Statement to the Oireachtas Committee of Inquiry into the Banking Crisis in Ireland

Mr. John Beggs

7 May 2015

Mr. Chairman, Members of the Joint Committee.

You directed me to give evidence on eight lines of inquiry relating to my role as "Chief Economist of Allied Irish Banks Plc." These come under a number of themes in three areas (i) Banking, (ii) Regulatory, Supervisory & Government and (iii) Crisis Management System & Policy Response.

Statement on Role in AIB

I have explained to the Committee that my role in AIB was that of Chief Economist Global Treasury from 1992 to 2011. I was promoted to the role of Chief Economist AIB in a restructured bank in late 2011, a position I held until my retirement in July 2012 (9 months). I was not, therefore, the Chief Economist of Allied Irish Banks Plc. in the period leading up to the banking crisis.

My actual role over my entire career in AIB was primarily focused on advice around propriety trading within Wholesale Treasury and supporting Corporate & Commercial Treasury in relation to general economic issues, but primarily around the outlook for interest rates and exchange rates. My unit, the Economic Research Unit (ERU), was located within Wholesale Treasury in the Capital Markets Division. The AIB Group's significant property related Irish exposures were in the Retail Ireland Division. Risk management, capital management and relations with the supervisory authorities were handled at Group Division level.

Though a function of Global Treasury, my unit, made up of four economists, was a limited resource available to other business units across the AIB Group. In this regard, my unit did provide occasional services to other parts of the Group, at their request. One area of support was in relation to stress testing.

In giving evidence before this Committee on the lines of inquiry indicated to me, I believe, therefore, it is important to clarify that I did not occupy a central Group management position in AIB or a management role in the lending strategy of the Retail Division. As a result, I intend providing the Committee with the fullest evidence from my perspective as Chief Economist Global Treasury.

This clarification of my role leads me on to a wider point about the structure of the AIB Group. From my perspective, there were limitations on Group-wide participation and decision-making in AIB arising from the divisional structure and the hierarchical nature of the organisation. The problems relating to AIB's structure were referred to in the Nyberg Report (Page 29, paragraph 2.5.16) particularly in relation to the appropriate divisional risk management of large property loans. Nyberg also acknowledged (page 97, para. 5.5.7) that silos created serious limitations on performance: *"There appears to have*

been little appetite or opportunity for looking at "the bigger picture" since, as related earlier, each part of that picture was "owned" by different authorities or, within the banks, by specific departments." This captured AIB very well in my view.

(i) Banking

Theme: Effectiveness of bank's credit strategies and risk management

Banks' risk appetite and the appropriateness of their property related credit policies.

The Committee asked me to give evidence on banks' risk appetite and the appropriateness of their property related credit policies. Most of my comments relate to the banking system as a whole.

A general description of a bank's risk appetite is the level and type of risk it is prepared to take within its overall risk capacity consistent with its business strategy and objectives. I have no specific knowledge as to how AIB Group's risk appetite and strategy and overall credit policy were determined in practice but, for instance, the AIB Annual Report 2007 sets out the framework within which it was determined at that time.[1]

Chart 9 (page 32) of the Regling & Watson report shows the property concentration of AIB and of other banks at the end of 2006 or early 2007. The report clearly regards these concentration risks as making the banking system particularly vulnerable. It showed AIB's construction and property loans (excluding residential mortgages) at over 30% of total loans. AIB reported the figure at 33% in its 2006 results presentation.[2] Reconciling the intent of the AIB risk appetite statement with the perceived concentration risks in property related lending as outlined by Regling & Watson and other public reports is only possible, in my opinion, on the basis that AIB believed that its business was well diversified geographicallyand sectorally, well managed, of good quality and low risk based on its customer profile and knowledge of its customers' financial standing.

Geographically in 2006, according to the Investor Relations Presentation of the 2006 results on AIB's website, 57% of AIB Group's property and construction loans were in the Republic of Ireland, 9% in Northern Ireland, 27% in the UK and 7% elsewhere. In relation to property loans in the Republic of Ireland, the Bank saw its portfolio as well diversified with commercial investment (35%), residential investment (8%), commercial development (20%), residential development (33%) and other (4%). AIB also believed that it had a more restrictive policy towards residential mortgages.

It is likely that banks focused primarily on what they perceived to be the quality of their individual loans books with less consideration of the potential systemic risks in the Irish banking system as a whole and the contagion risks should serious problems emerge in an important bank, particularly given their dependence on foreign funding.

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[1] AIB Annual Report 2007, page 32
[2] AIB Preliminary Results 2006, Investor Relations presentation

Furthermore, the main commercial banks had very large customer bases with a large share of current accounts and deposits. This gave them a sense of comfort about their customers' creditworthiness.

As to the appropriateness of property related credit policies, there was clearly a long period when banks' lending policies, including property related loans, were important to the growth of the Irish economy. To a large extent, the sustained growth in the Irish economy in terms of real GDP and employment meant that the assets of the banking system became increasingly tied up in bricks and mortar in one form or another. As banks are the main source of finance for the Irish private sector, there is a high correlation between the growth in credit and GDP/GNP.

The appropriateness of Irish bank lending policies cannot be diverced from the stance of fiscal policy, other macroeconomic policies and the stance of monetary and macroprudential policy. Strong growth in bank lending occurred against a very procyclical and expansionary fiscal policy which provided misguided support to bank lending policies. Monetary conditions were also relatively favourable. Banks, on the other hand, as documented by the Nyberg report, were engaged in high-growth strategies involving a significant expansion of credit.

In the context in which this question is raised by the Committee, however, I want to focus on some key data in the years leading up to the peak in lending in 2008. I intend discussing the issue of appropriateness in terms of annual changes in bank lending, its cumulative growth, its concentration and how key ratios were impacted by the expansion. All of this information is publicly available and most of it relates to the aggregate returns from commercial banks to the CBFSAI.

Research shows that while the decade of the 1990s was primarily driven by exports, the expansion of credit was also a key contributory factor[3]. Strong employment growth and a rise in the population led to a large increase in house building. Furthermore, the ratio of Irish private debt to GDP was well within the range of other countries. The underlying ratio was about 65% in the early 1990s. It increased to over 72% by 1998. This level of debt was not out of line with other countries (Kelly 2004).

Beyond the period after entry into EMU, in my opinion, developments prior to around 2002/2003 could be characterised as still within acceptable ranges for key ratios, though credit had risen by over 50% between 2000 and 2003. A period of slower growth was warranted thereafter as the growth in total lending carried increasing levels of risk as property price inflation and investment in construction headed for unsustainable levels based on international standards.

Data on the growth in bank advances, the increased share of property related assets in those advances and the growing funding gap resulting from the faster growth in credit relative to domestic resources have been documented in several public reports (Nyberg,

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[3] John Kelly "Benchmarking Irish Private-Sector Credit", Irish Central Bank Quarterly Bulletin, Spring 2004.

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Honohan, Regling &Watson). I want to highlight the following (all data from CBFSAI and CSO):

- Over the decade from 1998 to 2008, Irish private sector credit (personal and business related) increased by 493% or by 19.5% per annum. Excluding lending to IFSC companies, the cumulative underlying increase was 528% (over 20% per annum). As a result, underlying private sector credit rose from 72% of GDP in 1998 to 195% in 2008.
- In the three year period from 2005 to 2007, total underlying credit rose by 89%. This equates to an annual average increase of almost 24%. Total underlying credit rose another 6.5% in 2008, representing a peak in the expansion of overall lending. Such rapid growth in this three year period, after such a prolonged period of credit expansion stretching back to the 1990s, was surprising. As a result, outstanding levels of credit rose by another €160bn while Irish resident deposits increased by €43bn over the same three year period. This placed a further large burden of reliance on external sources of financing. The ratio of underlying credit to underlying resident deposits in the banking system rose from 197% in 2004 to 253% in 2007. It increased further to 273% in 2008.
- Within total underlying lending, personal lending rose by over 550% in the decade to 2008 (over 20.5% per annum). Its share of total lending rose from 46% in 1998 to a peak of 53% in 2004 before falling back to 48.5% in 2008.
- The personal debt ratio (the ratio of personal lending to personal disposable income) increased from 64% in 1998 to to a peak of almost 185% in 2007. In the three years, 2005 to 2007, personal lending rose by over €72bn., mortgage lending accounting for €63bn of this expansion. This equated to a cumulative rise of over 75%. Of course, this occurred in a period when cumulative house completions totalled over 250,000.
- In terms of overall lending to the construction, real estate and mortgage market, data indicate that this broad sector's share of total lending rose from 43% in 1998 to a peak of over 67% in 2007. In the three years to 2007, lending in this overall category rose from under €108bn in 2004 to almost €229bn in 2007. Excluding residential mortgages, the share of the remainder increased rapidly from under 8% in 1998 to a peak of about 26% in 2007. Property lending, excluding mortgages, increased from about €8bn in 2000 to €30bn in 2004 and to €88bn in 2007.

One of the main consequences of this expansion in total property lending was the oversized level of output and employment in the construction sector. This was unsustainable over a medium term horizon. Housing output peaked at over 93,000 units in 2006 which was close to double any reasonable estimate of short to medium term demand. A contraction on this scale back to more fundamental levels, however gradual, was likely to negatively affect the growth in real GDP by 5-6 percentage points. In the event, the decline in housing output was even greater, falling to lows of about 8,500 per annum by 2012.

Growth in credit on the scale that occurred in the 2005-2007 period, coming on top of a prolonged expansion in the 1990s and early years of the 2000s carried potentially serious risks for the economy and the banking system, particularly in terms of overvalued properties and high debt burdens, in a low interest rate climate. The banking system was

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supplying credit to both developers and investors on the one hand and making it possible for borrowers to purchase ever more expensive residential properties on the other. The commercial property sector was dependent on the overall health of the Irish economy.

Analysis of risk concentration in the base case, under different economic scenarios and the impact on capital structure

As regards the analysis of risk concentration in the base case, under different economic scenarios and the impact on capital structure, I have already referred to the growing property related concentration in banks' lending structures. I have also provided the Committee with evidence in relation to stress testing in AIB in relation to testimony provided by another witness.

Stress testing became a much more important part of banks' risk management framework over the past decade. The process usually involved assessing the impact on capital adequacy based on either a mild or severe economic recession over a one year or a three to five year horizon. Over the years, the test moved from considering credit and market risk to a wider consideration of credit, concentration, market, liquidity and all other material risks.

The Stress Testing Steering Group (STSG) carried out stress testing in AIB, which was part of the central Group Risk management framework. The architecture of the AIB risk management framework, which culminates in the authority of the AIB Board, has been outlined in the Group's Annual Reports.[4]

My task was to present an overview of the economic scenarios to the Stress Testing Steering Group (STSG) based on the initial economic data provided by the regulatory authority in either Ireland or the UK. The aim was to provide Group and divisional risk management, finance and credit units with the fullest possible understanding of the transition from the base case to the adverse scenarios.

The actual calculation of the effects of the adverse economic scenarios on the bank's capital measures was undertaken by analysts within the Group and divisional risk and credit units, with the support of the STSG.

Based on statistical analysis and the development of ad hoc models, divisional analysts used a number of economic variables to calculate the effect of adverse conditions on the grade migration of credits. As conditions deteriorate, some migrate to default status.

When it comes to concentration risk, there were additional studies carried out to examine the correlation between sectors particularly in relation to property. Adjustments were made to the impact on credit provisions to take account of this factor. I cannot tell the Committee how significant these adjustments were but it did form part of relevant exercises.

My experience of dealing with the Stress Testing Steering Group was that the stress tests

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[4] See pages 31-36 of the AIB Group Annual Report and Accounts, 2007 for a presentation of the Group risk management framework.

were carried out in a very professional manner, with full commitment on the part of the STSG and the other units within the Group responsible for assessing the impact of the shock economic scenarios on the Group's capital and other key metrics. The Executive Risk Committee (and from 2011, the Board Risk Committee) examined the output of these stress tests before sign off at AIB Board level. I was never involved in any discussions that took place once the STSG had signed off on the report.

(ii) Regulatory, Supervisory & Government

Theme: Effectiveness of the regulatory, supervisory and governmental regime structure

Appropriateness of the macro economic and prudential policy

This issue has been covered by many reports with a broad consensus that fiscal policy was expansionary and procyclical, micro prudential supervision was too deferential to financial institutions, the FR encountered breaches of policy without taking effective action and failed to foresee the potential liquidity and solvency risks inherent in banks' lending and funding policies. Macro prudential policy was focused on stress testing and the FSR process, which was benign in terms of exerting a moderating influence on the banking system. Changes in accounting policies from 2005, particularly pro-cyclical IFRS rules limited the information value of banks' financial statements but injected a further pro-growth bias into banks' positions in favourable economic conditions.

It is generally agreed that though external circumstances from mid-2007 significantly worsened the chances of avoiding a domestic crash in both banking and in the economy, some measures could have been taken to limit the devastating impact on the Irish economy and society. Clearly, interest rate policy was not an option, but other direct measures were available to the authorities. In the context of unchecked credit expansion, fiscal policy should have been more conservative and monetary instruments should have been employed to act as a break on property related credit expansion.

Many domestic and external commentators have criticised the overall stance of fiscal policy as being too expansionary over the period since the mid-1990s. The stimulatory impulses from successive budgets since the mid 1990s have been well documented. Taken over a period since the mid-1990s, however, the population grew by almost 15% in the decade from 1995. This required increased public spending. Necessary public spending measures should have been accompanied by caution in other areas.

Personal tax reductions and tax breaks relating to the property market certainly fuelled the demand for housing and non-residential investment, which, in turn, facilitated rapid credit expansion by financial institutions. On the other hand, the decision to join the euro placed greater emphasis on the role of fiscal policy and other macroeconomic policies to ensure balanced and sustainable non-inflationary growth in the Irish economy.

However, fiscal policy created problems for the private sector in terms of competitiveness with the introduction of benchmarking in the public service, funded by growing tax revenues from the property market. The introduction of SSIAs was another very costly measure which, on the eve of their maturity in mid-2006, amounting to an estimated €14 billion of disposable income potentially coming into the housing market over the following twelve months.

I would also highlight the decision by the Irish government to allow citizens from the 10 countries that joined the EU in May 2004 to work in Ireland immediately. This increased the size of the Irish labour force and employment over the period to end 2005 and added to the demand for housing in Ireland. Increased inward migration increased the demand for housing by up to 18,000 units per annum in the 2002 -2006 period compared with an estimated 13,500 units in the previous intercensal period 1996-2002.

Theme: Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector

In relation to this and the remaining lines of inquiry on which I have been asked to give evidence I must point out that I had very little involvement with the Department of Finance or the CBFSAI in my career in AIB.

As regards fiscal policy, the report of the Independent Review Panel on Strengthening the Capacity of the Department of Finance acknowledged that officials in the Department had cautioned internally to the Minister against expansionary fiscal policies at times when a more neutral or restrictive policy was more appropriate. However, government did not always heed this advice.

The budgetary process takes up a great amount of time and remains too focused on an annual adjustment of revenue and spending. Medium to longer term considerations remain secondary in the implementation of fiscal policy. Wider macroeconomic policy issues, in which fiscal policy plays a role, did not feature in communications from the Department of Finance in the period leading up to the crisis. Reports such as the economic and fiscal policy reports that are published as part of the annual budget are primarily intended to support the decisions and underlying forecasts in the Minister's statement and not to challenge or assess risks and uncertainties in the economy.

In the area of the monetary authorities, the Honohan Report outlined a number of areas where supervisory practice was weak and deferential towards the banking system. In my opinion, banks are systemically important and should have been subjected to much stricter regulation.

The prudential practice covered both micro and macro policy. Based on the findings of the Honohan Report on the micro prudential front there are no indications that the

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supervisory authorities were concerned to the point of being prepared to take effective action. A number of breaches of policy were outlined in the report but the issues seem not to have been resolved. Micro prudential assessment of the banking system, such as it was, did not raise any concerns about liquidity or solvency issues.

On the macro prudential side, stress tests were carried out and many aspects of the sector were examined in research reports. Stress tests were not sufficiently severe to test the banks' own assessment or sense of comfort of their capital position.

The CB also published an annual Financial Stability Report (FSR) in the years 2004 to 2007. These reports, destined for public consumption, contained plenty of analysis but apparently failed to trigger a more cautious approach within the banking system.

It would appear that in the period prior to the crisis in mid 2007 there was no major assessment or internal communication to the banking system about key liquidity or solvency risks. The CB did impost some additional capital requirements on banks in respect of 100% LTV mortgages, but this measure had little impact.

An important area worth noting is that several research papers produced within the CBFSAI and research produced by the ESRI, the IMF and the OECD, consistently came to the conclusion (however tentative at times) that Irish house prices were overvalued – often by significant amounts. I believe that the consistency of this conclusion, in addition to the possibility that the message was muted occasionally to prevent a setback in prices, should have convinced the supervisory authorities to investigate the implications of this more rigorously with the financial institutions.

A key ingredient missing from this period was a process of challenge to the prevailing view, primarily the chances of a soft landing. This should have occurred within individual banks and between the CB/FR and the banks as a whole. Roundtable meetings between the authorities and the banks on financial stability were low-key affairs. I believe that I attended two meetings.

Theme: Appropriateness and effective utilisation of the expert advice

Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used

It is impossible to know the extent of advice the Regulatory, Supervisory and Government sector commissioned before and after the banking and economic crisis. However, there are a number of international organisations that interface with all three official bodies as well as the banking sector and other parts of the private sector. These include the OECD, IMF, EU Commission and the ECB. There were also the rating agencies.

The Report of the Independent review Panel on Strengthening the Capacity of the Department of Finance (Appendix 6) outlined a summary of international reports on the Irish economy. These related to regular country reports from the EC, IMF and the OECD. These summaries show that there were occasional references to risks in Ireland but the economy was considered to be in good shape.

I want to focus on a number of research papers from the OECD and the IMF which provided wide ranging analysis of housing market developments in Ireland and in other countries and were an important external source of analysis for domestic economic and monetary policy consideration in Ireland.

1. The IMF in its 2003 staff report on Ireland acknowledged that the potential for economic fundamentals to justify the rise in Irish house prices could be justified "*qualitatively*" but it was difficult to assess "*quantitatively*" the degree to which fundamentals justified Ireland's housing boom. The IMF believed that Irish house prices were indeed significantly overvalued. The IMF returned to this subject in its 2004 consultations noting that studies focused on demand side factors put the degree of overvaluation in a range 16-50%. It also quoted a study in the Economist (2003) which concluded that Irish house prices were overvalued by over 40%. However, the IMF conceded that when supply side factors were included in the model, the degree of overvaluation "declined dramatically".

2. Research working papers published by the OECD in 2006 highlighted the international backdrop to the rise in Irish house prices. A working paper (no. 492, June 2006) Ireland's Housing Boom – What has driven it and have prices overshot? - began by noting that house prices across the industrialised world had surged since the mid-1990s. The authors of the report concluded that:

   "most of the increase in Irish house prices is justified by the economic and demographic driving forces. It should be remembered that in 1993 the average Irish house cost a mere € 75, 000, which was extraordinarily low for a European country. Since then, remarkable growth in incomes, low interest rates, strong population growth, especially among the younger house-forming age groups, a surge in immigration and changing living patterns have all contributed to the boom. However, prices have probably over-shot to some extent, and taxation may have contributed to fuelling the speculative boom. Looking ahead, the most likely scenario is that prices stabilise and the housing market stays flat for some years. But there is some risk that house prices will fall, and the market is certainly exposed should the economy be hit by a negative shock."

There were other housing market studies published by the OECD in 2006 looking at how close house prices were to their peak in a number of countries and examining housing markets and adjustments in a monetary union. These studies highlighted a number of issues for Ireland particularly, despite the undisputable fundamental drivers of housing demand, Irish property prices were high by international standards and probably overvalued by as early as 2003. This required careful consideration by the authorities and also by financial institutions.

Analysis and consideration of the response to contrarian views (internal and external)

With possibly one or two exceptions, what have been described as contrarian views about the risks to the property market and to the banking system came to public attention in late 2006 and into 2007 (Kelly, RTE *Future Shock*). Overall, reaction was quite negative to these reports. Honohan (2010, page 84, para.6.17) refers to the negative reaction within the FR to the Kelly analysis.

Given that many other studies over previous years had alluded to the risk of declines in Irish property prices, the negative reaction to these 'contrarian' reports may have appeared surprising. However, by late 2006 and into 2007, prior to the start of the subprime crisis, there were clear signs that the Irish market had peaked. Furthermore, some of these 'contrarian' reports were also discussing the potential risks for the banking system, citing similarities with the crash in Sweden and elsewhere.

However, prior to the publication of these reports, data on the Irish housing market had turned decidedly negative signaling that the boom in output was running out of road:

- By 2005, the ratio of average house prices to personal disposable income had reached 10:1. This was expected to rise to 11:1 by 2006.
- Affordability was deteriorating. There had been a significant shift from 20 year to 30-35 year mortgages in order to reduce monthly costs but, even on this basis, affordability was heading to its worst level in 10 years.
- Interest rates were on the rise. This coupled with rising house prices at a faster rate than incomes, meant that fewer applicants would meet the loan criteria to obtain a mortgage.
- Investors were increasingly concerned by higher interest rates and declining rental yields.
- Employment growth had leveled off.
- The annual growth in house prices had initially slowed in the course of 2005, but reaccelerated in the last quarter and into 2006 as month-on-month price changes moved in a sustained 0.8-1.2% range in the year to mid 2006. These increases so late in the boom were a serious threat to any prospect of stabilising the market.

(iii) Crisis Management System & Policy Response

Theme: Role and effectiveness of the policy appraisal regime before and during the crisis

Role of advisors in analysing the crisis (to include crisis management options)

I'm interpreting this to refer both the combined Irish supervisory bodies (including government) and within the banking system itself. One could also include research bodies

such as the ESRI. There was also a wide range of external organisations offering regular advice to Ireland.

Against the backdrop of so much data and analysis, it would be difficult to argue that there was not a build up of interrelated risks and uncertainties in the Irish economy and banking system. After all, notwithstanding the belief in our economic fundamentals going back to the 1990s, the build up to the Irish banking crisis had previously occurred in varying degrees and circumstances in other advanced countries.

There has been some discussion internationally whether central banks should intervene to prick property price bubbles. However, in the Irish case, after an extended period of expansion in property prices and credit growth since the 1990s, the speed of expansion in the 2003-2007 period proved excessive.

All of the reports published to date on the Irish economic and banking crisis highlight how both externally and internally (with due respect to a few contrarians) nobody saw it coming until it was too late to act.

From the onset of the subprime crisis in mid 2007, there was a greater sense of urgency among the supervisory authorities (Honohan, Chapter 5). However, this was against a background where serious liquidity and solvency risks were not suspected. I had no involvement in any discussions between AIB and the CB in relation to liquidity management during the crisis.

The liquidity versus solvency debate

In the case of the Irish banking system, from my perspective, the issues of liquidity and solvency were less a case of one versus the other but more a case of one following the other. While liquidity became the more immediate concern for Irish banks in 2007, the question of solvency was, with the benefit of hindsight, bubbling under the surface, particularly as Irish property prices were falling.

As noted in the Honohan Report (2010)(Box 8.1, page 121), the determination whether a bank was indeed solvent should not rely exclusively on the assessment by the troubled bank. The regulator had a key role in assembling the key information and analysis to determine a more accurate picture.

However, as noted by Honohan (2010)(para 8.15, page 118-119)
"It should be emphasised that because of the information gap discussed in previous chapters which acted as a blinker, at no point in the period was it thought by the authorities that any of the banks were facing imminent underlying solvency risks. This had the consequences that no attempt was made to urge the banks to raise – or even conserve – capital."

In 2007, the immediate headline problem for Irish banks was the growing funding issue in global financial markets. From the start of the subprime crisis in mid 2007 there was a significant change in the funding landscape. From an Irish perspective, where we were heavily dependent on external funding to cover a large property related portfolio, the

initial causes of the global crisis – the collapse in the US housing market and the impact on financial institutions specialising in buying and repackaging US mortgage loans - put all banks with large property concentrations under the spotlight. The collapse of Northern Rock in late 2007 brought the attention much closer to home.

The disruption to funding in international markets from mid 2007 onwards continued in waves throughout 2008 culminating in a virtual freeze with the collapse of Lehman Brothers in September 2008. Appendix 3 of the Nyberg report contains a banking crisis timeline. My recollection is that many of the events set out in the timeline had significant negative effects on liquidity as counterparty risk intensified. Furthermore, each event had a more damaging impact than the preceding one.

All the documents referred to in this statement are true and accurate and in the public domain.

John Beggs
9 April 2015