JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

WITNESS STATEMENT PURSUANT TO SECTION 67(1) OF
THE HOUSES OF THE OIREACHTAS (INQUIRIES, PRIVILIGES AND PROCEDURES) ACT 2013

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Secretary General

Department of Finance

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Introduction

The Direction to me relates to my role as Secretary General in the Department of Finance and all other relevant roles. It should be noted that I was appointed to the role of Secretary General on 14 July 2014.

From July 2003 to that date I was an Assistant Secretary in the Department. My responsibilities in that period were

- Assistant Secretary for the *Budget & Economic Division* from July, 2003 to December 2006
- Assistant Secretary for *Tax Policy Division* from December 2006 to July 2014
- Assistant Secretary for Budget (combined with Tax Division as *Fiscal Policy Division*) and *Human Resources* from 2012 to July 2014

In the period 1989-1999 I worked mainly on tax and expenditure issues (Administrative officer) and the Budget (Assistant Principal). In the period 2000 to June 2003 I worked outside the main Department and in the Department of Health. For a large majority of my career my work has focused mainly on fiscal policy and while I did not seek any reduction in the lines of inquiry addressed to me my statement provides responses from my experience and knowledge in those areas and where I have no direct knowledge on an issue I will say so.

R2b Nature and effectiveness of the operational implementation of the marco economic and prudential policy. **R3a** Awareness and clarity of roles and accountability amongst the regulatory and supervisory institutions of the State

The two main macroeconomic policy tools are monetary policy and fiscal policy. In terms of the different roles and accountabilities the former is the responsibility of the Central Bank/ECB, the latter for Department of Finance/Government.

The Central Bank is responsible for monetary, macro-prudential policy and financial stability. The Central Bank is independent in law in monetary and regulatory matters. It inputs annually into the consideration of fiscal policy via the "Governors letter". The annual letter from the Governor to the Minister for Finance on budgetary matters in the run up to the crisis did not suggest the Governor had concerns about financial stability. The Nyberg report notes that in the period 2003-2008 the letters *"did not provide any indication as to the likelihood of such a slowdown [housing] nor mention possible associated threats financial stability"*[1] although it did mention increased credit channelled to the

[1] Misjudging Risk: Causes of the Systematic Banking Crisis in Ireland – March 2011 (page 73)

sector in 2005 and 2006. IMF regulatory reviews and the OECD also suggested the Bank was managing its job appropriately. For example, the OECD noted in 2006[2] that stress testing by the Central bank suggests the banking system had adequate capacity to absorb a modest fall in construction and prices and in 2008 that the CBFSAI had identified vulnerabilities and had taken appropriate action to mitigate them[3].

The Department is responsible for advising on fiscal policy. Prior to 2008 the assessment of fiscal policy by the EU under the terms of the Stability and Growth Pact suggested that budgets were broadly consistent with the then terms of the pact i.e. that they were effectively prudent. The Department had concerns with the tools used by the Commission for measuring the cyclical stance of the budget, seeing them as inadequate. The core of that concern was that a "one size fits all" approach to modelling the cycle adopted by the Commission for all member states did not work, given the diversity of the countries to which it applied and the specific traits of smaller more open economies. That concern was proven correct, with fiscal policy being subsequently shown to be pro-cyclical on adoption and even more so on assessment later on the basis of outturn data.

R2c Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector. **R3b** Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the banking institutions. **R3c** Effectiveness of the Communication between the Central Bank and the Department of Finance

The relationship between the Department and the Central Bank was framed in various forms. The Secretary General was and is and an ex officio member of the Central Bank board/commission but was not prior to its merger with the Central Bank in 2010 a member of the board of IFSRA. There is ongoing contact on banking policy and legislation with the relevant Divisions in the Department and the Domestic Standing Group was set up involving representatives of the Department, the Central Bank and the Irish Financial Services Regulatory Authority. Since the crisis a group was established known as the "Principals Group" made up of the most senior personnel in the Department, the Bank and the NTMA and has effectively replaced the DSG. It is chaired and the secretariat is provided by the Department. This is now well embedded and integral element in the management of the relationship and serves as a communication channel between the three institutions.

[2] OECD: Ireland's Housing Boom: What has driven it and have prices overshot? - 9 June 2006
[3] OECD Economic Surveys – Ireland - April 2008 (pages 51 – 57)

Prior to 2008 I was not personally aware of a systematic engagement between the Department and the Banks. This changed post 2008 with recapitalisation/nationalisation of certain institutions and those relationships were and continue to be managed under the various Relationship Frameworks put in place for each institution. This engagement, managed by the Shareholder Management Unit of the Department, continues and has become a core element to the work of the Department. There is also engagement with the Banks beyond the "covered" institutions on specific issues of public interest.

In my experience there were very good operational communications between the Department and the Central Bank on economic issues pre-crisis. Discussions centred on economic prospects, outlook and risks and were greatly facilitated by having an experienced economist seconded from the Bank in 2004 onwards (now the Department's Chief Economist). The purpose of these discussions was to stress test or provide a second check of the forecasts being prepared in the Bank. The dialogue would have centred on key assumptions, data, modelling and the soundness of the resultant forecasts. It also facilitated the Department in having an advance view of the "Quarterly Bulletin" so that the Minister could be briefed in advance on the Central Bank views on the economy. The nature of the engagements meant they did not involve an assessment or communication by the Bank of the liquidity or solvency position of individual banks or the banking sector more generally. In the crisis period I understand it became the practice for the Department to discuss its forecasts during their preparation with the Bank, given the huge uncertainties in the domestic and global economies and in order to provide additional assistance to the Department which was resource constrained. As noted earlier the other strand of communication on macro-fiscal matters came in the form of an annual letter from the Governor to the Minister that provided his views on fiscal and macroeconomic policy and the risks thereto, mentioned earlier.

Furthermore, in terms of close communication with the Bank it was and continues to be the practice that the Bank attends the OECD country review examinations before the Economic Review Development Committee as part of the Irish delegation. The Bank has also a senior staff member on the EU Economic and Finance Committee (EFC) and the Economic Policy Committee (EPC) along with the Department – these are among the most important EU committees on economic and financial issues.

R4a Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used. **C2b** Role of advisors in analysing the crisis (to include crisis management options)

From a macro-fiscal perspective the Department did not commission external expert advice (other than on some very specific tax matters). This was the case both pre-crisis and as part of the crisis management response. Advice came through a number of channels. These principally included

- EU surveillance processes (including the Stability and Growth Pact, Broad Economic Policy Guidelines etc.)
- IMF via Article IV consultations
- OECD through country review process
- ESRI quarterly review
- Central Bank (Quarterly Bulletins/Governor letter on fiscal policy).

These engagements, in particular the first three, constituted on ongoing process of external peer review and challenge to the work that was being undertaken within the Department. The engagements with the international institutions were challenging, detailed and covered the full range of macroeconomic and fiscal issues. Their recommendations often provided helpful public guidance on policy issues.

In terms of the use of the macroeconomic advice given the impact was probably small in the short term. The recommendations on the need for structural reforms and the removal of preferences and biases in the tax system significantly informed the crisis response and therefore will have a longer term impact on the economy. In general terms the biggest deficiency of advice prior to the crisis was not linking macro-fiscal and financial stability risks. The Department shares in that deficiency although at the time the international agencies indicated their view that the Bank/Regulator were carrying out their functions adequately.

On tax matters, Indecon Economic Consultants and Goodbody Economic Consultants were retained to review property based tax incentives in 2005. These reports recommended the abolition or phased abolition of property reliefs. These recommendations were given effect in Budget 2006 with transitional arrangements. In many respects the action was probably already too late to have a material impact on the sector. In the period after the crisis the opportunity was taken to finally abolish all such schemes and curtail their legacy costs.

When it came to the formulation of a structured response to the crisis the Department drew (often extensively) on recommendations contained in these various strands of advice as well as recommendations from the Commission on Taxation (2009) in formulating policy measures in the preparation of, for example, the National Recovery Plan.

R4c Analysis and consideration of the response to contrarian views (internal and external)

On the matter of contrarian views prior to the crisis it should be noted that the Wright report[4] found that the Department did warn against the adoption of inappropriate policies. While the report criticised the Department for not increasing the tone as risks increased it nonetheless noted the warnings given were "*more direct and comprehensive than concerns expressed by others in Ireland, or by international agencies*" (executive summary, page 5). At the time these views were contrarian.

On the fiscal side, the general position taken by external institutional commentators up to 2007 was to identify the vulnerabilities to the public finances, suggest that the fiscal stance might benefit from tightening to buffer against macroeconomic risks but note that the overall performance was impressive. Notwithstanding the identification of vulnerabilities the IMF opened its 2006 assessment with the statement that "*the Executive Directors commend Ireland's impressive economic performance, which has been supported by sound economic policies, including prudent fiscal policy, low taxes on labour and business income, and labour market flexibility*"[5]. It has to be remembered that at that time the country was running a budget close to balance and the gross debt ratio was low at around 25% of GDP in 2007. Some domestic commentators were more critical of the stance. On the macro economy, external reports tended to concentrate on the sustained good performance of the economy while they pointed to some risks - external vulnerability as a small open economy, price pressures, wage inflation, loss of competitiveness and later the risks associated with the construction sector generally.

To a very large extent these assessments coincided with the view and the advice of the Department over the same pre-crisis period regarding core vulnerabilities i.e. the need to spend less/tax more in the annual Budget Strategy Memoranda to create a buffer against the risks among other things associated with the overreliance of the economy on the housing sector. This latter risk was specifically identified by the Department in the Stability Programme Updates 2005, 2006 and 2007 with the December 2005 Stability Programme Update saying that "*the fact that the construction sector now accounts for a historically high share of economic activity and employment implies that the economy*

[4] Strengthening the capacity of the Department of Finance, Report of the Independent Review Panel, 2010

[5] International Monetary Fund, Article IV consultation 2006.

is vulnerable to any shock affecting that sector". The Department had concluded that reliance on construction was becoming one of the biggest risks to economic development especially where some external shock might interact with and affect the construction sector.

Some of the more focused commentary on the housing sector came from the OECD between 2006 and 2008. Their 2006 analysis suggested that up to 90% of price increases were based on sound fundamentals but they had possibly overshot by up to 20% (Central Bank estimate at the time was up to 15%). They concluded that a soft landing remained the most likely outcome although something harder couldn't be ruled out. Their core recommendations or advice on this risk was fiscal in nature – "*the government needs to leave plenty of breathing space by balancing the budget or running a surplus, curtailing tax breaks and pushing ahead with public management reforms to get better value for money from public expenditure*"[6]. Further work by the OECD in 2006[7] that was drawn from the review returned to this theme of housing. The conclusions were the same. By the time of the 2008 OECD country review[8] the anticipated slowdown in the market was well underway. Notwithstanding the fact that the economy, and the housing in particular, was already in trouble it concluded that the CBFSAI had identified vulnerabilities and had taken appropriate action to mitigate them. Accordingly, it was their view in 2008 that Irish banks were well capitalised and profitable and had a cushion against difficult times.

In terms of the response to the specific recommendations of the OECD, and as previously mentioned, the Department had commenced a large scale review on the issue of property tax breaks in 2005 reports of which were published in 2006. The orderly phasing out of the schemes was announced in Budget 2006. The continued merit of property reliefs had been raised by the Department as early as 1998 as part of the Tax Strategy Group process (papers published).

As part of the crisis response after 2008 a property tax was introduced, mortgage interest relief and rent relief phased out (to create neutrality in tenure choice), stamp duty on property transactions reduced to 1% (to remove earlier risks associated with transactions taxes) and property based incentives finally abolished.

The Department was concerned with fiscal and housing developments. These concerns increased as time passed. Part of our job was to produce a single set of plausible forecasts that were credible to

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[6] OECD Economic Surveys – Ireland 2006 (page 8)

[7] OECD: Ireland's Housing Boom: What has driven it and have prices overshot? - 9 June 2006. Like the Survey the report suggests prices may have become overvalued; a soft landing is most likely; but if disorderly it "*would pose risks for macroeconomic and possibly financial stability*". On this latter point it notes the stress testing by the Central Bank suggests the banking system had adequate capacity to absorb a modest fall in construction and prices.

[8] OECD Economic Surveys – Ireland - April 2008 (pages 51 – 57)

external commentators, the markets and provided a sensible basis upon which to prepare the annual Budget. In terms of generating an economic outlook for the Irish economy there would be a series of ongoing interactions between the various economists working on the different elements of the economy that would be drawn together in a single forecast/outlook that would become the basis for all our budgetary projections. The projections and their assumptions would go through a series of challenges before they were signed off. These projections would also be subject to scrutiny by the external agencies and commentators. Where any individual may have had a differing view or emphasis on any aspect of the work they could raise those views through this iterative process, at more senior levels or they had the opportunity to give that view directly to the full senior management team in an annual Business Planning Review Meeting attended by all the Division.

R5b Appropriateness of the advice from the Department of Finance to the Government and the use thereof by Government

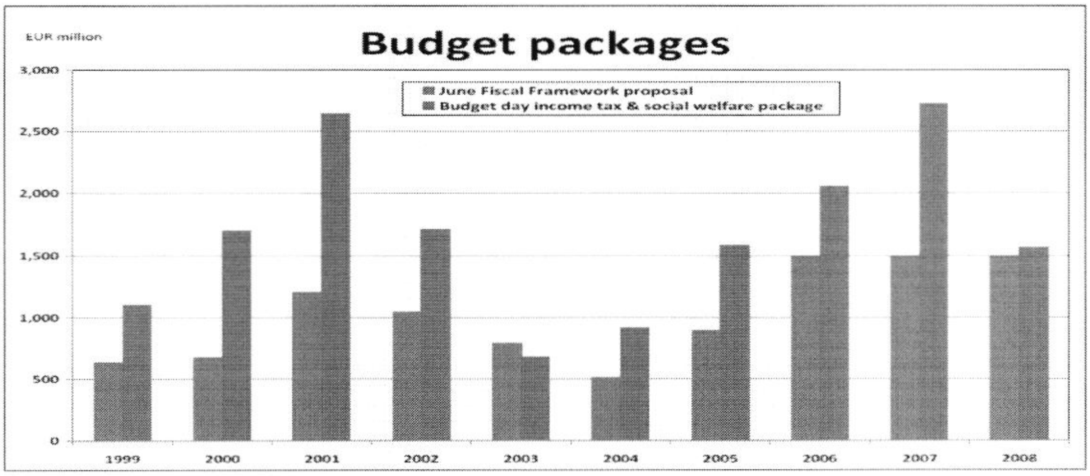
The Department of Finance did give appropriate advice to the Minister and the Government up to 2008 on the risks of pro-cyclical budgetary policy and the risks over reliance on construction. The Wright report concluded that had that advice been taken that Ireland would have been in better position to deal with the economic challenges it subsequently faced. Nonetheless it is critical of the fact that the tone of warnings did not escalate, that warnings were given within the framework of the Budget memoranda but not much beyond that and that advice was given to the Minister orally without a record being kept. This is on balance a fair comment.

The warnings on fiscal policy risks appear to start in the Budget Strategy memoranda around Budget 2000 (September 1999) and continued each year thereafter. Indeed the 2004 BSM went as far as suggesting that the exceptional growth period experienced by Ireland was over. The warnings at different times included

- Prices growing faster than anywhere in Europe
- Wage pressure and loss of competitiveness
- Unrealistic expectations on public pending
- Overheating evident in many sectors and the policy would add further to demand
- Cost increases in construction and housing
- Strengthening of the euro
- Difficult international environment
- Tight labour market and maturing SSIA money as a risk

- Run a fiscally neutral Budget that gives room for manoeuvre in an economic downturn
- Failure to control expenditure will lead to tax increase/higher borrowing and ultimately job losses.

The advice in every case was to run a tighter fiscal policy (than that adopted) recommending aggregate tax reductions and spending increases that would be consistent with a tighter policy stance. In no year other than 2003 did that happen. The Wright report graphs the tax/spend recommended in the Budget Strategy Memorandum with the outcome and shows very significant gaps[9].



Finance Departments are by their nature fiscally conservative. The Department had been warning of the risks to the Budget and the economy for nearly a decade before the eventual crisis hit in 2008. With every year that passed while the economy continued to boom there was the real risk that the advice proffered would be given less and less regard. It could be suggested that the Budget strategy proposed each year became an opening for policy discussion rather than a fixed fiscal framework, a floor rather than a ceiling.

The fiscal advice was appropriate but not implemented. The pressures and expectations deriving from the ongoing "boom" led to decisions that resulted in a deep fiscal crisis (independent of banking) that necessitated significant policy adjustments from Budget 2009 onwards. Throughout the period in question there was little in the way of domestic calls from interest groups or representative bodies for budgets to be less generous, expectations and demands were so high that it was more of a question of how much more should have been done in individual Budgets.

The failure to run tighter policies had profound consequences for the public finances once the crisis hit. For example, during the period 2000 to 2009 income tax credits and bands were increased by

[9] Strengthening the Capacity of the Department of Finance – Report of the Independent Review Panel (p 22)

about twice the rate of wage growth for the period and three times the rate of inflation. Had bands and credits evolved in line with price developments then tax receipts, all other things being equal, could have been about an estimated 2% of GDP higher - €4 billion in current terms – reducing significantly the need for expenditure cuts/tax increases during the crisis resolution period.

It is fair to observe that the Department gave warnings about over reliance of the housing sector but did not model the scale of meltdown in the property sector that actually happened. We did conceive of a rapid reduction of housing output from a peak of 90,000 to say 40,000 to 50,000 units and the very significant budgetary and macroeconomic consequence that went with that. A paper prepared by a colleague and I for the Management Advisory Committee and the Minister set out in detail the direct macroeconomic and budgetary impacts involved in every 10,000 unit reduction in housing output where the first round exchequer costs of hitting 50,000 units was estimated at €1.7 billion (c.1½ of GNP) in reduced taxes and higher unemployment payments (the costs would be higher based on the second round impact on confidence and prices). However, we did not model the much deeper collapse that actually happened. In the period up to 2006, at least, I have no recollection that anyone else did so either.

In the crisis and EU/IMF programme period (2008-2013) my role would have been in respect of tax policy advice. The advice given by the Department, often drawing on reports/analysis over the previous decade, was broadly accepted by the Government both as a means of addressing the deficit but also as structural reform of the tax system itself. It was an unprecedented period of change that saw a rebuilding of the tax base to put the public finances back on a sustainable basis. The tax changes delivered during the programme period largely derived from those included in the National Recovery Plan approved by the Government prior to entering the EU/IMF programme.

R5c Analysis of the key drivers of budget policy

Analytically the key determinant of Budget policy in the period up to the crisis was the terms of the Stability and Growth Pact – a balanced budget over the cycle. This objective informed the recommendations from the Department in the Budget Strategy memoranda and the overarching principle was generally reflected in Government Programmes and Social Partnership agreements. The EU Commission assessment of the Budgets in the period is that they were generally compliant with the rules. As mentioned elsewhere there were flaws in the methodology used at EU Commission level, in particular the measurement of the structural balance. The fact that Ireland complied with the "rules" possibly, over time, created a complacency among policy makers.

The drivers of budgetary decisions up to 2008 were Government Programmes, Social Partnership Agreements and the expectations created by a booming economy. Wright notes that both Government Programmes and Partnership Agreements of the time were highly prescriptive and detailed on policy measures. In addition various representative bodies and representative group would make submissions to the Minister for Finance and other Ministers.

Once the broad strategy was adopted by the Government in the middle of the year the spending estimates campaign would kick-off as would the preparation of tax proposals. The spending estimates would deal with the sectoral pressures and the allocations were agreed by the Cabinet. Taxation measures would be brought forward by the Minister for Finance having considered the various commitments, meetings with stakeholders and the work of the Tax Strategy Committee. As mentioned earlier there was a significant gap between the aggregate spending and tax concession levels proposed in the Budget Strategy Memorandum and what was presented in the Budget i.e. any additional room for manoeuvre was given over to higher spending/lower tax rather than tightening the deficit/increasing the surplus.

In the crisis and programme period (2008-2013) budget policy was driven by the nominal deficit targets agreed with the EU under the excessive deficit procedure and then subsequently with the Troika and the policy conditionality that underpinned those targets/commitments.

R5d Appropriateness of the relationship between the Government, the Oireachtas, the banking sector and the property sector.

I will restrict myself to the relationship between the Department and the property sector. Briefly the Department had and continues to have discussions about policy (tax and more recently funding) with, for example, the CIF and professional advisors acting on behalf of the property sector. Where policy is under consideration these parties can bring an expertise that will improve the quality of the analysis. These discussions would have been no different to the interactions with any sector on policy matters and the new lobbying legislation will make this process more transparent.

I have little direct knowledge of EU level oversight of banking and their policies and regulations. As indicated elsewhere, the analysis of oversight and regulation by the other major international institutions such as the IMF and the OECD tended to suggest that the sector was well regulated and that banks were well provisioned against adverse shocks. Those views continued to be expressed by those institutions as late as 2008[10].

In terms of the EU Stability and Growth Pact, as a tool for regulating fiscal policy outcomes across Europe, it was not sufficient to stop many member states breaching its terms, it simply didn't have the teeth. As referenced elsewhere, prior to the crisis the EU tended to give the Irish budgetary position a broadly clean bill of health it shouldn't have had i.e. it didn't escalate the excessive deficit procedure. It also fell short of pushing other countries through the various levels of the excessive deficit procedure which may have had a strong signalling effect across the Union.

The changes to the pact have been very significant, its principals elements are enshrined in domestic and constitutional law in member states and it is has become much more automatically enforceable – it now has real teeth. The main reforms include:-

- **Fiscal Compact:** This is the Treaty, which was approved by referendum in Ireland in 2012. The key features are a balanced budget rule and the debt reduction rule that had to be incorporated into national law (Fiscal Responsibility Act 2012) and the creation of the Irish Fiscal Advisory Council to monitor compliance with the fiscal rules.

- **The 6-pack:** This is a set of five regulations and one directive that strengthened the sanctions regime and introduced additional features such as the expenditure benchmark that limits the growth in expenditure. Council decisions on interest bearing deposits and fine (0.2% of GDP) under the preventive arm now use reverse Qualified Majority Voting which increases the automaticity of such decisions.

- **2-pack:** These are two regulations that harmonised the budgetary timeline and introduced the requirement for Member States to submit a draft budgetary plan by 15 October each year as well as introducing a requirement that fiscal planning must be based on macroeconomic projections that are produced or endorsed by an independent body (assigned to Irish Fiscal Advisory Council).

[10] OECD Economic Surveys – Ireland - April 2008 (pages 51 – 57)

In terms of domestic fiscal policy these rules have taken on a much greater significance than those that applied before the crisis. The Stability Programme Update is now a much more significant policy instrument as was seen in the 2015 Spring Economic Statement.

R7b Assessment of whether further changes are required (effectiveness of the policy and institutional responses post crisis)

The improvements in European level economic and fiscal governance arrangements over the last number of years should result in the earlier detection and warning of emerging vulnerabilities and the enforcement of earlier action/intervention by either the European authorities or individual member states as the case might be.

The reform of the Stability and Growth Pact significantly strengthens the position of the EU Commission on economic and fiscal policy risk as reversal of a Commission recommendation requires a reverse Qualified Majority Voting. Countries move through the various stages of the excessive deficit procedure more automatically than pre crisis. It is far stricter and penalties are more directly enforceable. National statistical offices now fall under the direct scrutiny of Eurostat. The capacity for certain countries to produce "patriotic" statistics is removed. Eurostat is now entitled to examine in detail a member state's national accounts which will serve as an early warning against any prospective problems. The Excessive Imbalances Procedure and the European Systemic Risk Board will look at systemic risk such as property or macroeconomic imbalances and make early recommendations for action so that countries can't just ignore an emerging problem. Banking Union should ensure that problems with large financial institutions can be tackled earlier with a full set out option up to an including resolution. The "bail-in" rules of the Banking Resolution and Recovery Directive and the Single Resolution Fund should protect European taxpayers much more that than they were in the crisis. The creation of the European Financial Stability Fund and the European Stability Mechanism means financial assistance can reach member states, subject to strict conditionality which proves a lever for appropriate reform, much more quickly which will be essential in any future crisis.

These changes are significant. They provide a buffer to member states against the dual risks of fiscal and financial crash. This is to be welcomed.

Domestically we need to ensure that we are institutionally well organised and prepared to address threats. Extensive changes have made in the organisation and operation of the Department since 2008. These are aimed at ensuring the Department has the capacity to do its job, relate appropriately with its stakeholders and has an enhanced and codified set of governance structures. Some of the main changes have been the creation of structures to handle corporate affairs, the professionalisation of HR, open recruitment, improved communications and cross-divisional working to breakdown silos, a sharper focus on risk, the prioritisation of learning and development to ensure we have the right skills as well as the bringing greater clarity to individual roles, functions and responsibilities. There is no fixed target for improving the Department, it is a process that should be ongoing where we continually challenge the organisation to be the best it can be and benchmark ourselves, where possible, against others.

As I indicated in my introductory comments there are lines of inquiry in respect of which areas I have little direct knowledge. These are C2c (The liquidity versus solvency debate) and R4b (Impact of the reliance placed upon information and reporting from statutory auditors of the bank) and I have therefore focused on the remaining lines of inquiry in this statement.

I confirm that everything above is true to the best of my knowledge.

D Moran

Derek Moran

28 May, 2015