**Joint Committee of Inquiry into the Banking Crisis**
**Witness Statement of Dr Peter Bacon**
**Wednesday 4 March 2015**

1. Chairman, I make this statement on foot of your invitation to attend this morning to assist your deliberations. You have requested that I address all or some of the following matters in my evidence:

    - Development of the proposal to establish NAMA, including the options assessed and the conclusions reached;
    - Tax Policy towards housing and property development;
    - Planning and Development during the boom;
    - Irelands housing market in the late 1990s
    - Debate about housing policy prior to the crisis; and
    - Ireland's housing market in the international context.
    - Recommendations made by me in respect of the residential property market in Ireland and their implementation.

2. I am happy to endeavour to assist you and the Committee, in relation to these issues, on the basis of certain consultancy assignments carried out by me and which have been published or placed in the public domain as follows:

    - An Economic Assessment of Recent House Price Developments, *A Report submitted to the Minster for Housing and Urban Renewal* (April 1998);
    - The Housing Market: An Economic Review and Assessment, *A Report submitted to the Minster for Housing and Urban Renewal* (March 1999)
    - The Housing Market in Ireland: An Economic Evaluation of Trends and Prospects, *A Report submitted to the Minster for Housing and Urban Renewal* (June 2000);
    - Evaluation of Options for Resolving Property Loan Impairments and Associated Capital Adequacy of Irish Credit Institutions: Proposal for a National Asset Management Agency (NAMA), *Abridged Summary of Report* (8 April 2009).

**Ireland's Housing Market in the late 1990s**

3. Developments in Ireland's housing market and in the Dublin region in particular were symptomatic of fundamental change in housing patterns. House price inflation especially in Dublin began accelerating from 1993, reaching 14 per cent per annum in the four years to 1997 and 25 per cent in 1997.

4. These trends were the result of favourable macro-economic developments in Ireland including lowering interest rates, reinforced by demographic factors and changing social patterns. For example, gross immigration was occurring at an annual rate of 44,000 and concentrated in household formation ages, almost half being aged 25-44 years. By contrast emigration was concentrated in the younger age of 15-25 years, about 62 percent being of that age. Changing social patterns were reflected in a rise of one and two person households from 41.9 per cent of the total in 1988 to 46.8 per cent in 1997. While housing output increased 80 per cent between 1993 and 1997, the share of completions in Dublin fell.

**Recommended Policy Response**

5 To be effective it was considered that a policy response would need to achieve the following:

- Achieve better balance between demand and supply in the short term;
- Improve the potential supply of housing;
- Engage in infrastructure developments; and
- Improve medium and long term planning of development of the East Region

6. The April 1998 report proposed specific policy initiatives under each of these headings although, most debate and commentary focussed on the fiscal measures which comprised:

- Repeal of Section 23 relief from investment in residential property;
- Removal of deductibility of interest on borrowings undertaken for investment in residential property against personal income for taxation purposes; and
- Reforms to the Stamp duty code and
- Changes to Capital Gains Tax as it applied to serviced zoned land.

7. The two subsequent reports of March 1999 and June 2000 contained more detailed proposals directed mainly at improving the supply side response. These latter recommendations were framed in the context of achieving:

- ***Credibility***, in the sense that what is proposed by way of supply response would be matched with the necessary commitment of resources to ensure that undertakings would be translated on the ground into serviced sites on which necessary planning consents could be obtained;
- ***Clarity***, as regards where development should take place
- ***Certainty***, as to when development can commence.

8. In support of these criteria specific recommendations were made with regard to:

- Achieving higher residential densities;
- Carrying out key strategic infrastructure investments to overcome bottlenecks such as the Northern Fringe Interceptor Sewer;
- Accelerating the process of securing required planning consents on significant sites in Dublin City and County through the use of Strategic Development Zones (SDZs);
- Improving the deployment of existing planning resources;
- Increasing the resources available to the planning system;
- Imposing fiscal penalties for non-realisation of potential of SDZs;
- Proposed revisions to the Stamp Duty regime;
- Establishing an Anti-Speculation Property Tax;
- Measures to Secure Improvements in the Quality and Availability of Rented Accommodation;
- Strengthening of the Institutional Framework for Securing a More Effective Housing response in the Greater Dublin Area.

**Outcome & Assessment of Response**

9. Rates of increase in prices of new and existing houses in Dublin and nationally slowed sharply from the middle of 1998. The peak rate of inflation in the new house market was 24.6 per cent (1998 Q1) countrywide and 33.8 per cent (1998 Q1) Dublin. By the first quarter of 2000 these rates had halved to 12.9 and 16.2 respectively. In the existing house market the

peak rate was 36.9 per cent (1998 Q3) countrywide and 41.7 per cent (1998 Q3) in Dublin. These rates too more than halved to 17.4 per cent and 20 per cent respectively in the first quarter of 2000.

10. At the same time the annual rate of new house completions increased about 10 per cent to 46,512 units, the highest annual rate of completions ever recorded to that time.

11. However, in 2001 the measure to exclude interest deductibility was reversed. Thereafter prices re-accelerated, despite a supply response rising to 90,000 units annually, as speculative forces gathered increasing momentum.

**Development of the Proposal to Establish NAMA**

12. At the heart of the banking crisis was a concern of capital markets with the adequacy of banks capital to meet future loan impairments and institutions' capacity to obtain additional capital externally. Future impairments were of concern because, for the previous decade Ireland had experienced rapid inflation in property values and lending to the property sector had become an increasingly important component in credit institutions' lending. In addition, there was heightened international concern about the health of the financial sector.

13. Irish banks were facing an extremely unstable outlook in respect of international, wholesale deposits, upon which they had become significantly dependent in the previous decade to fund expansion of their assets (lending). They were experiencing major withdrawals of these deposits, a shortening of the average duration of deposits and substantial recourse to the Central Bank for short-term liquidity support. This was not a sustainable trend. In addition, the initiatives taken to date by Government were considered to be insufficient to achieve rates of capital adequacy that would encourage investors to hold and invest further equity in Irish credit institutions, when prospective impairments were considered. As long as this remained the case it could be expected that share values would remain depressed and deposit liabilities would be likely to experience continued attrition and foreshortening in duration. Such a prospect would hinder economic recovery, complicate further the required adjustment of the public finances and leave Ireland's international credit rating subject to downward pressures and speculative attacks. Therefore, it was concluded that additional and far reaching measures needed to be undertaken, as soon as possible to place the banking system on a sound footing.

14. Deterioration in the Government Debt/GDP ratio was underway, as the general government deficit widened. A significant part of this deterioration arose from the effects of cyclical downturn. Moreover, discretionary budgetary adjustments to curtail the widening deficit would be partially undone by the deflationary impact of the discretionary measures themselves. To some degree, in the absence of international recovery and/or gains in competitiveness and productivity in Ireland the domestic fiscal adjustment process had the characteristics of a vicious spiral comprising weakening economic activity leading to widening of the Government deficit and indebtedness leading to discretionary fiscal adjustments leading to further erosion of economic activity and so on.

15. The deterioration in Ireland's credit terms associated with a worsening fiscal position was compounded by the additional contingent liabilities assumed by Government by virtue of the guarantee of the deposits of credit institutions from the previous September. Capital markets were uncertain how to value the additional liability of the Government on foot of the guarantee and the resulting confusion was causing Irish bond spreads to widen unfavourably.

16. Against this backdrop it was considered imperative that initiatives should be undertaken that would lead to stability in banks deposit and term debt liabilities and eliminate the need for a renewal of the guarantee. **To achieve this required removing all doubts about capital adequacy of the credit institutions and their capacity to deal with prospective loan impairments.**

17. There are a number of broad approaches (which are not mutually exclusive) to bank capital support schemes. These revolve around: Recapitalisation Programmes involving stress testing against expected losses; Asset Guarantee Schemes and Asset management arrangements.

*Recapitalisation Programmes*

18. The key features are:

    - Future Capital shortage is anticipated by testing adequacy of current capital in stress scenarios;
    - The adequacy of capital (quality and quantity) to absorb losses is assessed;
    - The regulatory authority may then require more capital, which may be raised from the market (e.g. by way of rights issue) or attraction of new shareholder, which may be either private or State;
    - Approach needs to take account of implications of market conditions for cost of capital to bank; dilutive implications for existing shareholders; protection of State capital if the external shareholder is Government;
    - There have been many recapitalisation programmes put in place in the US and EU in the current crisis including in Ireland.

*Assets Guaranteed/Risks Insured By the State*

19. The key characteristics of this approach are:

    - Troubled assets remain on the balance sheet of the banking system;
    - Troubled assets are not subject to upfront mark-to- market write downs;
    - The bank usually is liable to a relatively small first loss tranche and the State covers elevated losses for a fee;
    - Equity capital is not affected as assets do not have to be sold at the current marked-down levels;
    - No initial outlay is required from the State and a fee, premium or compensation arrangement is paid for the guarantee;
    - Compensation to the State in the form of convertible preferred shares or warrants is dilutive, of existing shareholders;
    - Such schemes have been implemented at ING, Citigroup and Bank of America, and RBS.

*Asset Management Arrangements*

20. The key features of this approach are:

    - Troubled assets are transferred from the balance sheet of the banks at an agreed price;
    - Mandatory participation required;
    - The banks take the impairment loss to profit and loss account now;
    - The bank is cleansed of troubled assets making valuation of the remaining part of the bank less complicated;
    - The removal of impaired loans reduces the risk weighted assets of the bank and releases capital (or reduces the shortfall in capital required)

- A discounted sale of assets may result in a significant reduction in the equity of the seller;
- Significant financing may be required from the State for the Asset Management Company, impacting negatively on the fiscal position;
- Examples include UBS and Securum/Nordbanken in the 1990s Swedish crisis

*Nationalisation*

21. Where a bank's net worth has already been wiped out or would be by future impending losses or where Government are or will become dominant shareholders, as a result of recapitalisation or other initiatives, nationalisation may be the most effective means of protecting the interests of all of the stakeholders – Government, equity and bondholders, depositors and the business franchise owned by the bank – and carrying out the required restructuring to enable the bank to stabilize its business in support of the wider economy in the future. For example, nationalisation could be used to facilitate mergers of operations and improve efficiency of scale in accessing wholesale credit markets; to bring about required strengthening of management and/or corporate governance. In effect where taxpayers are liable for guaranteeing the deposit liabilities of banks and also guaranteeing the bank against losses in the value of assets (in whole or substantial part), by any arrangement, such as those described above nationalisation may be considered necessary to overcome issues of moral hazard. These are mostly likely to arise with respect to shareholders, who may be seen to be bailed out or 'gifted' as a result of initiatives to support bank capital. Another such concern may be the additional cost to the taxpayer in terms of deteriorations of the markets' rating of sovereign debt instruments and the premium paid to bondholders in respect of this.

22. A number of nationalisations were made in the course of the current crisis in the UK, notably Northern Rock and Bradford & Bingley. And of course here in Ireland Anglo Irish Bank Corporation was nationalised in January 2009.

23. A summary comparison of the general attributes of the Asset Guarantee approach compared with the Asset Management Approach from the point of view of Government and banks respectively is contained in Table A below. A perusal of the main points indicates some seemingly comparatively attractive features to both Government and banks from the Asset Guarantee approach. Notably, from the Government and banks point of view: there is no initial outlay for the Government and therefore no impact on the fiscal deficit. For the banks, risk is transferred but equity capital does not require to be written down and the assets remain on their balance sheet and crucially, under their control. Conversely, in the case of asset sales the deficit of the government is adversely impacted from the outset, since it must directly or indirectly purchase the impaired assets. For the banks sales of assets at written down values will adversely impact equity investors and may require them to recapitalise, as losses are realized upfront. Intuitively, these aspects alone tend to favour the guarantee approach over sale of assets. However, in the Irish context, consideration of certain other aspects of these approaches tended to reverse this conclusion. These relate to the contingent liability problem inherent in the bank Guarantee approach; the implications of continuity of management of the impaired assets and future financing requirements of impaired assets.

**Table A: Comparative Analysis of Asset Guarantee vs. Asset Sale Approach**

| Asset Guarantee | Asset Sale |
|---|---|
| ***Government Considerations*** | |
| • Earns premium with no initial outlay; | • Purchase assets with significant outlay or government issuance or guarantee;<br>• Earns net income after financing cost; |
| • Has no immediate impact of General Government deficit or Exchequer debt; | • Each asset purchased has to be financed. The higher the price paid the larger the deficit to be financed; |
| • There is risk sharing with first loss retained by the bank providing an incentive; | • Risk sharing also, since the bank has to write off the difference between book value and the current value of the security; |
| • State may be able to impose restrictions on asset management. | • State gains control over asset management but may assume downside risk; however, this latter aspect can be avoided. |
| ***Bank Considerations*** | |
| • Risk is transferred , though assets remain on the balance sheet;<br>• Fees/premiums are determined based on credit risk alone; | • Banks balance sheets are cleansed of troubles assets;<br>• Asset prices assume a discount for credit losses as well as an illiquidity premium, so sales may result in considerable losses<br>• Will pricing of assets at one bank be carried across at all banks?;<br>• Loss guarantees provided to buyer can help improve pricing and lower loss on sales; |
| • Equity Capital is not affected as assets are not removed from the balance sheet;<br>• Regulatory capital ratios improve because of reduced risk weight of assets and increases further if compensation to State is in the form of preference shares | • Sale of assets at market prices will significantly worsen equity capital and may require re-capitalisation of banks as well as the AMC;<br>• In current market conditions it would be difficult to achieve recapitalisation without Government support |
| • Equity investors have to estimate losses on asset portfolios and the true extent of the risk transfer | • Position for equity investors is made clearer as they can concentrate on the valuing the franchise of the bank net of the bad assets |
| • There is flexibility in structuring attachment/detachment points for asset guarantee such that the bank can optimise risk transfer and the fees;<br>• Fees can be in terms of cash premiums or preference shares | • Clean asset sale with no downside risk retained by the bank is best for equity investors. However, it is possible to keep investors on the 'hook' after transfer. |

24. The very features which make the asset guarantee approach intuitively attractive - no money upfront from government; no write down in banks' balance sheet assets, - contain also inherent fundamental weaknesses. Namely, that a contingent liability is created in the balance sheet of the Exchequer. The situation would have significant parallels with the bank Guarantee of the six credit institutions. It too was adopted on the basis that it involved no up-front outlay on the part of the Exchequer and on the basis that it would not be 'called' and therefore the premium payments by banks would be a net receipt to the Exchequer. In the event, capital markets have not grappled well with the contingent liability created by the deposit guarantee. The tendency was to price Irish sovereign debt unfavourably, reflecting a view that more issuance of Government debt would be required. Indeed, an argument developed that if any part of the guarantee came to be called, in effect all would be called and that would lead to extreme problems for the Exchequer. The point of relevance here is that contingent liabilities are inherently uncertain in nature are often evaluated in an ill- informed way with resulting errors and the potential for further adverse speculation against Ireland. As a result of the decision to guarantee the debt liabilities of Irish credit institutions the credit rating of sovereign Ireland became inextricably bound up with the issue of Irish banks' capital adequacy. A further guarantee approach, this time in respect of banks' property related loan assets, would create a further layer of uncertainty through the creation of another contingent liability on the Exchequer. This would further entwine the sovereign rating with Irish banks capital adequacy problems without actually providing any clarity as to how capital adequacy would be achieved, other than through a calling of the contingent liability.

25. By contrast the asset sales approach, while involving the recognition of 'pain' at the outset contained the merit of certainty and clarity, provided of course the projection of the extent of impairment was accurate in the first place. In the particular circumstances prevailing it was considered that there was much to be said for recognising and crystallising prospective property related loan losses explicitly, rather than allowing them to remain on banks' balance sheets with a concomitant *additional* contingent liability on the Exchequer.

26. A feature of the Guarantee approach is that assets remain on the balance sheets where they have been created. Another side to this is that they continue to be managed by the officers and executives of banks which created the problem-assets in the first place. In the case where assets are complex financial instruments, such as many of the assets acquired by banks that were originated in the US and based on sub-prime borrowers then their valuation and resolution may best be undertaken in the banks which acquired them and which have the financial skills appropriate to this task. The nature of impaired property loan assets simply was not of this character. They are loans created and secured by property assets (i.e. development land, work in progress, completed but unsold residential stock and under-performing property investments), which are now worth significantly less than was envisaged by the loan. There is not a great deal banking skills can do to resolve this dilemma. Moreover, the property development companies involved in these transactions are almost entirely privately owned, championed by entrepreneurial characters and mostly without equity or recourse to equity markets, and in many cases do not have the depth of management skills to engage in the kind of portfolio sales and work-outs which ultimately are required to resolve the impairment issue.

27. AMCs offer prospects for avoiding many of the shortcomings associated with a continuation of the existing bank-property developer relationship. Potential advantages include: (i)

economies of scale in administering workouts (since workouts require specialized, and often scarce, skills) and in forming and selling portfolios of assets, (ii) benefits from the granting of special powers to the government agency to expedite loan resolution and (iii) the interposing of a disinterested third party between bankers and clients, which might break connections that otherwise could impede efficient transfers of assets from powerful enterprises.

28. Sweden's AMCs provide examples of some of these potential advantages, but other countries have found it difficult to realize them. First, government agents may lack the information and skills of (more highly compensated and incentivized) private market participants. Second, government agencies do not operate in a vacuum; they, too, are creatures of the societies that create them, and government agents must negotiate, rather than dictate, solutions, just as private market participants must do. In negotiations with government agencies and private participants alike, the strength of one's position depends on one's "threat point" (the ability to credibly threaten adverse consequences to one's bargaining opponent, if agreement is not reached).

29. Notwithstanding, it was considered that AMCs, by virtue of the potential advantages they contain (as noted above) have the potential to bring about better economic resolution of the impaired loans of Irish property developers than relying on existing bank management and banker-developer relations, which have brought about the problems in the first place.

30. A further important consideration relates to the future financing requirement of impaired assets. Many of the impaired assets will be capable of achieving higher values if they can be worked-out rather than disposed. A key issue to successful work out will be access to additional capital, (equity and debt) required for the work out. It is extremely difficult to see how existing property developers will be able to access capital markets effectively for such equity and banks' capacity to extend credit will be limited by the absence of collateral available from most of them. Potentially the amounts involved are large and a feature of Irish property developers is that they are not publicly quoted and have not had a history of recourse to equity markets for their funding, unlike for example the UK where there are many listed property development and residential house builders. Instead they have relied on retained earnings (for equity) and bank lending for the balance. This shortcoming cannot be put right now and it represents a significant impediment looking forward to resolution of the impairment issue, at least cost.

31. However, an AMC does have the potential to at least mitigate this issue in two respects. Firstly, it has the potential to achieve scale and overview of developments and projects. As it is banks will be concerned about the security they hold and how that can be maximized and realised. In many instances more than one bank will be involved in the security and their individual interests may not correspond. An AMC would be able to achieve project oversight. Secondly, if properly structured and resourced (with relevant property related skills) such an entity would have the potential to attract long term capital in a manner that individual development companies would not.

32. **In conclusion, it appears that the Asset Management approach has the potential to offer greater assistance to achieving resolution of the impairment issue upfront and maximising taxpayer returns, over the longer term.**