely, Anglo?

Professor Gregory Connor: That is clear. Anecdotally, one hears this repeated in conversations with bankers. They knew they were growing too fast. They say they knew their property development concentration was too high and that they were growing their liability side too fast but they were being pulled by their shareholders and managers to not let their market share continue to fall. One of the painful but necessary outcomes was that the cash value of all these shares went to zero. That was important and had to be done because shareholders shared some blame.

Deputy Kieran O'Donnell: Professor Connor produced the paper "Sliding Doors Cost Measurement: The Net Economic Cost of Lax Regulation of the Irish Banking Sector" with Brian O'Kelly. In hindsight, at what point should the Financial Regulator have moved and put controls in place to prevent the growth in property development and inflows of foreign debt?

Professor Gregory Connor: In early 2005 the Financial Regulator should have realised the problem.

Deputy Kieran O'Donnell: In property or debt inflows?

Professor Gregory Connor: Both. The two are obviously linked. The growth of the two is related.

Deputy Kieran O'Donnell: What practical measures does Professor Connor believe the regulator should have put in place to control the excessive growth?

Professor Gregory Connor: The first and obvious measure, as Professor Honohan stated, is that they should have stopped all growth and imposed some limits on Anglo Irish Bank and Irish Nationwide, which were growing at rates that were, clearly, beyond.

Deputy Kieran O'Donnell: Professor Connor said the Irish crisis was different, that it was purely a credit crisis and that Ireland did not experience a liquidity crisis. Surely the fact that the Irish banks were being forced to go to the ECB for funding was an indication. Was the fact that emergency liquidity assistance, ELA, funding was not provided to Anglo Irish Bank and Irish Nationwide on the night of the bank guarantee an indication that the Irish Central Bank and the ECB were queasy that there was a solvency rather than a liquidity issue?

Chairman: This is a leading question. Just ask the question.

Deputy Kieran O'Donnell: What does this indicate to Professor Connor?

Professor Gregory Connor: At that stage, ELA funding was in violation of the ECB's charter. We have it clearly stated. It is allowed to provide liquidity funding only to solvent banks, which is the definition of liquidity funding. Funding to an insolvent bank is not liquidity funding. Liquidity funding is replacing good quality assets with cash.

Deputy Kieran O'Donnell: What does the fact that ELA funding was not provided to Anglo Irish Bank on the night of the bank guarantee indicate to Professor Connor?

Professor Gregory Connor: That it was a solvency crisis, not a liquidity crisis. Anglo Irish Bank was not seeking liquidity funding but a cash infusion. It was a risky capital infusion.

Chairman: The Deputy is out of time.

Deputy Michael McGrath: Professor Connor is very welcome. My time is tight, so I will be brief in my questions, and Professor Connor could be brief in his replies. Does Professor Connor think anybody in authority outside the banks, such as the Central Bank, the Financial Regulator, the Department of Finance and the Government, knew at the end of September 2008 that the banks were insolvent?

Professor Gregory Connor: Yes.

Deputy Michael McGrath: Who?

Professor Gregory Connor: Certainly, the senior management of Anglo Irish Bank knew it was insolvent.

Deputy Michael McGrath: I mean outside the banks.

Professor Gregory Connor: For example, in the Department of Finance?

Deputy Michael McGrath: I mean anybody in the Central Bank, the Financial Regulator or the Department of Finance, politicians or anybody in authority outside the banks.

Professor Gregory Connor: To know a bank is insolvent is very difficult because it might not be technically insolvent. Its stated accounts do not show a negative equity residual, which can happen. The probability that the banks were insolvent was very high and I suspect many business people in the IFSC knew they were insolvent.

Deputy Michael McGrath: Is Professor Connor saying, as he appears to have said earlier, that some of the top executives in the main banks knew their banks were insolvent?

Professor Gregory Connor: Yes, I am, certainly.

Deputy Michael McGrath: Who?

Professor Gregory Connor: I think I am not supposed to name names.

Chairman: You are not to, although you can name institutions.

Professor Gregory Connor: In at least two institutions, Anglo Irish Bank and Irish Nationwide, I suspect senior people knew they were insolvent. I more than suspect it. I feel strongly that there were senior people at each of those who knew the banks were insolvent.

Deputy Michael McGrath: Should the Central Bank and the Financial Regulator have known at that time that Anglo Irish Bank and Irish Nationwide were insolvent?

Professor Gregory Connor: Absolutely. One does not provide a blanket liability guarantee unless one is 100% sure that one of the banks is insolvent. One provides a blanket liability guarantee because one is 95% sure that it is not insolvent. It is exactly the opposite position. One does not provide a blanket liability guarantee because there is only a 90% chance of insolvency; it has to be the opposite. It was very risky.

Deputy Michael McGrath: Professor Connor has given his view that Anglo Irish Bank and Irish Nationwide should have been let go at the time. In that scenario, what would have happened to depositors? Anglo Irish Bank had over €50 billion of customer deposits.

Professor Gregory Connor: It is a good question. They are "power passive" with the senior debt holders who should have been forced to take losses. The Government could have passed legislation to compensate the depositors, and I think it would have happened.

Deputy Michael McGrath: Would that have been up to the deposit guarantee level?

Professor Gregory Connor: Perhaps it would have been up to a limit. It is a difficult question for me because it is a political question. I think the Government would probably have decided to refund depositors entirely or up to a high limit. This would be typical in such a situation.

Deputy Michael McGrath: Had the banks been let go, would there have been some losses for depositors?

Professor Gregory Connor: Yes, for some large corporate depositors and foreign financial intermediaries.

Deputy Michael McGrath: Professor Connor attributed blame to bank managers for engaging in risky lending. In Ireland, the term "bank manager" tends to mean branch manager. Could Professor Connor clarify to whom he referred?

Chairman: I advise Professor Connor to be mindful. In the nexus phase, we will deal specifically with individuals from the financial institutions. I would not advise him to name individuals, but he can base his response on evidence in terms of behaviour and attitudes in the banks.

Professor Gregory Connor: I have left that-----

Deputy Michael McGrath: Professor Connor mentioned "bank managers".

Professor Gregory Connor: I have left it vague.

Deputy Michael McGrath: I am giving him the chance to clarify it.

Professor Gregory Connor: "Blame" is a loose, ambiguous concept. The blame goes right down to the line manager providing mortgages and property development loans that he or she knows are dodgy. I would blame them as well, although they are in a chain of command. Causally, it is not a fundamental.

Deputy Michael McGrath: Professor Connor cited the massive inflow of foreign debt capital as the main cause of the banking crisis and said the Financial Regulator and Central

Bank had the powers to prevent it. Looking at the history of the years leading up to the crisis, when should they have acted? When was the evidence clear that they should have intervened?

Professor Gregory Connor: They should have acted early in 2005, and even 2006 would have been better. The charts in my paper show that had they acted in 2005, although the system was already unstable, it would not have been as disastrous as it was.

Deputy Michael McGrath: If, during the meetings of 29 September and the early hours of 30 September 2008, the Government had said the problem was potentially too big for it and contacted the ECB to seek a temporary line of credit, an extension of ELA, to keep the banks afloat so it could assess their true health, would such support have been forthcoming?

Professor Gregory Connor: The ECB did not have in its functional mandate providing risky capital. That flaw in the system has been dealt with. I am not sure the ECB would have responded. We can see that it had a flawed system in the fact that it broke its own rules in providing risky capital to the Irish banks. Some of the capital provided through ELA was not liquidity funding, given that the banks were insolvent and, therefore, any funding was risky capital injection. Obviously, the banks had a Government guarantee, and that was how they allowed themselves to call it liquidity funding.

Deputy Michael McGrath: Professor Connor stated that the net foreign borrowing of the Irish domestic banking sector was 88% of Ireland's GDP in the third quarter of 2008. Did this represent a financial stability risk to the country at that time?

Professor Gregory Connor: Enormous. If one reads some of the other speakers, it was net of property development lending. Most of the foreign property development lending is Northern Irish or British construction by domestic-based borrowers.

Deputy Michael McGrath: Should it have featured in the financial stability reports from the Central Bank?

Professor Gregory Connor: Yes, that was a big mistake and John FitzGerald has noted that this big debt overhang was missing from the macro perspective because it was hidden.

Deputy Eoghan Murphy: Picking up on the previous questions and on this knowledge of insolvency in two of the institutions - this knowledge the management would have had - how do you know they were aware their bank was insolvent?

Professor Gregory Connor: Only from the discussions on the capital market desk, which I recommend the Deputy listen to. That was key, I think. Other than that, there are few direct quotes but it certainly looks obvious after the fact. I do not want to discuss individuals, so I do not think I can answer that question without discussing individuals. I apologise.

Deputy Eoghan Murphy: Just to clarify, you are basing your knowledge on the recordings that you have listened to from the capital desk-----

Professor Gregory Connor: And other statements by individuals, who cannot be named, so I-----

Chairman: Deputy, you are moving into individual territory and also into matters that might be the subject of a criminal investigation, so I will pull you back from that area and ask you to change your line of questioning.

Deputy Eoghan Murphy: I thank the Chairman. Professor Connor, you said earlier that it was dead obvious with hindsight, and probably at the time - the insolvencies in the banks. You also said that a thoughtful Cabinet meeting should have been able to see that Anglo and INBS were insolvent, even with the bad information they were getting from regulators. Can you expand on that, please?

Professor Gregory Connor: Yes. Keep in mind that for a blanket liability guarantee, you only need a credible risk of insolvency so they did not need to know, as I have stated and as Professor Honohan has stated. With hindsight, it is completely clear they were insolvent but you only need a credible high risk of insolvency for a bank liability decision to be clearly wrong. I think it was obvious to any thoughtful analyst when the blanket liability guarantee was given that, in fact, two of the banks were either insolvent or were highly probably insolvent. There was a high probability that they were insolvent. I think that was fairly obvious, even with the poor information provided by those banks. Just by looking at their sets of accounts and the enormous exposure to property development lending and their need to roll-over liabilities, which are in a frozen global interbank borrowing market, they were in deep trouble.

Deputy Eoghan Murphy: When you say "thoughtful Cabinet meeting", what are you saying?

Professor Gregory Connor: In other words, if they had thought "What is best for the Irish public this stage?". I think there was a political bias. In other words, I suspect - again, I was not at this Cabinet meeting - they thought it is politically in our interests. I suspect that played a role, which it obviously should not in such a high-stakes, expensive decision. They should have said, "Let's just think about this from the perspective of the public". I suspect there was a political angle to the decision because it seems such a wrong decision. I think Professor William Black, in earlier testimony, said the decision was insane. That is an overstatement. It was a wrong decision, clearly, on balance. Despite the poor information, it was wrong and I suspect the thing that tipped it into the wrong category was probably the political benefits they saw from the policy.

Deputy Eoghan Murphy: Can you just expand on the political benefits from the policy?

Professor Gregory Connor: That is speculative but, of course, the property development community was a very strong lobby at this point. The banks also had lobbying power but the property development community had very strong relationships with members of the Dáil and they were going to hurt most if the two biggest supporters of the property development community were let go in a shock bankruptcy. They would all be then subject to immediate restructuring. So I suspect that played a role, but that is clearly beyond my expertise. I do not know why they made the wrong decision but I believe strongly that the decision was wrong.

Deputy Eoghan Murphy: I will move to a different area in the time I have left. There was a delay in setting up NAMA and you said there were unfortunate consequences of that. Do you know why there was that delay?

Professor Gregory Connor: I do not but again this probably feeds on my distrust of the property development community. This was very convenient for wealthy property development borrowers. The delay in setting up NAMA was very convenient for many large borrowers to the detriment of the Irish taxpayer.

Deputy Eoghan Murphy: Thank you.

Deputy Pearse Doherty: Cuirim fáilte roimh an tUasal Connor. In your 2012 co-authored paper, The U.S. and Irish Credit Crises: Their Distinctive Differences and Common Features - I think we have given you notice that I would be asking questions in relation to this paper - the following point is made. A key feature of an asset price bubble is that "traders are often not interested in the asset for its intended use or its earning capacity but only in its expected price appreciation." The paper goes on to state that in Ireland this interest in expected asset appreciation and not the intended use of the asset was "reflected in a significant increase in the number of vacant properties, especially in the investment sector of the market". Can you explain to the committee what you mean by this point? Why was this interest in asset price appreciation reflected, as you say, in a significant increase in the number of vacant properties?

Professor Gregory Connor: In an asset pricing bubble, particularly on the mortgage side more than on the property development side, especially in investment mortgages, people were interested in flipping properties, that is, buying a property not because they had a long-term interest in holding it for rental but to flip it quickly within a few years for a profit. This worked for several years in a row. That is common in asset pricing bubbles - that people buy a property not for its intrinsic value but the fact that they can sell it on in what is sometimes called "the greater fool problem". You think you can buy a property, even though it is overvalued, because you can sell it to someone who will pay even more. There was some of this. As the debt capital inflow into the Irish banks manifested itself in excessive of mortgage lending, that pushed up prices properties. The banks then encouraged speculative investors to buy properties in order to flip them. It was obviously a Ponzi scheme which could not go on forever.

Deputy Pearse Doherty: As you are probably aware, if you are following the inquiry - it is clear from your testimony that you are - the inquiry will move into the property, State and finance nexus quite soon and it will look at the relationships between finance, property and the political and State institutional worlds. With that in mind, in that paper I mentioned, the following point is made: "Another source of regulatory imprudence in Ireland was the long and close relationship between the Fianna Fáil political party (the dominant party in coalition governments during most of the pre-crisis period) and the Irish property development industry." You touched on this in regard to Deputy Murphy's question. Could you briefly explain to us what you meant by that statement, what you mean by regulatory imprudence and how this is linked with the long and close relationship between Fianna Fáil and Irish property development industry?

Professor Gregory Connor: I would say I am not an expert. That is a political question and that relationship requires someone who really knows the political landscape at a deep level, which I do not. In terms of overview - that paper is a comparison of the US sources of their credit liquidity crisis and the sources of the Irish crisis - in both cases, as in the Greek case, some of the problems are political over-enthusiasm or political biases. For instance, in the US, there was a massive political movement to increase mortgage lending to poorer sectors of society. There was a massively strong political consensus to do that. In Ireland, the equivalent was the relationship with the property development sector - between the coalition governments and that sector. I do not think I can give you a deeper understanding of that. I just do not think I have the expertise and the deep knowledge. That requires a deeper statement than-----

Deputy Pearse Doherty: This is something the committee will have to examine. You are the person who made this claim. The effort is to either back up that claim or withdraw it. Do you stand over that claim?

Professor Gregory Connor: I stand over that claim. I think most of you are familiar with

that situation being true at the time. If you read the books about the bubble, they all clearly state that. I do not remember the author of *The Builders* but if you read that book or the book on the Anglo bank, that is clearly stated in those books. I am a consumer of that. I do not know the political landscape at that level of depth. I am an economist. I am very interested in the Irish economy but I am only here since 2008, so I do not have the depth of knowledge others might have.

Deputy Pearse Doherty: I appreciate that. In the same paper, Professor Connor uses a phrase the committee has heard on a number of occasions, with Dublin being described in the pre-crisis period as the "Wild West of European finance". The paper states: "Starting in the early 1990s, the Irish government made a strategic decision to become a world-leader in 'off-shore' financial services." Among the attractions of this country was the "light-touch, almost nonexistent, tax and regulatory oversight". The paper goes on to state:

> An unintended consequences of the extremely light-touch financial regulatory regime in Ireland was to hobble Irish regulators in their oversight of domestic banks. The actions of the Irish financial regulator [were at that time] secretive with limited public disclosure.

Will Professor Connor explain these very strong statements?

Professor Gregory Connor: The IFSC has been a success in many ways but it does specialise in very light regulation. German taxpayers probably have bigger losses than Irish taxpayers arising from the light regulation of the broader Irish financial sector through their losses in the IFSC. It specialises in regulatory arbitrage and tax-type situations that are perhaps pushing the limits. That has worked and is partly what offshore centres do, but it probably has been done to excesses in some cases in the IFSC. Furthermore, that tendency or philosophy washed back to the domestic economy. The regulation of financial markets in domestic Ireland was hobbled by the very light-touch approach that was one of the founding principles of the IFSC.

Deputy John Paul Phelan: I welcome Professor Connor. Will he outline for the committee the different factors that affect a bank's ability to attract corporate deposits versus bondholder funding? What are the principal factors there?

Professor Gregory Connor: Deposits are considered a more stable source of funding than bank bonds. However, corporate deposits can be quite volatile, whereas retail deposits are a very stable source of funding for banks. As to the relationship between bank bonds and corporate deposits, bonds can give a more stable stream but it depends on their length. A long-maturity bank bond is somewhat more stable than a corporate deposit and the most stable is the retail deposit. The Deputy is asking what would lead a bank to have more corporate deposits than bonds. I am not sure that is something it would prefer from a risk perspective. It might prefer the longer-term bonds because they are more stable than a volatile corporate deposit.

Deputy John Paul Phelan: In his opening statement Professor Connor spoke about the difference between blame and causation and noted that shareholders were pushing other banks to follow some of the leading banks he mentioned. Were there any other groups, either internally within the banks or externally, that were pushing some of the more long-established financial institutions to go down that route?

Professor Gregory Connor: That is a good question and it raises a factor I have not mentioned. The foreign entrants to the Irish market tended to be a very bad influence. Bank of Scotland (Ireland), for instance, was a very bad influence in its actions. Even the Icelandic

banks were threatening to enter the Irish market, with talk of one of them attempting a takeover of Irish Nationwide Building Society. The foreign banks were another troublesome feature in the Irish banking landscape. The statement of the proportions of market share misses that there was also an increase in foreign actors. The foreign share grew but the domestic versus foreign shares were roughly constant.

Deputy John Paul Phelan: Aside from financial institutions, were there any other push factors?

Professor Gregory Connor: In terms of causality, there was this enormous debt inflow which spread into the banks, with the latter forcing themselves to take more and more as part of the inter-bank rivalry that was going on. Shareholders were part of the problem. We had pensioners with their Bank of Ireland and AIB shares, many of whom never voted. Are they to blame? They paid the cost; in fact, all shareholders equally paid the cost for encouraging the banks down that route.

Deputy John Paul Phelan: I have a direct question regarding a point on which Professor Connor touched. Does he believe our EMU membership was a critical part of the financial collapse in Ireland?

Professor Gregory Connor: There has been a great deal of work by Paul de Grauwe and others on the very deep error in the design of EMU, which relates to the inability to control fast capital flows across member states. That was fundamental, yes. If Ireland had its own currency, French and German savers would not have felt they had the implicit guarantee of investing their low-risk, high-yield money into Irish banks.

Deputy John Paul Phelan: Professor Connor referenced Iceland, which did have its own currency. Previous witnesses, including Professor John FitzGerald in particular, have noted that Latvia and Estonia had property bubbles similar in nature to Ireland but were outside EMU. What was the difference in those countries, which were European Union members but not members of EMU at that time? Why did they have the same type of property bubble we had?

Professor Gregory Connor: Those are small economies - even smaller than Ireland - and they saw a lot of German fund inflows despite the currency difference. The euro currency is not necessary for a financial bubble. An important feature of bubbles is that they are all different and, superficially, each looks different from the previous one. That is the nature of them because one prevents bubbles wherever one can, which means the next one will be something one did not think of.

Deputy John Paul Phelan: Professor Connor mentioned several times that economists at the time downplayed the potential difficulties involved in economic and monetary union. I was a student of economics at the time and recall several significant voices in Irish economics who did express concern. In fact, it could be argued there was a 50:50 divide.

Chairman: The Deputy is over time. Will he put his question?

Deputy John Paul Phelan: Will Professor Connor comment on that?

Professor Gregory Connor: I agree there were economists who expressed concern and they actually received a lot of grief for stating something that was so politically unattractive as to deter countries which we wanted to be members of our club for good reasons. Economists should have been more forthright and allowed that level of criticism to have more impact.

Whether they would have had an effect on the decision makers is not clear.

Senator Michael D'Arcy: Professor Connor is very welcome. He has made strong statements about insolvency. Specifically, he said that Anglo Irish Bank and Irish Nationwide Building Society were insolvent at the time of the guarantee.

Professor Gregory Connor: I repeated that from Professor Honohan's report and I agree with him. I say I repeated it but, in fact, I made that statement and then received Professor Honohan's follow-up document where he also states it.

Senator Michael D'Arcy: How does that statement tally with the PricewaterhouseCoopers report that was issued immediately after the guarantee?

Professor Gregory Connor: That is a very good and difficult question in that the PwC report is not consistent with the fact that the Irish taxpayer had to pay a €35 billion capital infusion to close these banks. A going concern should not need €35 billion to be closed. In fact, it was a supported closure because, as we know, the NAMA assets were bought at above their value to provide some support. I believe the PwC report is clearly flawed. That is all I can say. I agree there is an inconsistency, that they provided such a report, which is not justified.

Senator Michael D'Arcy: In terms of the special resolution regime, we know from Mr. Peter Nyberg's evidence that the Department of Finance began thinking about the resolution regime in 2007 after Northern Rock. Many of us were unaware that the Department of Finance had even considered a special resolution regime. Should that have advanced?

Professor Gregory Connor: Yes, although I do not believe this is strictly an Irish problem. One of the reasons that Northern Rock had a run was that the British bank resolution system was also flawed at that point. It was a fairly widespread European problem, including in Ireland. Ireland has had to renew many of its finance related legislative systems following the crisis, for instance, bankruptcy was also very out of date.

Senator Michael D'Arcy: Mr. Nyberg stated also that the Department of Finance brought the resolution regime to the Domestic Standing Group, DSG, and other institutions did not believe that this was a good idea. Can Professor Connor comment upon his evidence that the other institutions, the Financial Regulator and the Central Bank, believed that this was not a good idea following the Norther Rock debacle?

Professor Gregory Connor: No, I do not believe I can comment upon that in a useful way. I do not remember that statement in his evidence.

Senator Michael D'Arcy: In page 6 of Professor Connor's statement he says that Irish bank shareholders and share markets also pressurised bank management to pursue risky strategies; there was an expectation of rapidly increasing annual earnings and dividends in the absence of which share prices suffered relative to competitors and the bank risked becoming a takeover target. When he mentions Irish bank shareholders is he referring to individual shareholders or institutional shareholders?

Professor Gregory Connor: I am talking about the AGM and the feedback from shareholders to the board of directors. The board of directors is responsible to the shareholders; the shareholders clearly wanted more of this and questioned why their bank was not growing the way Anglo Irish Bank was growing. That is the claim, obviously partly to diffuse the blame. I know from speaking to managers that they were under a lot of pressure, both internally and

from shareholders, to follow Anglo Irish Bank. Until it collapsed, Anglo Irish Bank's stock price had increased spectacularly, and shareholders believed that they were lagging and that their share price should do the same.

Senator Michael D'Arcy: In Professor Connor's presentation he spoke about high growth economies and that the investment from the very stable deposits flowed into Ireland on the basis that Ireland had the potential to be a high growth economy. Would that have been standard or unique in terms of very stable deposits moving towards a high growth economy?

Professor Gregory Connor: That contributed. Ireland was unlucky in that it was seen to be a reliable, fast growing, economy, and that generated over-confidence in the banks, in the property development community, in the mortgage buying community, and in the policy makers. Yes, the fact that Ireland had a long, very good period of growth contributed to over-confidence and that contributed to policy errors.

Chairman: I want to move on to deal with a couple of matters. In Professor Connor's deliberations today he spoke about net foreign borrowings and the proposal that Irish banks should have contained or limited these at that time; I assume that in terms of a recommendation he would be making that going into the future as well. Could Professor Connor explain to the committee how that can happen, given the nature of EU laws and the principles of free movement of labour and capital, and how we could keep other European funds out of the Irish financial institutions?

Professor Gregory Connor: The net foreign borrowing figure is delivered every month by the Central Bank in table A4.1 so the number is there and I am sure the macro-prudential economists in the Central Bank are following it, as they should have been following it then. When it is a problem the Central Bank should immediately turn to the individual banks and take action on a bank by bank basis. I do not believe it is necessary, when alarm bells ring, to take action against all banks; instead, each individual bank should be looked at and told what they must do.

Chairman: That is not the question I am asking Professor Connor. I am asking him whether this can actually be done under existing European law?

Professor Gregory Connor: Absolutely. Any one of the banks may be prevented from focusing excessive concentration in a sector or on illiquid volatile sources of liabilities.

Chairman: Professor Connor spoke at length this morning about illiquidity and solvency. In general terms, in any given country or at any given time, should a Central Bank and a financial regulator be cognisant of the solvency of the banks under its remit? Should that be part of its day-to-day job?

Professor Gregory Connor: That is and should be a part of its job. The Central Bank should be sure at every point in time that the banks under its remit are solvent and, if they are close to insolvency, it should move in immediately and restructure.

Chairman: Was that behaviour visible during the crisis period?

Professor Gregory Connor: They missed that and they should have acted much more strongly. That is very clear with hindsight.

Chairman: I want to touch back upon the issue of ELA because this has been referred to by a number of different witnesses so far. Was ELA provided to the Irish banks after the guarantee?

Professor Gregory Connor: Yes.

Chairman: Given Professor Connor's comments this morning that two of those banks were insolvent prior to the guarantee - one would then assume that they remained insolvent after the guarantee - how was it that the ECB was able to provide ELA? The rules of ELA are very clear with regard to solvency; money cannot be given to insolvent banks.

Professor Gregory Connor: That is correct. The liability guarantee was a fix-up. It was a patch-up to allow funding into the banking sector in the absence of solvency. That is the first of my three caveats regarding the liability guarantee. It was used as a fix-up. The ECB said it was not liquidity funding but that it had a Government guarantee that the funding would be repaid. In my opinion they were using the liability guarantee indirectly.

Chairman: Can Professor Connor expand upon that? Did the provision of ELA after the guarantee reflect the structure of ELA's intended use?

Professor Gregory Connor: Could the Chairman repeat that question?

Chairman: Was the provision of ELA after the guarantee in line with its intended use?

Professor Gregory Connor: No, it was not. I believe that in reality the €136 billion of liquidity support was not all liquidity support.

Chairman: Does that mean that ELA was being provided to banks that were insolvent?

Professor Gregory Connor: Yes, certainly the €30 billion in terms of promissory notes.

Chairman: What was the consequence of the provision of ELA to insolvent banks at the end of the guarantee period, two years and two months later?

Professor Gregory Connor: That is a difficult question. I have trouble working through all of the possible scenarios there. I do believe it is clear that the ECB was in some sense pushing its charter to the limit in the amount of liquidity support it was providing and it was using the liability guarantee as a cover. The ECB was in an impossible situation where it had to keep the bank system running yet could only provide funding to solvent banks and could not deal with insolvent banks, because those were a national responsibility.

Chairman: Did this have any relationship with Ireland entering a bailout programme two years later?

Professor Gregory Connor: Certainly. The other aspect was that much of the €136 billion in liquidity support was made during 2009. As the banks could not roll over their bond funding, they turned it into liquidity support from the Irish and European Central Banks. They then realised this liquidity support was risky capital. They had a Government guarantee but that was no longer good enough. Now providing funding to the Irish Government was risky capital, meaning the backstop for liquidity support was also risky. It was like someone who had a mortgage but who lost their job and their backstop - their parents - also lost their jobs. Liquidity funding was provided to risky banks, backed up by a risky government. That was a lot of the reason the ECB wanted Ireland into the troika bailout programme. It wanted its support to turn into liquidity support and not become a risky position.

Senator Sean D. Barrett: Regarding the Watergate moment, are the tapes of the capital market desk distinct from the Anglo Irish Bank tapes? How many bankers are recorded on

those tapes admitting they were insolvent? How long did it take place before the embellishment document that Professor Connor described?

Professor Gregory Connor: It would be very interesting for the committee to hear more of those tapes. I do not know if the committee can ask for them. I have only heard little bits-----

Chairman: I need to put on the record that these are matters that may be subject to a criminal investigation and cannot be dealt with by this inquiry. I will give the Senator some leverage to ask a different question or else we will move on.

Senator Sean D. Barrett: Esmond Birnie wrote very strongly against entry into the euro. In the Northern Ireland Parliament, three of the five parties accepted the dangers of the euro. There were some in Irish economics and public life who acknowledged there were dangers in entering the euro without reading the small print.

Professor Gregory Connor: Several prominent Irish economists who I will not name were strongly opposed to euro entry. There were more who were sceptical about the Greek entry, not the Irish entry. Many of them found it quite uncomfortable because of the political pushback from expressing that view.

Senator Susan O'Keeffe: In 2008 in a letter Professor Connor co-wrote to *The Irish Times*, he spoke about bank management and shareholders failing in their duties with managers presiding over a loss of wealth unprecedented in the modern economy and shareholders failing in their duty to monitor and control management. He said, "Neither side should get away with this dereliction of duty". Does he believe there needs to be individual penalties for banking officials or fines levied against their institutions? Does he believe officials in the Central Bank or in the Financial Regulator should resign?

Professor Gregory Connor: It is very easy, especially in this Chamber, to talk about punishing the bankers because the only bankers left, except for Bank of Ireland, are the taxpayers. There is no one left to punish. All the shareholders have walked away with zero cash. There is nothing left under limited liability. The shareholders cannot be punished any more than being left with zero cash. As for the bank managers, it is true. It might be through the criminal system and not part of the committee's investigation.

Chairman: I thank Professor Connor for his participation today. It has been a very informative and very valuable meeting which has added to our understanding of the factors leading to the banking crisis.

Professor Gregory Connor: I thank the committee for inviting me to make a presentation to it.

Sitting suspended at 11.25 a.m. and resumed at 11.45 a.m.

Professor Eamonn Walsh

Chairman: I welcome Professor Eamonn Walsh, UCD, to discuss the regulatory and supervisory policies, systems and practices which may have underpinned the banking crisis in Ireland and, in particular, accountancy standards and auditing. Professor Eamonn Walsh is PwC professor of accounting at UCD. He has served as Dean of the Smurfit School of Business and chairman of the accounting department. Prior to joining UCD he held faculty positions