Statement to the Joint Committee of Enquiry into the Banking Crisis

Dan McLaughlin

I was employed by Bank of Ireland in the role of Chief Economist from February 2001 to August 2013. During that time I was based in Global Markets, which was responsible for executing the bank's funding strategy and in providing a service on foreign exchange and interest rates to the customer base. I was in charge of the bank's Economic Research Unit which published analysis and commentary on the Irish and UK economies, and on developments in financial markets. The unit also provided support to other areas of the Bank of Ireland Group, including a written monthly summary of economic and financial developments for the Chief Executive. As Chief Economist I also participated in meetings with rating agencies, counterparty banks, and on occasion debt and equity investors as well as presentations to customers on the economic outlook. I reported to the Head of Global Markets.

I would like to make a number of general points which I feel are relevant to the Banking Crisis before addressing the specific lines of enquiry as directed by the Committee. The first relates to the banking system that operated in Ireland prior to the crash and to highlight that although there were common features shared by most of the banks, the range of the subsequent losses illustrates that banks differed in terms of credit standards, risk appetite, geographical spread of exposure and degree of loan concentration.

Second, banks are mainly staffed by specialists and in light of the fact that the Bank is a publicly traded company, other than information published to the market, everything is done on a 'need to know' basis, which is particularly true in times of crisis

A third point relates to the narrative that has developed around the Banking Crisis, which, given the benefit of hindsight, risks overstating what was known at any point in time. To that end my view is that there were three separate factors contributing to the crisis, each overlapping and exacerbating the other.

The first was the property market. Ireland experienced a property boom which lasted over 10 years and in my view, until around 2005, was mainly driven by fundamental factors, including strong growth in employment, rising household incomes, a move to a lower interest rate regime following euro membership and an extraordinary increase in population (a 615,000 or 17% rise in the decade to 2006). The latter stages of the boom saw an easing of credit standards, according to Central Bank survey data, and my own affordability model pointed to a marked increase in the cost of servicing a new mortgage in 2007, particularly following the monetary tightening initiated by the ECB, which saw the repo rate rise from 2% to a high of 4.25%, reached in July 2008. I initially felt that any correction in the housing market would involve flat or falling real prices (i.e. house prices relative to consumer prices) and not a fall in

nominal prices, although the latter had only happened once in Ireland over the previous 30 years.

It is also worth noting what information was available at various points in time, particularly that known in September 2008. The CSO's Residential Property Price index incorporates data back to 2005 but was first published in May 2011. Prior to that there were two main sources of information on house prices, the PermanentTSB /ESRI index (based on lending data from that mortgage provider) and a quarterly release from the Department of the Environment, which included average (mean) prices, based on mortgage data from most of the active lenders. The former showed a 5% fall in national house prices in the first half of 2008 (published in mid-August) and an annual decline of 9.7%, while the latter showed a 2.8% fall in the half-year to June and an annual decline of 7.8%. In contrast, residential rents, as recorded in the Consumer Price index, were still rising, increasing by an annual 5% in the second quarter of 2008.The economy at large had started to contract in the first half of 2008, albeit modestly; the initial GDP readings showed a 0.2% quarterly fall in q1 and a 0.5% decline in q2, while the Quarterly National Household Survey, published in August 2008, showed an unemployment rate in the second quarter of 5.1%, from 4.8%. Employment had fallen in the quarter but was still higher compared with the previous year.

The Irish economy is very open and hence heavily influenced by the international economic cycle, although from 1970 onwards the Irish economy had contracted in GDP terms in only one year (1982). The consensus view in mid-2008, which I shared, was that any US recession would be as short lived as had been the case in the previous two, in 1990-91 and 2001 (both lasted 8 months). That did not prove to be the case and I believe that the unprecedented collapse of the global credit markets which followed the Lehman bankruptcy in September 2008 was the second and decisive negative which hit the Irish economy and banking sector. The Chairman of the Federal Reserve, Alan Greenspan, called it a '*1 in 100 year event'.* We will never know how steep the Irish property correction would have been in the absence of that collapse.

The impact of the credit crunch was certainly extreme, both internationally and in Ireland; the S&P equity index fell by over 50%, GDP in the developed economies experienced its largest post-war contraction and Irish GDP, having risen by 1.2% in the third quarter, contracted by an extraordinary 7.1% in the final three months of the year, which was over half the total decline recorded in the recession. Commercial property prices also tumbled, with record falls recorded in many countries (UK prices fell by 26% in 2008 according to the IPD index) while the plunge in Irish values was also unprecedented; capital vales had fallen by 10% in the first half of the year, according to IPD, before falling by 15% in the third quarter, another 18% in q4 and a further 18% in the first half of 2009. Few if any envisaged the effective collapse of the global credit system and the unprecedented scale of the policy response, including massive State support for banks across many developed economies, zero and even negative interest rates, the printing of money on a massive scale by the major central banks in order to purchase government bonds

DML01B01

DML00001-002

and new capital and liquidity rules for the global banking system is also testimony to the singular degree of financial disruption that emerged post-Lehman, with the ramifications still being felt, notably in the euro area.

A third factor emerged in 2010, related to sovereign debt, which by 2012 had developed into an existential crisis for the euro. State support for the banking sector, initially seen as positive, was now perceived as adding stress to already high sovereign debt levels and the subsequent fall in government bond prices added to bank losses, given their holdings of government debt. In that context it is interesting that a number of official reports into the Banking Crisis in Ireland were commissioned in 2010, presumably on the view the worst was over, but ECB lending to Irish headquartered banks was higher in early 2011 than in 2008 and ELA support also peaked in 2011. New regulatory capital requirements also resulted in widespread bank deleveraging, so adding to further downward pressure on asset property markets - by 2012 the Central Bank's housing models (as published in *Economic Letters ,No 5, 2012. Central Bank of Ireland)* showed that Irish residential prices were now as much as 26% below fundamental value. It is also worth noting that the Central Bank's Prudential Capital Assessment Review (PCAR), which in March 2011 identified a large capital shortfall in the main Irish banks, substantially overestimated their projected pre-impairment profitability. In the event the requirement to offload assets and to increase deposits put significant pressure on net interest margins. The scale and extent of private sector deleveraging in Ireland, which is still apparent, also resulted in a larger fall in bank assets than envisaged in the PCAR.

I will now turn to the specific lines of enquiry outlined by the Committee.

Appropriateness of property related strategies and risk appetite

Bank of Ireland's strategy was set by the Board, generally based on a five-year horizon which in turn was informed by the consensus view on likely economic developments in Ireland, the UK and the US, the countries that the bank was mainly exposed to in credit terms. The bank had traditionally been one of the main mortgage lenders in Ireland and also had a sizeable mortgage book in the UK (indeed slightly larger in euro terms) with residential mortgages in total accounting for around 45% of the loan book in March 2008. Some 25% of the loan book was in property and construction at that time, with again less than half of that in Ireland. Information on the bank's assets was published in the half-year results and Annual Reports and I do not recall being asked for any opinion on the bank's asset mix, although having regard to the information available at the time I certainly did not envisage the scale of the credit crunch and subsequent fall in commercial and residential values, nor the speed at which employment fell in Ireland.

Analysis of Risk Concentration in the base, the adverse economic scenarios and the impact on capital structure

The Central Bank set a number of stress tests in which they designated the economic variables to use. Bank of Ireland itself undertook internal stress tests and I was involved in estimating consistent relationships between the macro-economic variables used e.g. what would the likely impact be on unemployment and house prices for a given fall in GDP. That macro data was used by the bank to model the impact on credit growth and impairments although the results were clearly sensitive and therefore not widely disclosed or discussed and I never saw the final outcomes. Ireland had not experienced a substantial fall in nominal house prices, nor in GDP, so prior to 2008 it would not have been deemed plausible, in any adverse scenario, to factor in a 50% fall in house prices, a 67% fall in commercial property and a 12% contraction in GDP, all of which materialized, given the past data available. Also in previous cycles rapid monetary easing had stabilized the major economies and precipitated a recovery, and that experience also informed risk modelling. If a large retail bank in Ireland had identified a serious risk to its Irish asset book and decided to significantly reduce its exposure to the Irish economy, such a move would have had a materially negative impact on economic activity in Ireland.

Role of Advisors in analyzing the crisis and crisis management

The Bank of Ireland's Economic Research Unit (ERU), which I headed, produced regular commentary on financial markets and on a quarterly basis an economic '*Outlook',* incorporating an analysis of developments in the Irish economy. In addition, a quarterly review of the Irish property market was published by the ERU, based on publicly available information on the housing market, with some coverage of commercial property market returns. Apart from that research, I provided an opinion when requested on economic issues. For example, following the US recession in 2001 and the significant slowdown in the Irish economy in the same year there were a variety of views as to the economic outlook. I expressed my view, by request, to the bank's Board that the Irish economy would recover, with growth of around 5% likely in the medium term (growth actually averaged 4.9% between 2002 and 2007). As noted, I did not envisage the scale of the 2008-9 recession, either domestically or globally, as I anticipated that a prompt policy response would lead to the type of recovery witnessed in the two previous global slowdowns, and a quick return to trend growth in the Irish economy. The quarterly '*Outlook*' publication meant that my views on the economy were in the public domain. I am not aware of the extent to which Bank of Ireland sought external advice during the crisis. While I did not have visibility on all of the crisis actions being taken by the Bank, based on my

DML01B01

DML00001-004

experience, the key imperative from mid-2008 onwards was seen as the need to preserve liquidity, and to that end Global Markets was involved in seeking to secure funding via corporate deposits and the issuance of securities to debt investors. To that degree the crisis management, on which I had visibility, was largely focused on the liability side of the balance sheet.

The Liquidity versus Solvency debate

As noted above, few if any in the summer of 2008 envisaged the collapse of the global credit system (indeed the ECB was still raising interest rates) and there was a widespread belief that the main central banks had now enough knowledge and experience to limit the damage wrought by an economic downturn, in terms of duration and severity. That much is certainly clear from forecasts published in 2008 from a range of agencies, including the IMF and the ESRI. I shared that view. That proved wrong. It is also interesting to note that one of the published options put forward by Merrill Lynch was that AIB and/or Bank of Ireland should take over Anglo Irish Bank and INBS, hardly plausible if a systemic solvency issue had been envisaged.

Appropriateness of the macro and prudential policy

Ireland's membership of the euro means that fiscal policy is the only macro policy lever open to the Authorities, although Irish Finance Ministers have never discussed or indeed even mentioned the policy stance to this day when delivering the annual Budget. Economists generally advocate counter-cyclical fiscal policy and Ireland is often accused of running pro-cyclical policy although, as is often the case, events are clearer in hindsight. The policy stance often looks different ex-post, for example, compared to the ex-ante position, given the margin of forecast error inherent in an economy as open as that of Ireland. Fiscal policy also operates within a specific social and cultural backdrop and electorates in general do not reward governments for raising taxes and/or cutting spending; a glance at the manifestos of the main political parties contesting the 2007 election confirms that none envisaged anything other than tax cuts and increased exchequer spending. It is also worth noting that Ireland ran a General Government surplus from 2003 to 2007.

At the micro-level, on the other hand, the strength of construction spending implies little evidence of market failure in the housing market (the general test as to whether State intervention is warranted) and so there was little economic justification for the fiscal incentives given to the property sector.

As for prudential policies I can add little to that that is already in the public domain, other than to observe that it is now widely perceived that the degree of bank regulation and surveillance

was inadequate across many jurisdictions, with banks internationally now required to hold far more capital, particularly equity capital, and to observe liquidity ratios. Interest rates were also set exclusively to hit an inflation target by the major Central banks, with little emphasis on containing possible asset price bubbles, again a deficiency which is now being addressed via macro-prudential controls. In Ireland's case the balance between encouraging competition and regulation was also probably wrong, with too much emphasis on the former at the expense of the latter, and perhaps it was misconceived to charge one agency with both tasks.

Adequacy of the Assessment and Communication of both solvency and liquidity risk in the banking sector

The Central Bank and Financial Services Authority produced an annual Financial Stability report which was the main public forum in which issues related to systemic risks in the banking sector were addressed. In general the later Reports identified concerns in relation to credit growth, house prices and household debt and so welcomed the signs of a slowdown in the housing market which appeared in 2007. Apart from these concerns, the Reports generally appear to share the consensus view of the time and never envisaged that the correction would turn in to a collapse, with the accompanying implications for bank solvency, nor the risk that the interbank market would close down as it did, so precipitating the liquidity crisis.

Appropriateness of expert advice sought

I had no contact with the Regulator or the Government in terms of policy advice and am not aware of the source of any advice they sought, other than that now in the public domain. I was not involved in any discussions on the Guarantee. Apart from the latter a key decision was the one to set up NAMA in 2009 and it is of note that such a model has the disadvantage of crystallising losses for the banking system, in this case over €42bn. Asset values tend to ultimately recover, as is evident from the results of the sales of assets by NAMA and, indeed, by the Special Liquidator of IBRC.

Analysis and response to contrarian views.

The consensus tends to be right more often than not and all the contrarian views that proved to be wrong are forgotten. Who now remembers those predicting oil at €200 a barrel in 2007 or that Ireland would be unable to borrow in the absence of a debt default? There is a huge

volume of research on the Irish economy published in any given month, as well as a plethora of newspaper articles, and so at the time the issue is which is the more plausible given the known facts. Events can prove some views right and some wrong but that is with the benefit of hindsight. Post crisis, there is now probably a greater willingness to believe that shocks deemed to have a very low probability can indeed occur ('fat-tail risk'). Yet events are still the main arbiter of competing views.

Dan McLaughlin

9 April 2015