HOUSES OF THE OIREACHTAS

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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉIREACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 4 Márta 2015

Wednesday, 4 March 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.

Professor Alan Ahearne

Chairman: We now move back into public session for the second hearing of this morning. I welcome to the meeting Professor Alan Ahearne, NUI Galway, on issues relating to early warnings, and divergent and contrarian views in the context of the banking crisis in Ireland. Professor Alan Ahearne is a professor and head of economics at the National University of Ireland, Galway. He is chairman of the steering committee governing the newly launched Economic and Social Research Institute, the ESRI, and Department of Finance Joint Research Programme on the Macroeconomy and Taxation. He has served as external adviser to the Strategy, Practice and Review Department of the International Monetary Fund. He is a member of the Commission of the Central Bank of Ireland. He is also a member of the Central Bank's audit and risk committees. Prior to coming to Galway in 2005, Professor Ahearne was senior economist at the Federal Reserve Board in Washington, D.C, where he worked for seven years. There he advised Alan Greenspan, Ben Bernanke, and other Federal Reserve governors on developments in the global economy. He was principal economist at the Federal Reserve covering the Japanese and Chinese economies. He served as a special adviser to former Minister for Finance, the late Deputy Brian Lenihan, from March 2009 to March 2011. Professor Ahearne's areas of expertise are macroeconomics and international finance. His research includes studies on property markets in Ireland and other industrial countries, global current account imbalances and exchange rates and the economic performance of the euro area. Professor Ahearne is very welcome before the inquiry this morning.

Before I 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 he is directed by the Chairman to cease giving evidence in relation to a particular matter and he continues to do so, he is entitled thereafter only to a qualified privilege in respect of his evidence. He is directed that only evidence connected with the subject matter of these proceedings is to be given. As he has been informed previously, the committee is asking witnesses to refrain from discussing individuals in this phase of the inquiry. Members are reminded of the long-standing ruling of the Chair to the effect that members should not comment on, criticise or make charges against a person outside of the House or an official by name, or in such a way as to make him or her identifiable.

I now invite Professor Ahearne to make his opening remarks to the inquiry please.

Professor Alan Ahearne: Chairman and members of the joint committee, I thank you for inviting me here to testify today. In the invitation to appear before the committee, I was asked to discuss issues relating to early warnings, divergent and contrarian views in the context of the banking crisis in Ireland. In my opening statement, I will focus on the views that I expressed during the bubble years about house prices, the potential effect on the economy and the financial system of a reversal in property prices, and the evidence on which those views were based.

My own perspective on the Irish housing market during the bubble years was informed in large part by research on the international experience with housing booms and busts that I had done when I worked for the US Federal Reserve. In a study I wrote with several of my former colleagues, which was published on the Federal Reserve's website in September 2005, we identified no fewer than 44 episodes of house price booms and busts in 18 advanced countries since 1970. I have provided a copy of this paper to the members of the committee.

It struck me at the time that paper was published that given developments in the housing market in this country, the analysis contained in the paper could be relevant for Ireland. As I wrote in articles in *The Sunday Business Post* and the *Sunday Independent* in October 2005, shortly after I left the Federal Reserve to move back to live in Ireland, "Given the eye-popping gains in house prices in Ireland over the past decade, the foreign experience is particularly relevant". What the foreign experience analysed in the paper shows is that periods of prolonged rises followed by protracted falls are a surprisingly common feature of house prices in advanced countries. The study shows that certain financial conditions, such as low interest rates, ample liquidity, and financial deregulation, are usually present in past house price surges, though other factors such as demographics and buoyant income growth also help explain these booms.

At the time, interest rates in Ireland were at very low levels, with the European Central Bank's main policy interest rate at 2%, having been cut from a peak of 4.75% in 2000. It was clear at the time that such low interest rates were not appropriate for Ireland's rapidly growing economy.

A common feature of housing booms and busts is that around six to eight quarters before the peak in house prices, interest rates begin to move up. The ECB began to hike interest rates in December 2005, and within 18 months the ECB's policy rate had doubled. Writing in 2007, I pointed out that, "The blow to affordability from rising interest rates and the knock-on effect on house prices should be obvious". The 2005 Federal Reserve study of the international experience of booms and busts shows that, after reaching a peak, real house prices subsequently fall for about five years, on average, and their previous run-up was largely reversed. Put simply, the bigger the boom, the bigger the bust.

The study found that swings in house prices can have important implications for both economic activity and financial stability. We found that in the past, major declines in house prices were often associated with economic downturns, slumps in consumer and investment spending, and at times contributed to financial distress, particularly when nominal collateral values also declined significantly.

Looking across countries, we noted that a historically high number of countries at that time were experiencing abnormally rapid rises in house prices. We warned that, "If these prices follow the same patterns as before, house prices in a large number of these countries are likely to decline in real terms at some point in the not-too-distant future". One question that arises is whether there exist indicators that can act as reliable telltale signs that housing is overvalued. The evidence suggests that comparing house prices and rents provides a useful, but by no means infallible, benchmark for valuing houses, in the same way that the ratio of stock prices to dividends is commonly used to measure valuation in the stock market. Rents are a key determinant of the value of housing and as such should not move too far out of line with prices. House prices that are unusually high relative to rents may indicate that housing is overvalued.

Writing in October 2005, I noted: "Ireland's price-rent ratio is currently higher than at any time for which we have reliable data, having soared since early 2002 as rents began to decline. In the first quarter of 2005, the average price paid for a house nationally was about €256,000 and the average annual rent was €8,800. The resulting price-rent ratio of 29 stood roughly 2½ times above its level in 1996."

I concluded that this unusually high level of house prices relative to rents was mainly supported by large expected increases in house prices. The property market was pulling itself up by its own bootstraps. Property investors, for example, were not too bothered that rents were low, since they anticipated hefty capital gains on property. Once investors came to realise, however, that those rosy expectations were going to disappoint, it became clear that house prices were badly misaligned with rents and the market went into reverse.

Another question we address in the Fed paper is how house price reversals affect different sectors of the economy. We found that home buyers appear to be the most affected by fluctuations in house prices, especially if they lose their jobs in a downturn. We did note that low initial loan to value, LTV, ratios offered some protection to home owners. From that perspective, I expressed concern in 2006 and 2007 about rising loan-to-value ratios for mortgages. Data showed that one in three new home buyers in 2006 took out a 100% mortgage. Moreover, the number of first-time buyers taking out loans with little or no deposit doubled in 2006 from the year before. In an interview for *Irish Property Buyer* in July 2006 I said: "What we should be seeing are moves to restrict the loan to value ratios for mortgages, for instance. That would be a good start. Giving people 100% mortgages is a move in completely the wrong direction. It brought in people on the margins and in the event of a downturn they are going to be very exposed." Worryingly, the data also shows that nearly two thirds of all new home mortgages taken out in 2006 had amortisation periods of 31-35 years or longer. Such heavy borrowing rendered many households very vulnerable to a downturn.

Mortgage lenders are also affected by swings in house prices, though we found that their exposure to house prices does not, in and of itself, pose a significant risk to financial stability. We identified three factors that generally limit the prospects of credit losses on mortgage loans. First, loans are not typically made for the full value of the property, that is, loan to value ratios are usually low. Second, mortgage lenders can substantially reduce exposure by securitising a significant portion of the loans that they originate. A third factor is that nominal house prices are less volatile than commercial property prices. In the case of Ireland's banks, these three potential mitigating factors were of limited help in containing credit losses. As I mentioned earlier, loan to value ratios were high, a significant portion of loans were not securitised but rather stayed on the banks' books, and the banks were heavily exposed to commercial property, including speculative property development.

In the Fed paper, we also examined the recent historical experiences with banking system stress associated with declines in property prices. In particular, Japan, Sweden and Norway experienced significant financial system stress in the early 1990s, including, at least *de facto*, major bank insolvencies. Although declines in the value of commercial property collateral were a factor in these episodes, residential mortgage lending was not. As I put in a piece I wrote in July 2007: "The most important point, however, is that the banking crises in Scandinavia was more directly linked to drops in the value of commercial property rather than to the decline in house prices. A struggling homeowner that hands back the keys of the house causes a mild sting to a bank; a property developer that folds owing the bank a packet inflicts a terrible pain."

Finally, we pointed out that typically the residential construction sector, home building, is very vulnerable to corrections in house prices. The evidence suggests that booms and busts in residential investment can be pronounced.

To conclude, I would like to note that, notwithstanding the patterns that we observe in the data, we did note in the paper that housing bubbles are intrinsically hard to identify, especially when they are occurring. This is because it is very difficult to differentiate between price changes coming from underlying economic fundamentals, some of which are unknown, unobservable, or unquantifiable, and those based on so-called "irrational exuberance". That concludes my prepared remarks.

Chairman: I thank Professor Alan Ahearne for his opening remarks. Perhaps I can deal with two matters before I move to the lead questioners. This relates to pre the crisis of property and the banks. As discussed in his opening statement, in a newspaper article in October 2005, Professor Alan Ahearne warned of the likelihood of a hard landing in the Irish property sector where he cited evidence from research he conducted with former colleagues of his at the US Fed board. Did Professor Ahearne get an opportunity to present or discuss this research with officials at either the Central Bank or the Department of Finance and, more generally, did he get any feedback on this research from Government officials?

Professor Alan Ahearne: I presented that paper at the Central Bank, I think, sometime in 2006 but I am not exactly sure of the dates. I was invited to give a seminar at which I presented this data. There was some feedback at that presentation in the sense that there would have been some questions about the study we had done. I was not invited to present it to the Department of Finance

Chairman: In terms of what was the main finding, that a hard landing in the Irish property sector was coming down the tracks, as indicated in his report, does Professor Ahearne believe that view was listened to at that time?

Professor Alan Ahearne: When I gave that seminar, I did not give a projection. I did not say, "Here is my forecast, here is what is going to happen". I did not do it that way; I presented it in much the same way as I presented today. I presented the evidence, "Here is what we found when we looked at the international experience". Most of the questions at that seminar, if I remember rightly, were about some of the technicalities. Nobody said, "This is nonsense", and nobody said, "We are all doomed", and stormed out of the room. It was not like that.

Chairman: Would Professor Ahearne consider that there was a consensus in regard to the hard landing theory at that time?

Professor Alan Ahearne: That was very difficult for me to tell just from that seminar. If one looks at the stuff that was being the commentary in newspapers and in the media, there were very few predictions of a hard landing and very little was discussed about the risks of a hard landing. It did seem to me at the time that the overall consensus was certainly that there was going to be a soft landing.

Chairman: In another article in or around early 2007, Professor Ahearne wrote in the *Irish Independent*, warning that the property market was likely to crash and advising investors to get out of the market. He also featured in the "Futureshock" documentary that was broadcast in April 2007, making a remark of stark warnings. For example, he said he could name 30 or 40 hard landings after studying booms and busts in other countries but could not name one instance of a soft landing. He said housing markets just do not work that way. It was about a seven-minute piece in which he was involved. Did Professor Ahearne get any reaction to these comments from people in property-related sectors or from Government officials or politicians following that programme?

Professor Alan Ahearne: Not long after that I was invited to speak to the Fine Gael Parliamentary Party which, I think, was in Galway. I assume it was on the back of that programme. I spoke about the international experience of house price booms and busts at that meeting. I did not speak with any officials. In regard to the property market, I did not get any calls from people in the industry. I would have socially bumped into people who worked in that industry and I remember somebody saying to me shortly afterwards, "There are a lot of guys gunning for you after what you have said" - jokingly, I take it. I think this was in April 2007. Somebody on the ground was saying to me that the bubble burst last summer, and that this had been the best kept secret in Ireland for the past nine months.

Deputy Eoghan Murphy: Professor Ahearne is very welcome. In November 2008, *The Irish Times* called Professor Ahearne "the economist who told you so". That area of his work is very important, and I want to go into it today, but another area of his work that was also very important was when he was working for the then Minister, Brian Lenihan, as an adviser. He wrote about that in a chapter of a book published recently. With Professor Ahearne's agreement, I was hoping to get some facts on the record about that period that could help us better prepare for the next stage of the inquiry in mapping out the work we would like to do.

Professor Alan Ahearne: My invitation to come here was to discuss early warnings and contrarian views, and that is what I have prepared in my statement. To be honest, I would have to look up my records if we are dealing with some other issues. This is the context phase, and I was invited in that context. I know the committee will move on to the nexus phase when it will deal with subsequent issues. I would be delighted to come back, if I am invited, and discuss those issues. I am happy to deal with the issues when I was working for Brian Lenihan but, in fairness, in order to give accurate answers, if the Deputy wants to ask me about some of the details, I would need to have a look back at my records.

Deputy Eoghan Murphy: What I had hoped to do was go through the chapter in the book and clarify certain facts, but if Professor Ahearne would like to wait until the nexus phase-----

Professor Alan Ahearne: I want to give the committee accurate answers so I would prefer to have some time to prepare for that.

Deputy Eoghan Murphy: Does Professor Ahearne mind if I ask him questions about the period prior to when he was working for the Minister? I want to begin with the pre-guarantee period and those few months around the guarantee. Professor Ahearne had a meeting with the then Minister, Deputy Lenihan, in August, just prior to the guarantee being announced.

Professor Alan Ahearne: That is right.

Deputy Eoghan Murphy: Where did that meeting take place?

Professor Alan Ahearne: In his office in the Department.

Deputy Eoghan Murphy: Who initiated that meeting or how was it arranged?

Professor Alan Ahearne: It must have come at his initiative. I got an invitation to come up to the office.

Deputy Eoghan Murphy: Was it a meeting between Professor Ahearne and the Minister or a group discussion?

Professor Alan Ahearne: There were several people in the room coming and going, but it was mostly the Minister and myself.

Deputy Eoghan Murphy: How long did that meeting last?

Professor Alan Ahearne: I would say over an hour, maybe an hour and a half.

Deputy Eoghan Murphy: What was the purpose of the meeting?

Professor Alan Ahearne: We had a very wide-ranging discussion about many different things that were going on in the Irish economy.

Deputy Eoghan Murphy: Did Professor Ahearne find it odd that he had been invited to have a meeting with the Minister at that stage?

Professor Alan Ahearne: Not particularly. I had written a lot of stuff and had been vocal in the media. It struck me as a sensible thing for a Minister to do, to reach out. I subsequently learned that he was meeting many economists around that time. That was his style. He spoke to many people, and bounced ideas off many people, so I did not find it odd.

Deputy Eoghan Murphy: What was Professor Ahearne's impression during that meeting? Did he believe the Minister had an accurate picture at that point of what was happening in the banking system?

Professor Alan Ahearne: I was a little concerned that he might not have had. We had a discussion about the banking system. I talked to him a lot about the international experience and stuff that had happened. I was not there to give him advice. I was just giving my experience and talked about the stuff I had known. I did say to him that it would be important that he would have a very accurate picture of what these banks are like, and what their loan books really look like. I was not assuming that he did not have that, and he said: "Thank you. That is very good advice."

Deputy Eoghan Murphy: If I am correct, Professor Ahearne spoke in particular about the prospects of Anglo Irish Bank and Irish Nationwide Building Society. Does he recall if he or the Minister raised the issue of those two banks?

Professor Alan Ahearne: I do not recall.

Deputy Eoghan Murphy: Was the issue of potential bank failure discussed?

Professor Alan Ahearne: No, we did not use those terms. We were talking about the property market and we may have got on to Anglo and Irish Nationwide because those were the two most exposed to the property market. I must say I did not know much about Irish Nationwide. I remember him saying that this bank was extremely exposed, or something along those lines, and that was news to me. I knew very little about that bank. I had known anecdotally that Anglo was very exposed.

On that discussion, he mentioned that Anglo was highly exposed and therefore troubled but that it also had some good stuff. He said something like that, which surprised me because all the rumours I was hearing at the time was that it was a complete basket case, but he mentioned that. He may well have been talking about the fact that it had some properties in New York or London, or some in Dublin. He did not have any such comments about Irish Nationwide. He seemed to think that it was even worse.

Deputy Eoghan Murphy: Was nationalisation or a guarantee mentioned at all?

Professor Alan Ahearne: No. There was no discussion of solutions or what was going to happen.

Deputy Eoghan Murphy: Moving on to September, on 14 September, Professor Ahearne wrote an article in the *Sunday Independent*. He was talking about the banks and he said that the information they had been releasing about the quality of their loan books did not always square with anecdotes about potentially huge losses associated with land purchases and unsold developments. To what extent did he understand then the threat posed to the financial system by the problems in the banks?

Professor Alan Ahearne: I had known from my own experience and research that a big property crash is always damaging to banks. There have been times, as I wrote about, where it has put the entire banking system, or large parts of it, into insolvency, for example, in Scandinavia. There have been times where although the property market has crashed, the banking system has got through that without that much damage. Hong Kong is an example. I covered that economy at the Fed. It had a 50% decline, peak to trough, in property prices. It was a really bad crash in the property market but it did not burst the banks. The banks more or less sailed through that. I did not have information to make predictions about what the crash in the property market would do to the banks. It depended on many factors.

Deputy Eoghan Murphy: However, Professor Ahearne took the anecdotes seriously enough to make him question the information that was being released by the banks.

Professor Alan Ahearne: That is right. They were just that, anecdotes and rumours one would hear socially. I had always tried to base my commentary on evidence and facts. Perhaps occasionally I did write commentary in terms of when I talked about anecdotes but what I had been hearing was that the property market had stalled in mid-2006 into 2007. The price index was not falling but there were very few houses being transacted. Developers had finished projects. They might have been able to sell a couple of houses at the asking price. That meant that the index did not fall. It looked like the prices were not falling but they were selling very few. That meant that these developers were not able to pay back their loans. What happened was they were getting loans. They would sell off all these properties. They would then use the money from the properties to pay off their loans, but they must have been stuck at that stage. What I was hearing was that the some of the banks may have been rolling over these loans. They were not getting repaid by the developer, and that was a problem, but rather than a developer formally defaulting, they were making a new loan to the developer. The developer would use the money from the new loan to pay back the old one, and the developer would therefore not be in default. It would look on the bank’s books that the loans were fine, but there was a big problem because the developer was not selling the properties. That is the sort of rumour I picked up on, and that worried me. It reminded me of the Japanese experience where the banks kept rolling over the property developers even though they were de facto bust, and that worried me a little bit.

Deputy Eoghan Murphy: From the information Professor Ahearne had, were there any indications at the time about risk of insolvency in the banks?

Professor Alan Ahearne: I was writing these articles from an office in Galway so I had no details other than the experience that in previous property crashes, banking systems had gone bust in some cases. In other cases they had not.

Deputy Eoghan Murphy: Professor Ahearne met the Minister again at the Fianna Fáil parliamentary party think-in on 15 September 2008, and he wrote that the Minister mused whether it would be possible to knock over two dominos without knocking the other four. That was his expression.

Professor Alan Ahearne: Yes.

Deputy Eoghan Murphy: Professor Ahearne assumed he was contemplating the closure of Anglo Irish Bank and INBS but was concerned about the knock-on effects.

Professor Alan Ahearne: Yes.

Deputy Eoghan Murphy: Why does Professor Ahearne think he was contemplating this at that time?

Professor Alan Ahearne: It may have been related to the earlier discussion about exposures. Both institutions were heavily exposed to the property market. The other banks had more diversified loan portfolios. They had mortgages and other types of corporate loans. Anglo Irish was a monoline merchant bank. All it did was property. I had not realised that Irish Nationwide was like that in many ways too. It probably reflected those facts.

Deputy Eoghan Murphy: I think Professor Ahearne said that he got the impression he was exploring a wide range of alternatives. Did he mention any alternatives to Professor Ahearne in that discussion?

Professor Alan Ahearne: No, even in Galway he did not discuss guarantees. It was a little cryptic. He did not mention banks at all. He talked about dominos. I was not an advisor so he could not give me too much information.

Deputy Eoghan Murphy: Does Professor Ahearne think his thinking may have changed at all since Professor Ahearne's previous meeting in August?

Professor Alan Ahearne: Not particularly. It was a bit more developed. He had not mentioned dominos in the previous discussion. It looks like it was evolving and developing. In neither of those meetings did he say "Here is what we plan to do". It was not like that.

Deputy Eoghan Murphy: Did Professor Ahearne speak again before the guarantee was brought in?

Professor Alan Ahearne: No.

Deputy Eoghan Murphy: Did Professor Ahearne speak in the period immediately after it?

Professor Alan Ahearne: No.

Deputy Eoghan Murphy: Professor Ahearne did respond to the decision on the guarantee with an article in *The Irish Times* on 1 October 2008 which documents Professor Ahearne's reaction well. Other academics had a different reaction. What is Professor Ahearne's position now on whether the guarantee was a well-designed policy versus Professor Ahearne's position at the time?

Professor Alan Ahearne: I have an open mind on it. Like the committee members I am listening to all the witnesses and I would rather wait until they have all come in and all the information is gathered before I make a decision. It is complicated. I said at the time that it was important not to let the banks go into a disorderly failure. It was important that people did not walk into an Irish bank next morning to withdraw money only to be told there was no money. That would have been chaotic. That is a disorderly failure. The Government was absolutely right to make sure that did not happen. I mentioned how important it was to safeguard deposits. A few weeks earlier there was some panic around and people saying on radio programmes that they were withdrawing money. I had written an article saying that people should not panic, deposits would be safe, that I was sure the Government would do everything to protect deposits.

I did raise the issue of subordinated debt in that article. I was puzzled as to why it was included. That does not mean there was not a good reason but only that I could not think of one. That might have been my problem. I said it would probably prove controversial.

Deputy Eoghan Murphy: Did Professor Ahearne discover subsequently why it was included?

Professor Alan Ahearne: I did not.

Deputy Eoghan Murphy: Professor Ahearne said the European finance Ministers announced a co-ordinated response on 7 October but that undoubtedly Brussels and Frankfurt had sent a clear message to capitals weeks earlier that there would be no repeat of the Lehman Brothers debacle in Europe. Would Professor Ahearne like to expand on that?

Professor Alan Ahearne: A lot of work would have been done in the European committees in August and right through September as the global financial crisis was getting more and more intense. They must have been discussing this. I think they would have come to an informal agreement on how to handle the crisis and in particular not to have a Lehman Brothers in Europe. After the Lehman Brothers collapse and the chaos it spread, I am pretty sure there would have been a message at committee level, transmitted from there back to the capitals, there would be no Lehman Brothers in Europe, no disorderly bank failures.

Deputy Eoghan Murphy: Professor Ahearne has been critical of Olli Rehn for saying the blanket guarantee was a mistake. Was that a fair assessment?

Professor Alan Ahearne: I was not critical but I said it was puzzling that he said it was a mistake when it had to go to the Commission for legislative approval and it approved the guarantee. Under the legislation it can approve an intervention like that only under certain conditions. I cannot remember the exact terms. The Deputy may have them in front of him, something like if the intervention is appropriate and proportionate. If it deemed the guarantee to be an appropriate, proportionate and not excessive response in approving it, how could it then be a mistake? That puzzled me and I said that might be clarified at some stage.

Senator Marc MacSharry: I thank Professor Ahearne for coming here. At the time economists like him would consider the output gap and whether there was one. Since then it seems they consider structural deficits. Can Professor Ahearne outline how the system has changed and how that may now show things up that they did not see at the time?

Professor Alan Ahearne: It is not so much that the techniques economists use have changed but that one can get different answers if one adds some more data. That was quite dramatic in the Irish case. For example, when the IMF was here in 2006 and 2007 for its annual estimate of the Irish economy, it made estimates of things like the structural deficits and the underlying budget position in which it tried to look through the cyclical factors. At the same time it considered what economists call the output gap which is a measure of whether the Irish economy is overheating or going along about where one would expect it to be.

In 2006 and 2007 it said the output gap was zero, the economy was exactly where it thought it should be, there was no overheating. It thought the structural balance was in surplus so it said even if one went deeply into it and took out the cycle, the public finances looked fine. That was published in its Article IV reports. I presume at the time that must have been taken as a sign.

Here was an experienced international organisation giving the green light to the Irish economy.

When it reworked that, using the same methods but with more data now, and everybody is wiser after the fact, it estimates that the Irish economy was greatly overheated to the tune of almost 7% of GDP in 2007 and there was an enormous underlying structural deficit of 9% of GDP. It is now saying that the public finances were greatly boosted by the property bubble but the techniques they had did not identify that. Now it sees the bust and that changes everything but at the time it issued its report and other economists were making similar calculations it did not have the benefit of seeing the bust and those techniques produced what looked like benign results.

Senator Marc MacSharry: Dr. Peter Bacon said earlier this morning that the stock market could see clearly that there was a serious problem here. What is Professor Ahearne's sense of why the IMF, the ESRI, the Commission, the regulator, the Central Bank and everybody else got it so wrong? Was it because of the output gap?

Professor Alan Ahearne: We are probably talking about different time periods. These reports were for 2006 and the stock market was still buoyant then. It came under some pressure in 2007.

Senator Marc MacSharry: Notwithstanding that, all these organisations have this expertise, they are all examining everything and with the exception of Professor Ahearne at a later stage, Morgan Kelly and David McWilliams, no one spotted what appears with the benefit of hindsight to have been the elephant in the room.

Professor Alan Ahearne: It was particularly disappointing in the case of the IMF. It is an international organisation that had seen these booms and busts all over the world in advanced countries and developing countries many times. Part of what happened is that when the EMU was formed the view was that now there is a currency union in Europe, exactly the same as in the United States and therefore we will think about it the same way. For example, Ireland had a big current account deficit but in 2006 and 2007 it was borrowing huge sums of money from other countries, through the banks.

Senator Marc MacSharry: Is that sovereign borrowing?

Professor Alan Ahearne: It was the country as a whole and it was coming through the banking system. If one looked at Ireland borrowing from abroad, there was massive borrowing. The sovereign position was fine but it was Ireland as a whole. Usually that would ring alarm bells for the IMF, but the IMF does not care if, for example, Pennsylvania or California have a current account deficit. It does not even measure it because it is part of a currency union. Therefore, the whole issue of current account deficits, which would normally trigger alarms in the IMF and other observers, because we were now part of the euro area, one would no more look at Ireland's current account than one would look at Pennsylvania's.

Senator Marc MacSharry: Were the way things operated at the time adequate or inadequate in terms of economic analysis by these organisations?

Professor Alan Ahearne: They have said that they missed us completely. They have written reports and have done a lot of looking back themselves. All of that is on the record. There are lots of papers written by these organisations on how it is that they missed this.

Senator Marc MacSharry: In Professor Ahearne's time with the Federal Reserve, and his examination of the 44 booms and busts that he looked into, can he outline the impact of actions by governments, political parties and oppositions in each of them? I do not want him to go through 44 of them, but can he give us a sense of the impact of their actions and the role they played?

Professor Alan Ahearne: To be honest, I cannot because I do not know the politics. I am just an economist looking at economic data.

Senator Marc MacSharry: Are there patterns of activity?

Professor Alan Ahearne: There are patterns of economic activity.

Senator Marc MacSharry: What causes the economic activity? Was there a discourse in each of these countries that led to an economic policy that led to a particular outcome?

Professor Alan Ahearne: That I do not know. What I do know is this - as I mentioned in my statement, they are surprisingly common. Some countries have booms and busts every couple of decades. That has to tell us something about how popular they are and how difficult it is to stop them. If we only had one or two and did not have another one in 40 years, we would say: "We learnt the lessons and now it is easy to stop booms and busts." However, the fact that they repeat so often and there are so many of them, tells us that when they get going there must be something in the system that makes it very difficult, even though we know they are devastating if one gets hard landings. We know they do terrible things to society and to people's standard of living.

Senator Marc MacSharry: Were the 44 instances equally missed by the international community?

Professor Alan Ahearne: I do not know that. I did not look at that.

Senator Marc MacSharry: To go back to the earlier question, in the context of the Irish situation, did the political discourse in the run-in to the crash here, in terms of government, political parties or media, contribute to our problems? Did it fuel the problem or not?

Professor Alan Ahearne: I am very reluctant to get into a political space.

Senator Marc MacSharry: It is not political. It is a case of the economic fact of the day and what caused the economic actions to be taken.

Professor Alan Ahearne: There was a consensus that there was going to be a soft landing. That was a very general consensus, including, I think, across the political system. I did not move back until 2005 so I cannot speak of what happened before then in terms of the politics. I do remember noting in the run-up to the general election in 2007 that none of the political parties was recommending the sort of policies that one would have needed to stop the bubble, which were to get rid of tax deductibility of mortgages; force much higher loan-to-value ratios, perhaps with new regulations; and increase income tax. I presume that if a political party wrote down those policies as an election manifesto, it would not get elected. However, that is what it would have taken in those days to try to stop the bubble.

Senator Marc MacSharry: The discourse was consistent with the policy of a pro-cyclical nature, rather than counter-cyclical.

Chairman: A question.

Professor Alan Ahearne: It is difficult on the political system in the sense that booms are very popular when they are happening. It is fantastic. The amount of money coming into people's pockets is just brilliant. I remember that, in 2005 and 2006 at the height of the boom, people were complaining about the price of houses but, boy, there were a lot of people employed and wages were rising fast. The amount of cash coming into people's pockets because of what was going on - this money was being borrowed by the banks from abroad and put into cash in people's pockets - it was extremely popular.

Senator Marc MacSharry: In Professor Ahearne's experience as a economist who has worked in a number of different areas, what sort of regulatory system ought to exist? He has just said that governments want to get elected. What should exist to be able to take the punch bowl out of the room? What safeguard ought to be there, or should be there, given the realities of the political discourse, as Professor Ahearne has outlined them? Booms are good and people like them.

Professor Alan Ahearne: What needs to happen is that the Financial Regulator and the Central Bank need to do intrusive, proper banking regulation. It is not so much the structure of it, or whether one has a financial regulator separated from the Central Bank, or whether they merge together. I do not think that is particularly important. What is important is that the regulator does good regulation and acts like a referee in a football match.

Senator Marc MacSharry: Earlier this morning, Peter Bacon said that he was unclear what legal force the Central Bank can apply to determine what mortgage lending should be. Others have questioned the force of the regulator, and so on, in other testimony. What is Professor Ahearne's view of that in the period? I have just two other questions after this.

Professor Alan Ahearne: I do not think the regulator lacked the tools that were available which could have prevented the increase in loan-to-value ratios, for example, and could have been much more intrusive with the banks and limited the concentration of property lending. The regulator could have done all that stuff, but they had a certain interpretation of principle-based regulation which meant that they really just looked at whether the banks had certain governance systems in place, including having an audit committee. They put a lot of trust in the senior management of the banks. That is the very opposite of intrusive, proper regulation and so the implementation of regulation failed dismally.

Senator Marc MacSharry: Professor Ahearne said earlier that there was an informal agreement, to quote his own words, at European level that we were not going to have a Lehman's in Europe. As an economist, can he give his view of the scale of the fiscal adjustment here if we had allowed banks to fail or if we did not pay bondholders? Would there have been an adjustment in the fiscal adjustment we had to undertake and what would that be?

Professor Alan Ahearne: As regards the vast bulk of the fiscal adjustment we have had to undertake, the €30 billion since 2008, very little of that has to do with the banks. People often look at the €30 billion put into Anglo and the €30 billion of fiscal adjustment and say that every single penny that was taken out in terms of fiscal adjustment, all the tax increases and all the reductions in wages, all that money has just gone into Anglo. That is simply wrong, however, and it is an inaccurate way to think about this.

In terms of the banks, the headline number is €64 billion. Anglo or IBRC is €35 billion. One really needs to think about the financing cost of those. If one can finance a bank recapitalisation at a very cheap interest rate, the actual burden of that is much lower than the headline number. For example, with Anglo and IBRC the vast bulk of that capital being put in by the State has been financed via the Irish Central Bank. It is the Central Bank which initially owned the promissory notes and now owns the bonds. They are only now selling debt into the markets.

Interest rates are extremely low at the moment. They are less than 1% which means that although the headline number looks huge, it is being financed at a really low cost. If one looked through all the payments from one arm of the State to the other, the annual cost of Anglo is probably somewhere like a couple of hundred million euro. That is not a small amount of money but it is small relative to the €30 billion adjustment, or relative to the total amount of Government expenditure.

Senator Marc MacSharry: I have a final question and there are two brief parts to it. First, can Professor Ahearne clarify whether or not, in his view, the fiscal adjustment that had to be made would have been close to the same? Second, in testimony here, Governor Honohan has said that the cost of saving the banks is €40 billion. Is he right or wrong with that figure?

Professor Alan Ahearne: The net cost would be a lot less than €40 billion I think. The problem is that the cost is changing all the time. As long-term interest rates have fallen dramatically over the last 12 months, the cost of the burden of recapitalising the banks has been reduced. The €64 billion is a particular number, it is the headline number, but the actual cost, the burden in terms of the Irish people paying out, has fallen quite dramatically over the last 12 months because long-term interest rates have fallen because of the ECB's OMT programme that it announced, and more recently the quantitative easing. The cost is determined by when the State issues the debt into the market that it is using to recapitalise. The debt that was used to recapitalise Anglo was not issued into the market. It was given to Anglo and given to the Irish Central Bank. That has not gone into the market. It is still within the system. It is only now that the Irish Central Bank is issuing that debt to the market. That is the key time period. At the moment ten-year money is less than 1%.

Chairman: The question that Senator MacSharry asked was about the tax hole that had to be filled of in and around €30 billion.

Professor Alan Ahearne: If, for example, no money had been put into Anglo, so that the €30 billion fell on the depositors and the senior bondholders, it would make a difference I think at the moment of a couple of hundred million euro less expenditure for the Irish Government. It is in that ballpark.

Senator Marc MacSharry: Interesting.

Chairman: Can I clarify one matter that Professor Ahearne dealt with in regard to Deputy Murphy. It comes back to that article on 14 September 2008 which I think was in the *Sunday Independent*. Professor Ahearne said:

> The rumour mill concerning the health of Irish banks kicked into overdrive last week. Frankly, I find some of the more alarmist statements unhelpful. Still, banks must take their share of the blame for the heightened sense of uncertainty. The information that they have been releasing about the quality of their loan books does not always square with the anecdotes about potentially huge losses associated with land purchases and unsold developments.

Can Professor Ahearne expand upon this point? What is his assessment, if any, of the quality and reliability of the information contained in the published accounts of the Irish banks at this point and were there any indications that the Irish banks were insolvent at that time?

Professor Alan Ahearne: It relates back to what Deputy Murphy had asked me about that time. The rumour mill that I was talking about was the anecdotes I was hearing that certain banks were rolling over loans rather than facing up to the fact that these borrowers were in deep trouble.

Chairman: How would Professor Ahearne view the reliability of the information that was published?

Professor Alan Ahearne: At the time I just did not know. I did not have any details. I was concerned that some of the practices I had seen before, particularly in the Japanese case, that that may have been going on, and therefore distorting the picture, giving a much more rosy picture. If the banks were doing that, and I do not know if they were or not, they may say that was proper practice. After all, if one thought that this was going to be a temporary downturn one may try to evergreen one's developments.

Chairman: That is just speculation on Professor Ahearne's behalf. That is not based on hard evidence that he had before him.

Professor Alan Ahearne: That is true.

Senator Susan O'Keeffe: Can I clarify something that I think Professor Ahearne said to Deputy Murphy? The Deputy asked Professor Ahearne about subordinated debt and he asked him what had happened. Professor Ahearne said that he did not discover a reason for including subordinated debt. Is that what Professor Ahearne said?

Professor Alan Ahearne: Yes.

Senator Susan O'Keeffe: So in all the work that he did subsequently and in the last two years, Professor Ahearne never discovered a reason for including subordinated debt?

Professor Alan Ahearne: I never asked about it.

Senator Susan O'Keeffe: Professor Ahearne will recall being accused of dangerous talk and he will recall the expression "merchants of doom". He responded to that by saying that such comments were an attack on democracy. I am just wondering what was going on at that time, if you like, for ordinary people looking on and seeing economists at odds with each other, many people at odds with each other, and the Taoiseach making inappropriate comments about naysayers. Why does Professor Ahearne think all that was going on? It seems extraordinary looking back.

Professor Alan Ahearne: I suppose it does but maybe it goes back to an earlier point that this was extremely popular and there were many people getting money from this. If one thinks of a property boom there are many different stakeholders who are getting a lot of money out of it, from people selling land, some professionals, the banks themselves. The property sector, if one defines it broadly, includes not only construction workers, but a huge number of people, all of whom were benefitting personally from what was going on. Then I think in a wider dimension the Government was a stakeholder in the sense that the Exchequer was taking a huge amount of money from the property bubble in the form of capital gains tax and stamp duty and all that, and was then dishing that money out left, right and centre. So it was great. It felt great at the time. People were saying, "There's something wrong here, there's a large imbalance, and there are risks and this thing could all go pear shaped". However, people just did not want to hear that.

Senator Susan O'Keeffe: In 2008 the ESRI in its medium term review said among other things, "The fundamentals of the Irish economy are sound." When Professor FitzGerald gave evidence here he said that the ESRI had done no research on the financial sector for a number of years. Can an economist ever say the fundamentals of an economy are sound without examining the financial sector?

Professor Alan Ahearne: The surprising thing about the economics profession, particularly the academic economics profession, is that banking sectors essentially got dropped out of economic models in the 1980s and through the 1990s. Most graduates getting PhDs in economics would have worked with extremely complicated models on computers, and they look very sophisticated, but they would not have had a banking sector. There was no credit in those models. They started to develop some models with money in them but not credit. So the profession went down a certain path in which credit, certainly for advanced economies, was completely ignored. So it does not surprise me, in a way, that economists here, working with the models and the techniques they were working with, would not have paid enough attention to a banking sector.

Senator Susan O'Keeffe: So it was true for the model but not true in the real world.

Professor Alan Ahearne: I think that is true. I had come from a central bank and I had worked on countries like the emerging Asian countries and Japan and Hong Kong and these countries, which in the real world had banking crises and stuff like that, so I had seen it, but to publish a paper in a top journal one would not put a banking sector into one's model.

Senator Susan O'Keeffe: In 2007 Professor Ahearne wrote in the *Sunday Independent*, "If the degree to which new homeowners had to stretch themselves to buy property last hear doesn't convince you that the housing market has overheated badly then nothing will." And he went on to say:

> It's obvious to everyone, that is except the economic commentators who this time last year seemed to think that rapidly increasing house prices and rising interest rates were perfectly consistent. Five minutes with a simple calculator would have told them differently.

Why does Professor Ahearne think the economists did not spend five minutes with a simple calculator?

Professor Alan Ahearne: It is very hard for me to put myself in somebody else's shoes. One of the things that was said a lot is that interest rates were low. The ECB's interest rates were 2%. They had doubled to 4%. People point out that 4% is still low. That is true but they had doubled and I think people forgot the last part of it, namely, that they had actually doubled. If one had an interest-only mortgage one's interest payments would have doubled, even though they had gone to what one might think is a low rate of 4%. If one is extremely stretched, if one has borrowed a lot of money, one would be very sensitive to that. So if I said the interest rate went from 10% to 20% one would say that was disastrous, but that is a doubling as well. So I think it was that point that people may not have appreciated fully.

Senator Susan O'Keeffe: David McWilliams said here in February 2015 that the Irish property crash and the banking crash were both incredibly predictable and absolutely preventable. What does Professor Ahearne think?

Professor Alan Ahearne: In my very last paragraph I did try to emphasise something we had said in the paper even after studying all of these patterns that seem to reoccur, namely, that notwithstanding the patterns that we observe, housing bubbles are intrinsically hard to identify, especially when they are occurring.

Senator Susan O'Keeffe: Professor Ahearne used the expression "housing bubble" in 2005 so he must have known that there was a bubble.

Professor Alan Ahearne: No, because we were talking about the previous experiences. We were able to identify bubbles that had occurred since 1970 in 18 advanced countries but we were looking backward with the benefit of data. The very definition of "bubble" that we used was that house prices had to have fallen in three years following the peak, so we picked out these bubbles but we were doing so looking backwards.

Senator Susan O'Keeffe: Professor Ahearne said we were on our own if the bubble were to burst.

Professor Alan Ahearne: That was the headline. I did not write the headline.

Deputy Michael McGrath: Professor Ahearne is very welcome. I will start with the September 2005 study he did with his colleagues in the Federal Reserve. He looked at 44 episodes of house price booms and busts in 18 advanced countries since 1970. If he were to go back to update the study in light of what has happened in Ireland in recent years, where would Ireland stand or rank in the context of the countries he studied?

Professor Alan Ahearne: It would be one of the biggest booms and busts, perhaps in the top three, in terms of the movement of house prices-----

Deputy Michael McGrath: From peak to trough?

Professor Alan Ahearne: Yes; that is correct. I think house prices fell here by around 50%. They have moved back up, but certainly, if one looks at it from peak to trough, it would have been one of the top three.

Deputy Michael McGrath: What other examples would be up there in the top three?

Professor Alan Ahearne: The Netherlands had a very bad boom and bust in the 1970s. The Japanese had an atrocious boom and bust in which property prices fell by 90% from peak to trough, at least in Tokyo. Their data are a little hard to interpret, but it occurred over a very long period.

Deputy Michael McGrath: Just to take Professor Ahearne on to the link between the property price crash and the impact on the banking system, was that link fully understood in the years leading up to the crisis? Was it understood that the risks that were being built up through dramatic property price increases could potentially have a major impact on the banks and the banking system? Does he think that was sufficiently understood by the authorities?

Professor Alan Ahearne: It is difficult to say. There have been examples in which even a very large decline in property prices did not create an outright banking crisis. The example I gave was Hong Kong, where property prices in the late 1990s, at the time of the Asian financial crisis, fell by 50%, but they did not have a banking crisis. What happened there was that they had very low loan-to-value ratios, which protected them. The banks also had huge amounts of capital and they may well have been more exposed to residential rather than commercial property. So it is not automatic that if there is a property boom and bust the banks are all going to go bust. It depends on the extent of it: how bad is the boom and bust, what is the wider context and what happens to the economy. If the economy goes into recession, does it go into a depression? One has to take all of that into account and then see what the banks are like and what is their ability to withstand that bust in terms of capital. That is extremely complicated. One would have to have the details.

Deputy Michael McGrath: In the Irish context, in terms of the banking crisis that did develop, and looking at the exposures in commercial real estate and residential mortgage lending, if Professor Ahearne were to attach a weighting to both of those in terms of the underlying risks and losses in the banking system, which was more important and what kind of ratio would he attach?

Professor Alan Ahearne: I am sure one can actually get the hard data, but as far as I know, the losses suffered by the banks from commercial property lending, and particularly lending for property development, have been greater than the losses they have suffered on the mortgage lending, but I say that without any hard numbers in my head.

Deputy Michael McGrath: When Professor Ahearne was answering Deputy Murphy earlier about the meeting he had with the late Brian Lenihan in August 2008, he said that around that time there were rumours and anecdotes about Anglo Irish Bank. The term he used was “a complete basket case”. Was that what he was picking up socially? When was he talking about exactly? Was it July to August 2008?

Professor Alan Ahearne: It was probably around then. I used the term but perhaps I should not have. I do not think anybody described it to me as a complete basket case, but there were worries that this was a bank that was deeply exposed to property and the property market was in trouble, and so the logic was that there had to be risks and worries about that particular entity, perhaps more so than for the other banks.

Deputy Michael McGrath: What is Professor Ahearne’s view, then, on the characterisation a month later, at the end of September 2008, of the problems within the banks and even in Anglo Irish Bank - we will explore that, obviously, in much more detail - that it was a liquidity issue and not a solvency issue at heart? Does Professor Ahearne think, given the loose talk that was going around at that time, that it was credible that people in authority - the Central Bank, the regulator, the executives of the banks themselves - would have been of the view that it was a liquidity crisis? Is that credible or not credible in Professor Ahearne’s view?

Professor Alan Ahearne: I would only be speculating. I do not know. It is difficult to really know whether the bank was insolvent. First, one does not have the data. One does not know exactly what is going to happen over the next couple of years and one does not have the information on when the economy went into such a deep recession. One would really have to know the bank’s books. One could say €100 million was lent to a certain developer against collateral, but is it real collateral or is it unrealised capital gained from some other property project that has been used as collateral? One would have to know that and know the loan-to-value ratios. One would have to know whether the developer has a different income stream on which to draw or dividends from some shares he or she has bought in order to make good on the loan. The amount of detail one would have to know to make that assessment is huge.

Deputy Michael McGrath: Finally, in Professor Ahearne’s opening remarks he characterised quite starkly the change in the nature of mortgage lending in Ireland around 2006 and the data from the Department of the Environment, Community and Local Government that one in three new home buyers in 2006 took out 100% mortgages. That rate had doubled from the year before. Two thirds of all new home mortgages taken out in 2006 were 31 to 35 years or longer. Is Professor Ahearne satisfied that the tools were there within the legislative powers that the regulator and the Central Bank had to deal with that issue? Why does he think those risks were not identified and action was not taken?

Professor Alan Ahearne: I am satisfied that the regulator could have done something about that. The 100% mortgages in particular were extremely dangerous instruments. They were being used by people who clearly could not afford a property, and they were used to get them into the property market. I remember, when I lived in the United States, hearing guys talking at half time during a football match about buying houses using these exotic mortgage products in which they got very low interest rates for a few years and then they were restructured. The point is that one must refinance before the interest rate is reset, or one sells the property before it resets, so the higher interest rate is irrelevant. That is an instrument that allows people to get into the property market, but boy, is it dangerous, because if the property market falls you are caught. These seem to me the same sort of thing. Loan-to-value rates of 100% seem fine if prices are rising, because if house prices go up by 20% the following year a house will have generated equity, so as long as the market is going up it is fine, but the problem is that if the market goes down one is in negative equity. I was very concerned about that particular development.

Chairman: Let me expand on that with Professor Ahearne, in that the mortgage products that were there at the time, as he indicated to Deputy McGrath, were very much for the home purchaser, but those products were also available for investors, particularly in the buy-to-let sector. Earlier in his testimony, Professor Ahearne discussed how the traditional model of valuing residential property was through rental income. I think it is ten to 12 times the annual rental income that determines what the price of a house should be, and so forth. Given that in the buy-to-let sector there were100% mortgages and interest-only payments, and the rent was required to justify the repayments back to the banks, even though no capital was being paid back due to the interest-only payments, did that in any way distort the valuation process? People could afford the rent even though the landlord was not clearing any capital on the loan.

Professor Alan Ahearne: Could you just clarify the final point, Chairman?

Chairman: Perhaps I will give the lecture to Professor Ahearne. I am simply saying that if somebody buys a house over a 20 or 30-year schedule, he or she will pay interest and capital during that period and pare down the debt. One could value a house in terms of affordability, at three times the income of the purchaser and his or her partner. Another way to value it is to consider the rental income it would accrue annually and multiply it by ten or 12. In terms of prices increasing, and given that there were investors in the market as well as people buying homes, for the purchasers of buy-to-let properties who were paying interest only, spread over 35 years with a balloon payment at the end, the loan-to-value ratio was very low but because the rent serviced the interest no capital was paid down. Was that distorting the value of rents and therefore distorting the value of the property?

Professor Alan Ahearne: I think the Chairman is right that the buy-to-let investor could buy a much bigger property and was able to cover the interest-only loan with the rent because no capital was being paid down.

Chairman: Was that picked up at the time? Professor Ahearne spoke of writing about rent ratios and other matters in October 2005, but was the picture I gave picked up at the time?

Professor Alan Ahearne: I brought up the fact that prices were getting out of line with rents because we had seen it before. It was an issue. Some investors had no rents coming in. The 2006 census found a large quantity of empty properties. They were buying up property but not even bothering to rent it out.

Chairman: Was that because the equity in the property was accumulating so rapidly that one could turn it around in 12 months without having let it and still make a profit?

Professor Alan Ahearne: Exactly. If they waited two years they expected to have a 30% capital gain and therefore they would sell it. The gains were capital gains, not rent. That is why prices getting out of line with rents is an alarm signal.

Chairman: On that analysis, the equity increase on a compound basis was greater, in some cases, than rental income on a property.

Professor Alan Ahearne: It was all driven by the capital gain investors were expecting to get. If they had been told the capital gain would be zero they would not have bought these properties because the rents would not have made it worth their while relative to the interest they had to pay. The interest rates rose and that made buy-to-let investing disastrous.

Senator Michael D'Arcy: Professor Ahearne is very welcome. What was his reaction to the news that the bank guarantee had been put in place on the night of 29 September?

Professor Alan Ahearne: I would have heard about it the next day. I was a little surprised at how broad it was. I had thought the Government would eventually do something to safeguard deposits. In early September a deposit of €20,000 was guaranteed but one could lose 10% of it, which I wrote at the time invited a run. That was increased to €100,000, but I was pretty sure that if push came to shove the Government would increase it again, as many countries had done, and make it unlimited to secure deposits.

As I wrote, the wholesale funding was a little more puzzling, particularly the subordinated debt part of it. I had not appreciated how intense the funding pressure was. When I wrote that article I was writing about money flowing out of some of the banks and into AIB and Bank of Ireland. It turned out that those banks were under pressure as well but not quite as much pressure. I had not appreciated that this was not just a couple of banks but a system problem.

Referring to the earlier discussion about dominos, this guarantee included all the institutions, so there were no two dominos separated from the other four, and I concluded that the Government had decided it was not possible to knock down two dominos without knocking the other four. I assumed it had considered it carefully and determined that that was the outcome.

Senator Michael D'Arcy: At that stage, when no major analysis or empirical research were available, did Professor Ahearne think it was a good or a bad idea?

Professor Alan Ahearne: I did not know. I was sitting in an office in Galway. The people making those decisions had much more information. I queried the subordinated debt. That could have been a good idea but I just could not think of a reason for that.

Senator Michael D'Arcy: Professor Ahearne had spoken with the Minister, Brian Lenihan, in mid-September 2008 - the dominos conversation. The guarantee was put in place, and at the end of December he wrote:

In the case of a failing bank, the EU will only allow state funds to be used to wind up the bank or for a complete restructuring. Rightly so. Pumping funds into failing banks is simply pouring taxpayers' money down the drain.

Was there an alternative to pouring taxpayers' money down the drain?

Professor Alan Ahearne: That is a turn of phrase I used.

Senator Michael D'Arcy: Professor Ahearne used it.

Professor Alan Ahearne: I did. I would not say the money used to recapitalise the banks was money down the drain. When money goes down the drain nobody gets it. The money used to recapitalise the banks did go to the depositors and the senior bondholders.

Senator Michael D'Arcy: We knew subsequently that Anglo Irish Bank and Irish Nationwide Building Society were failing. In that case, pumping money into failing banks was simply "pouring taxpayers' money down the drain".

Professor Alan Ahearne: Even in those banks the money was not literally going down the drain. Somebody was getting it. In the case of Anglo Irish Bank, the people who got it were the depositors and senior bondholders. If the Government had not recapitalised those banks there would probably have been a 50% discount on all deposits and all senior bonds. The fact that the money went in made the deposits good and kept them whole. If the failed banks had not been recapitalised the guarantee would have been triggered. They were recapitalised to prevent the guarantee from being triggered.

Senator Michael D'Arcy: Did the bank guarantee lead in part or completely to the nation's bailout in late 2010?

Professor Alan Ahearne: The collapse of the banking system and the economy meant that the markets were not confident about lending to the Irish State at adequately low interest rates. The fact that the Irish State had to recapitalise the banks was an element of that. It was expensive. The headline figure was €64 billion. There was uncertainty around that period about how much extra funds would have to be put in. That uncertainty was an element, but only one element. If the Irish economy had grown strongly - if the growth prospects were strong - the markets would have been less worried. If, for example, outright monetary transaction or the ECB's quantitative easing had been introduced in mid-2010, presumably that would have calmed the sovereign debt market and the market would have continued to lend to the Irish Government at low interest rates and Ireland would not have needed official assistance. There were many components.

Senator Michael D'Arcy: One third of tax receipts prior to the collapse of the banking sector were coming from transaction taxes and capital taxes. How would you itemise that quantum of tax coming from a source of funding that is not available every year?

Professor Alan Ahearne: In retrospect, that is a very risky source of funds. It means that a large chunk of tax revenue will only come in if the bubble keeps going. At the time, perhaps in 2006-07, I talked about Norway, which had huge budget surpluses. This is, of course, because the country has oil and is squirrelling away all the oil revenues. The oil will eventually run out in 50 years or so, and revenues are therefore being squirrelled away. I said at the time that if one has a temporary source of revenue, it is a good idea to squirrel it away and not spend it. In retrospect, that did not happen in Ireland. There was a temporary source of revenue, the one to which the Senator referred, but it was spent because it was given out in higher public sector pay, welfare payments and Government expenditure. When the bubble burst the revenues disappeared but the expenditure remained, and fiscal adjustment was required.

Deputy Pearse Doherty: Tá fáilte romhat go dtí an coiste. Professor Ahearne signalled a series of warnings in the period leading up to the crisis. How convinced was he that he was correct? Perhaps he could express his answer in simple percentage terms.

Professor Alan Ahearne: I did not say at any stage that I was absolutely certain that this was going to happen. I did not have a crystal ball. All I could do, and it was what I did, was to look at other countries' experiences and say there was a risk. I tried very reluctantly to put some numbers on over-valuation. I think I mentioned, possibly on the "Future Shock" programme, a figure of 30% and I gave a figure of 20% to other people. It was very difficult to put a number on it but it was a significant risk. The problem I saw with it was that even if one thought there was only a 30% chance of a crash and a 70% chance of a soft landing, the effect - that is, the devastation caused by the crash - would be so large that one would have to take that into account. One cannot always make policy based on what one expects to happen. One has to look at the distribution of risks.

Deputy Pearse Doherty: With regard to Anglo Irish Bank, on 4 January 2009, the *Sunday Independent* published the following comment from Professor Ahearne:

> The markets quite clearly don't believe in the future of Anglo, and yet the Government is saying it's too important to let go. I'm not convinced by this.

Will Professor Ahearne outline the reasons he was not convinced of the Government's view that Anglo Irish Bank was too important to let go? What should have been done at the time?

Professor Alan Ahearne: "Let go" is a loose term, and I should have been a bit tighter in that regard. I think the talk at the time was that the Government was going to put capital into Anglo, which was going to continue running as a functioning bank. We were going to have Bank of Ireland, AIB and Anglo Irish Bank and they were just going to continue. What I was not convinced about was whether Anglo Irish Bank really had a future in the sense that it was a monoline bank. Where was it going to make its money in the future? Running Anglo Irish Bank as a going concern into the indefinite future was the part I was unconvinced about. That was different from saying it should have been shut down there and then, because that was not possible in the sense that Anglo was a very big bank with €70 billion or €80 billion of funding. If one shut it down there and then, one would have to pay back all the guaranteed funders because it was covered in the guarantee. Where would the State get €80 billion to repay them all?

Deputy Pearse Doherty: On Anglo Irish Bank, Professor Ahearne described how he arrived at his assessment that there would be a hard landing. He did not have access to the internal data available to the banks, which the Central Bank may also have had. If he had been aware of the information provided in the Nyberg report, which shows that 50% of Anglo Irish Bank's loan book was held by 20 individuals, what types of warning would he have issued before the crisis?

Professor Alan Ahearne: I am not sure it is *per se* an issue of concentration among certain individuals. One could lend a lot of money to an individual and the loan would be perfectly fine if he or she was able to make the repayment. The question is whether there was genuine collateral behind the loan or whether these developers were completely exposed to the property market without any sort of diversification. What we know now is that the latter scenario was the case and, therefore, the loan losses were colossal. There was not much genuine collateral there and the developers in question had not diversified. The loan-to-value ratios, even on commercial property lending, were extremely high. All of those risky bank practices were in place.

Deputy Pearse Doherty: A number of names have been mentioned today, including those of Professor Ahearne, Mr. David McWilliams and Professor Morgan Kelly. Does Professor Ahearne share the view that there were only a number of contrarian voices, or was the evidence wider? Will he comment on the note that UBS issued to its investors in January 2008 in which it advised them to sell shares in Anglo Irish Bank and AIB? This was done at the start of 2008 and was based on its expectation that commercial property prices would fall by 30%. How widely available was this information in terms of people who were trained or had access to this information?

Professor Alan Ahearne: I do not think the really detailed information one would need to make a very good projection about how bad things were getting in the bank was available to anybody. I do not think the Financial Regulator had that information. The Financial Regulator's approach - so-called light-touch regulation - meant that regulation was not intrusive and the regulator did not gather the sort of information that one would really like to have. I mentioned talking to the late Brian Lenihan about really needing to know what the books looked like. That is the sort of stuff I was getting at.

Deputy Pearse Doherty: Professor Ahearne noted in response to Senator MacSharry that in the period leading up to the 2007 election none of the parties recommended policies to stop the property bubble. He also stated that booms were very popular and that no party would have been elected it if had recommended policies to stop the property bubble. Will Professor Ahearne clarify the matter by indicating which parties he was referring to? Did he mean all the parties? I am only familiar with the 2007 election manifesto of the party I represent, which referred to high-risk 100% mortgages, ending property tax incentives and intervening in a market that was in crisis. I am wondering, therefore, to which parties Professor Ahearne was referring. Does he include the Socialist Party, the Fine Gael Party, the Green Party and others? He made a very broad statement on a matter that the inquiry may address subsequently as part of its terms of reference.

Professor Alan Ahearne: I understand the Deputy's point. I was referring to what were the three major parties at that time - Fianna Fáil, Fine Gael and the Labour Party. I remember thinking myself at one stage, and I may have said this to somebody, that if one took the covers away, it would be difficult to tell which party the manifestos were coming from. They were similar in many ways.

Deputy John Paul Phelan: One of the previous questioners referred to the report on banking crashes that Professor Ahearne produced for the Federal Reserve. Professor Ahearne referred to his meeting in August 2008 with the late Minister for Finance, Deputy Brian Lenihan, which was held in the Minister's office. Did any other officials or politicians approach Professor Ahearne in the period leading up to the banking difficulties? Was the meeting with the Minister the only meeting he had at that time?

Professor Alan Ahearne: I do not think I met any other officials. I am trying to get the dates right, but I met the current Tánaiste, Deputy Joan Burton, probably in late 2008, and Deputy Richard Bruton, also I believe in late 2008. Those were discussions about banking issues.

Deputy John Paul Phelan: There were no other discussions with any Ministers at the time that Professor Ahearne can remember?

Professor Alan Ahearne: No.

Deputy John Paul Phelan: Can he rationalise the apparent decision of the academic economics profession to exclude the banking sector from economic modelling? This issue was raised by Senator O'Keeffe. It appears to be a glaring omission, even if I accept that we have the benefit of hindsight. Why was banking omitted from economic modelling?

Professor Alan Ahearne: There were two reasons. In the 1980s, much of the literature tried to explain why economies go through booms and busts and why we get business cycles and seemed to be able to explain this without referring to banking sectors. The literature suggested the booms and busts were driven by different factors, either by productivity shocks that hit our economy or, at a later stage, by monetary policy, but that there was no need for credit cycles *per se.*

In addition, modelling for this was different technically, as the more elements put into a model, the more difficult it gets. Therefore, when one added in credit markets - although critical - the model got very complicated. Deputy McGrath asked me earlier what we would see differently if we added extra countries and their experience over the past six or seven years into a study like ours. What we see that is different - the IMF has done this type of study - is that the relationship between the credit and property is now very clear. However, it was far less clear when we were doing our study. We had some property booms where credit had not expanded that much. The finding we all talk about now is that we should get worried about property booms if there is an accompanying credit boom. This is a more recent finding, which benefits from the fact we have far more observations in the current experience.

Deputy John Paul Phelan: Last year, Professor Ahearne co-authored an IMF paper on economic surveillance. Can he briefly outline some of the principle findings of that paper, in terms of improving economic surveillance in the Irish economy? I think the paper was produced in July last year.

Professor Alan Ahearne: We were looking at a certain type of surveillance, a surveillance of structural issues. We had recommended, for example, that in its annual surveillance of a country, the IMF should look for evidence of what we call "rent seeking" where there are distortions. The IMF does not do that, but we believe it would be a useful thing to do. We also talked about regulation of State owned enterprises, such as energy, as something that should be included in the IMF's surveillance. We also mentioned negative findings, but the IMF does not have the expertise to add value in the surveillance of the labour market. That was the purpose of the study.

Deputy John Paul Phelan: I will refer briefly to the first part of Professor Ahearne's response. Does he believe the IMF's surveillance, and its report from 2006, exacerbated the problem because it was seen to give the all clear to an economy that was in difficulty?

Professor Alan Ahearne: I think it must have. One can imagine the fact that a number of different external organisations were all sending clear signals that there was deep trouble here and that the country was in trouble. When one is in the middle of it, it can be hard to see the facts, but outsiders have an advantage, particularly international organisations with experience. Their voice can be very powerful, but if their voice is very quiet, it is difficult.

Deputy John Paul Phelan: I want to refer to chapter 1 of the book, *Brian Lenihan: In Calm and Crisis*, which quotes Professor Ahearne as saying that a lethal expansion in credit had occurred due to borrowing by the Irish banks. Will the professor elaborate briefly on what he meant by "a lethal expansion". When does he believe that expansion became lethal? Can he put an approximate time on that?

Professor Alan Ahearne: If one looks at the numbers, lending accelerated from 2003 to 2007, but the three years from 2004 to 2006 were particularly damaging in the expansion of banks' loan books. It was not just that they were lending more, but there was very concentrated lending, particularly into speculative property.

Chairman: in that regard, was that the optimum period for an intervention to have been made by the State or the regulator?

Professor Alan Ahearne: Bubbles are best nipped in the bud, as quickly as possible. If there could have been intervention in 2004, that would have been the time.

Chairman: Would it have been possible to have made a successful intervention after 2004?

Professor Alan Ahearne: Sure. It would have been possible any year and to do it in 2005 would have been better than no intervention. However, if we are looking at the optimum time, the best time to intervene would have been 2004.

Senator Sean D. Barrett: I welcome Professor Ahearne. Will he refresh my memory in regard to his time in the Minister's office? When did he join and when did he leave?

Professor Alan Ahearne: I was there from March 2009 to March 2011.

Senator Sean D. Barrett: When was the hard landing seminar in the Central Bank held?

Professor Alan Ahearne: I think it was in the second half of 2006, but the Central Bank may be able to clarify that, as I am not certain of the date.

Senator Sean D. Barrett: Who attended the seminar and what was the reaction when the professor gave the "hard landing" finding?

Professor Alan Ahearne: It was mostly people from the Central Bank. I remember somebody remarking that there were very few people from the regulator - they were separate at the time. Somebody remarked at the time that it was disappointing some people from the regulatory side had not attended. It was mostly economists from the Central Bank.

Senator Sean D. Barrett: The finding in the Wright report is that there was far too little economic expertise around. He estimated that approximately only 7% of senior people in the Department of Finance had qualifications at master's level or above. He compared that to 60% in Canada and 40% in the Netherlands. Did Professor Ahearne find that a problem when he went to work in the Department in March 2009?

Professor Alan Ahearne: Not particularly. I found people were very knowledgeable. Of course, they had been in the trenches for quite a while. They were extremely hard working and very knowledgeable. It was not clear to me at that stage that the country could be saved by more economists. Perhaps more economists during the bubble years could have made a real difference.

Senator Sean D. Barrett: Did we understand the full implications of euro membership?

Professor Alan Ahearne: I think most counties did not, in the sense that once they joined the euro, that had implications for all other types of economic policy or how it had to react. This was because they had now lost control of their interest rate and exchange rate, two of the most powerful economic tools an economy has. Having lost control of those, everything else needed to adjust, but nothing adjusted. That was not just true in Ireland, but all across the euro area. I think governments had been exhausted by the effort to join the euro and from meeting the Maastricht treaty requirements and so on and had kind of relaxed. They seemed to believe that now that the euro was up and running, that was good, without recognising that now they had to be cognisant and very careful of other aspects of economic policy. They were not. They took the benefits, in Ireland and other peripheral euro countries, of the very low interest rates, which was good, but that also created risks and the risks were ignored.

Senator Sean D. Barrett: Did we understand the implications of the savings and loans collapse in the United States, given what happened to building societies and financial institutions here?

Professor Alan Ahearne: That was in the late 1980s in the US. On whether there were lessons learned from that, probably not. It was a long way away and time had made a difference. In 2005 and 2006, the height of the bubble here, I do not remember anybody here talking about savings and loans.

Senator Sean D. Barrett: Did economists working in banks ever relay any fears to Professor Ahearne that the bank they were working in might go down the tubes? Did they see it coming or discuss it?

Professor Alan Ahearne: No.

Chairman: In regard to Senator Barrett's earlier comments on the period during which Professor Ahearne was working for the late Brian Lenihan, were you compensated for your role during that period?

Professor Alan Ahearne: I was.

Deputy Joe Higgins: In regard to the bubble period, the professor said on a number of occasions today that property was extremely popular, that many people were making lots of money - land sellers, professionals, banks, construction workers - and that this felt great at the time. He was an adviser to the then Minister for Finance, Brian Lenihan, in October 2010 when he said, controversially, "Let us be fair about it, we all partied." Is the professor re-echoing that sentiment in regard to the bubble? Does that tally with the fact that a substantial number of people felt they did not party? Many people were excluded from the housing market because of the huge price increases. The generation that managed to get on the property ladder were saddled with 35-year or 40-year mortgages pitched at unsustainable levels. Plus, a substantial number of people never bought or sold a home over that time.

Professor Alan Ahearne: I did not mention anything about partying. As the Deputy said, it was the late Brian Lenihan's comment. It was not my comment.

Deputy Joe Higgins: Yes, I understand. Does the professor echo that belief?

Professor Alan Ahearne: No. I agree with the Deputy that the effects of booms and busts, as I said much earlier, are devastating for people. With the huge increase in unemployment and huge declines in employment, added to the fact that people had borrowed huge amounts, many ended up in huge financial distress. People have lost a lot of money because the Government had to raise taxes and cut expenditure to restore order to public finances. All of these things are terrible.

Deputy Joe Higgins: Yes.

Professor Alan Ahearne: That is why we should not have booms and busts. I did not recommend booms and busts as a policy. I was trying to warn about the dangers of a boom and bust because they are devastating for individuals.

Deputy Joe Higgins: In the course of the ten years between 1996 and 2006, our researchers have told us, based on hard facts, that the price of a home for an ordinary person increased by the equivalent of the average industrial wage each year for ten years. It finished up at 11 times the average industrial wage, when the normal value was considered to be two and half to four times that amount.

Professor Ahearne said it was difficult for the Government to intervene in the bubble while this stuff was happening, with policies such as income tax increases and loan-to-value ratio adjustments. There was also what many people would call an incredible, breathtaking, increase in house prices. What about radical policies to outlaw profiteering in building land and housing, which many felt was underpinning what went on?

Chairman: Please allow Professor Ahearne time to respond.

Professor Alan Ahearne: I agree that unsustainable increases in house prices, or bubbles, are bad. One of the things that added to this situation was the reduction in capital gains tax. That meant the profits for people buying and selling land were taxed at 20%, which was extremely low. That situation added to the incentive to speculate in property and, therefore, was extremely damaging. If land is going to be used for buildings then it should be used to build houses at a reasonable cost. In terms of policy, that was certainly a contributory factor and a problem.

Chairman: Deputy Higgins has a minute and a half remaining, so I suggest he move towards asking his final questions.

Deputy Joe Higgins: The NAMA assets were transferred with a haircut of about 57%, but the European Commission later judged that the banks had received €5.6 billion in State aid by the end of 2011 as a result of loan transfers, which amounted to a 22% aggregate premium above the November 2009 loan market value, according to NAMA's section 227 review in July 2014. What is the professor's view of the NAMA setup in retrospect? Why was an alternative course not more seriously considered, such as nationalising the banks and burning the bondholders, rather than transferring the loans?

Professor Alan Ahearne: NAMA did not prevent any burning of bondholders. It is not true to say that we had to either set up NAMA or carry out nationalisation and burn bondholders. Anglo Irish Bank was nationalised, but it sold a lot of property to NAMA. There was a bit of a debate at the time that these were alternatives. That was just flawed thinking, because they are not alternatives. I think the system we have now has done very well. The pricing was fair and it gave a big discount on the loans it bought. I do not think one can be too precise about these things. Sometimes we suffer from false precision. The discount was 57%. If somebody is going to argue that it should have been 59%, 55% or 60% I would wonder how he or she could be so precise.

Deputy Joe Higgins: The Comptroller and Auditor General estimated that Bank of Ireland got €1 billion in State aid in reality.

Professor Alan Ahearne: One had to come up with some sort of number. NAMA followed EU regulations. It presented a formula for calculating things, and an allowance of 8% was given for long-term economic value. If one looks at what property prices have done over the past 12 months, that allowance looks modest. Let us remember that the formula, although it looked complicated, came from the European Commission. I can understand why the European Commission would want every country to follow the same formula. The formula is still just an estimate, and that is all. One is trying to value a piece of land in Leitrim, for example, but there are no sales going on. How can one possibly value land with accuracy in that case? The best one can do is talk about a range or margin of error. I think what NAMA did, in terms of pricing, is that it got the price approximately right. It is better to get things approximately right than precisely wrong.

Deputy Kieran O'Donnell: Professor Ahearne wrote extensively around the time of the guarantee, and stated that he had questions about the information on the quality of loans that was released by the banks. Does he believe that on the night of the guarantee, Anglo Irish Bank should have been allowed to fail? Does he believe that it should have formed part of the guarantee, or not?

Professor Alan Ahearne: To be honest, I have an open mind. I just do not know. I might be able to come to a better opinion at the end of the inquiry when more information has come in. I just do not know.

I heard that Governor Honohan had a footnote in his report in which he talked about an alternative scenario in which Anglo Irish Bank was not included in the guarantee but was put under some sort of administration. That is an interesting hypothesis, but it was only a footnote in a report. I have not seen a ten- or 20-page paper that goes through that in a counterfactual manner explaining how it would have worked - that the next morning the Government would have announced this, that excluding Anglo Irish Bank would have affected things in a particular way or that it would have worked in a particular way. Without seeing a worked-out scenario and a detailed paper, it is just a hypothesis at the moment. It is a footnote in a report, so I do not know.

Deputy Kieran O'Donnell: There was no question of looking at how much this would cost or what potential saving could be made for the taxpayer if Anglo Irish Bank had been kept out of the guarantee. Did that aspect ever come up in discussions?

Professor Alan Ahearne: The numbers are the numbers. Anglo Irish Bank was recapitalised to the tune of €30 billion, as I have said. If I remember rightly, it had, on the night of the guarantee, about €50 billion of deposits and about €10 billion of senior bonds. Again, I am talking a hypothesis or a counterfactual scenario. If one considers the counterfactual scenario in which the Government says it is not going to put a cent into Anglo, the €30 billion of losses that the State covered would have fallen on its creditors. Then, one had €60 billion of senior creditors - €50 billion in deposits and the €10 billion - and one would have discounted them by 50%, which is the number I gave earlier. That measure would have saved the State €30 billion, if that is what the Deputy asked. On the other hand, one is talking about depositors, small businesses and individuals with their life savings getting back 50 cent in the euro. That means that if an elderly person had €200,000 saved with Anglo Irish Bank, he or she would have got €100,000 back. If one were a small or medium-sized enterprise with the wages for the next few months on deposit then one would have got half of them back.

Deputy Kieran O'Donnell: Is it fair to say that if the State had guaranteed just the deposit holders in Anglo, and not the bondholders, there would have been a significant saving to the taxpayer?

Professor Alan Ahearne: I do not think so. What if the bank had been liquidated? In a liquidation all unsecured creditors must be treated equally. The liquidator could not have told bondholders he was going to give them nothing back but give all the revenues from selling the assets to the depositors. Maybe the State could have made good all the depositors but we would still have diluted the losses that could be forced onto senior bondholders by the fact that there were depositors. It may have saved 50% or €5 billion of the total of €10 billion.

Deputy Kieran O'Donnell: Professor Ahearne wrote an article about NAMA in July 2008 in which he said the best practice was for banks to recognise the losses of the loans up front and sell the assets at fair market value. Dr. Bacon, who was before the committee this morning, was the architect of NAMA and he said there were €34 billion in impairments on €80 billion of loans, a write-off of between 50% and 60%. When the then Minister for Finance, the late Deputy Brian Lenihan, introduced the legislation in the Dáil, he said NAMA was being put forward on the basis of a discount of 30%, which would have been some €23 billion rather than the €42 million it transpired to be. Did the design of NAMA, and the fact that it was based on a 30% discount rather than a discount of nearly 60%, feed into the need for the banks to be recapitalised? If the eventual level of discount was known at the early stages of setting up NAMA, would the professor have proceeded with setting up the agency?

Professor Alan Ahearne: Absolutely. The Minister did not put forward NAMA on the basis of a certain discount but gave an estimate of the figure. The actual discount could only be determined by European Commission rules after they had calculated it loan by loan. The extent to which the property market fell mattered as to the discount but NAMA would have been a good idea irrespective of whether the discount was going to be 20%, 50% or 80%. The arguments put forward for an asset management company never depend on there being a certain discount as the argument for an asset management company stands on its own two feet.

I was struck by what Professor Dirk Schoenmaker from the Duisenberg School of Finance said at a conference last month. He is one of the world's leading experts in banking. He is an independent and highly regarded individual who has also written a paper about the Irish banking crisis. On page two he writes: "The establishment of the bad asset agency, NAMA, serves as an international example of the successful management of bad assets." On page 24, he states: "The establishment of NAMA was instrumental in the successful management of the Irish banking crisis." That is his assessment

Chairman: We will wrap up soon. I invite Deputy Eoghan Murphy, followed by Senator Marc MacSharry.

Deputy Eoghan Murphy: I have two brief supplementaries. In his opening statement, Professor Ahearne talked about the price-rent ratio as an indicator of a bubble. How important an indicator is it? Does it rank in the top three indicators? Is it something that needs to be scrutinised continuously?

Professor Alan Ahearne: As I said, it is not foolproof. We looked at this in a 2005 paper and we found examples of price-rent ratios which suggested a boom or a bust but where a boom or bust did not materialise. There is no infallible tell-tale sign. It is useful but it has to be supplemented with other types of information.

Deputy Eoghan Murphy: There has been some discussion in this context phase of the extent to which this crisis was home grown. Professor Ahearne wrote in *The Sunday Independent* that the housing market began to turn sour around the middle of 2006, a full year before the global credit crisis erupted in August 2007. Can he give an opinion on the relationship between the international and domestic factors?

Professor Alan Ahearne: At its most intense, the crisis here was an interaction between both crises. If the bubble had burst here but the global economy was still flying, we would still have had trouble here but not as much, and the recovery would have been much faster. The first sign of trouble in 2006 was some failed auctions in Dublin's high-end market. The market had been flying as the overall market rose but some failures in 2006 represented the start of trouble for developers and sellers.

Senator Marc MacSharry: I would like to seek clarification on my last question. I put a question to the Governor of the Irish Central Bank, Professor Honohan, about the costs of recapitalisation. He said it would amount to some €40 billion but Professor Ahearne said it would be much less than that. How much does he think it will be?

I asked earlier if the fiscal adjustment would have been less or more had we allowed Anglo Irish Bank or another bank to fail. The professor said that, as of today, the saving would be just a couple of hundred million euro. Can he clarify those two points?

Dr. Peter Bacon said in his closing remarks that the main causes were interest rate deductibility for investors, low interest rates, capital inflows and interbank lending. If that were true and a Government could see there was going to be a boom in, say, six years' time, what kind of lead-in time would it need to act to alleviate the difficulties coming down the line?

Professor Alan Ahearne: The final cost of recapitalisation, by which I mean the true burden, taking into account financing and not just the headline rate number, changes every day and, indeed, every time bond yields move. It depends how quickly the Central Bank sells these bonds into the market. These are all factors.

Senator Marc MacSharry: Is the trend upwards or downwards?

Professor Alan Ahearne: Thankfully, it is very much downward and it has been getting a lot cheaper. It is still very expensive, though. I did not use the word negligible. A couple of hundred million is not negligible.

Senator Marc MacSharry: I used the word.

Professor Alan Ahearne: The real cost is in terms of what it has done to people, the high unemployment and debt, rather than the cost of recapitalising the bank *per se*, which, because of the way it was financed, has turned out to be a bit cheaper.

Senator Marc MacSharry: Is it correct that the real cost so far has been a couple of hundred million euro?

Professor Alan Ahearne: That is the ongoing annual financing cost of recapitalising that particular institution. The time to implement policies to prevent the bubble growing was probably 2003 or 2004.

Chairman: I want to wrap up a couple of matters. I return to a earlier question by Senator Michael D'Arcy. Did the way the guarantee was designed have any relationship with Ireland being required to enter a bailout programme two years and two months later?

Professor Alan Ahearne: Concerns were certainly expressed to me just before we went into the programme about how much Anglo Irish Bank would ultimately cost. The uncertainty about that was a contributory factor.

Chairman: I was asking about the way the guarantee was designed.

Professor Alan Ahearne: If the markets knew Anglo Irish Bank had losses greater than expected and that somebody else would take those losses, such as a European fund, they would have not been as worried about that aspect of it.

Chairman: I am asking if there is a relationship between the design of the guarantee and our ultimate entry into the bailout programme.

Professor Alan Ahearne: There is no simple answer to that. It is very complicated. If, for example, the State could have put on to somebody else the €30 billion that was put into Anglo, let us say, by not including it in the guarantee, then clearly the national debt would have been lower by €30 billion. However, the €30 billion would have fallen on to depositors and bondholders and there would have been economic consequences from that. As to where that would have led us, it is difficult to say.

Chairman: The other matter I want to deal with goes back to an article Professor Ahearne wrote in 2008 and I believe it was written for the *Sunday Independent*. He posed the question of how much of what ails the Irish property market we can blame on the US sub-prime meltdown and the resulting international credit crunch. He answered it by stating that it was probably a lot less than some people would have us believe and that the housing market here began to turn sour around the middle of 2006, a full year before the global credit crisis erupted in August 2007. With the benefit of hindsight, what is his assessment now of the roles played by the domestic and international factors in regard to Ireland's banking crisis?

Professor Alan Ahearne: The bubble was always going to burst. There was always going to be deep problems in the Irish economy as a result of the domestic bubble. The international factors contributed to the bubble, for example, the inappropriately low interest rates in the economic and monetary union. It intensified the downturn and made it worse because the external environment was so poor. There was a global recession, the worst downturn in the global economy since the Great Depression. All that deepened the downturn here.

Chairman: If international factors were not at play and given the behavioural aspects in Ireland, in terms of weighing up the situation with regard to international and domestic factors, in Professor Ahearne's judgment where does it fall at either side with regard to the behavioural aspects of it? Was it a domestically manufactured crisis or was it an internationally manufactured crisis?

Professor Alan Ahearne: As I said, it was an interaction of both.

Chairman: In terms of weighing them, was it a ratio of 40:50 or 50:50?

Professor Alan Ahearne: If I tried that, it would be a false position and I do not want to do that.

Chairman: In view of the severity of the banking crisis in Ireland and the hard lessons learned by the country, what does Professor Ahearne believe are the main lessons for improving economic surveillance and policy-making by Irish authorities in the coming years? Given that this inquiry is as much about looking to the future as it is about looking back to the past, does he have any thoughts that he would like to share with the inquiry in his closing comments?

Professor Alan Ahearne: It would be only to emphasise the importance of proper financial regulation. The good news is that I think that lesson has been learned. Financial regulation has changed dramatically in Ireland and now it has been moved to Europe. The importance of financial regulation is key.

Chairman: Professor Ahearne would have confidence in the surveillance mechanisms used by those external international agencies.

Professor Alan Ahearne: They, too, have learned lots of lessons. That said, we cannot depend on outsiders. As a country, we have got to have our own institutions and we have got to take care of ourselves. It also underscores the importance of having proper institutions here that guard against these sorts of excesses and imbalances.

Chairman: Much of the testimony of people, like Professor Ahearne, who have examined booms and bust cycles has been that the difference with the next boom is that there will be a material difference compared with the previous one and that is why it is not actually identified. Given the current context of the Irish property market, does Professor Ahearne see any abnormality in it at present that was not spotted in the past that could indicate towards a future crisis?

Professor Alan Ahearne: It is problematic that Dublin house prices are rising so rapidly because it is pricing lots of people out of the housing market. That is the problem. Consistent with the evidence I proffered earlier, one really gets worried about housing booms when they are associated with credit booms. So far we have not seen a credit boom accompanying the recent increase in house prices, but that does not mean that it would not morph into that. It may well morph into that and that is why it was very important for the Central Bank to introduce the loan-to-value rules that it did. That will help to keep people safer.

Chairman: Is Professor Ahearne in agreement with the Governor's position on that?

Professor Alan Ahearne: There were good rules introduced and I think they will protect borrowers from the excesses and the damage that we have seen in the past.

Chairman: Thank you very much, Professor Ahearne. I thank you for your participation before the inquiry today. It has been a very informative and a valuable meeting which has added to our understanding of the factors leading to the banking crisis in Ireland.

The joint committee adjourned at 2.05 p.m. until 5 p.m. on Tuesday, 10 March 2015.