<u>Opening Statement to the Joint Committee on the Banking Crisis</u>

<u>Introduction</u>

Ireland's banking and economic crash should never have happened, should never have been allowed to happen with all the consequences of huge increases in unemployment, rising emigration, enormous debt, suicides, etc. that we have seen. As well as addressing the aspects that I have been asked to deal with by the Joint Committee, I would like to talk about our experiences from my perspective as the head of the Economics function in the Central Bank from 2005 until 2009.

In his report, Professor Honohan described what happened here as a world-beating property bubble. As early as around the turn of the millennium, the head of the IMF Article 4 Mission when visiting Ireland, James Morsink, declared that a country could not prosper on the basis of selling property to one another at increasingly elevated prices - an obvious truism. The huge excesses here are well known, but I think that it is worth recalling some examples. As Donal Donovan and Antoin Murphy have noted in their book on the crash, the size of Anglo Irish Bank's balance sheet in 2007 was 6 times what it was in 2001. The former Chief Executive of Bank of Ireland has stated that it took Bank of Ireland 200 years to grow its balance sheet to €100 billion; it took only 4 years to expand the balance sheet a further €100 billion to €200 billion. And, of course, Bank of Ireland was the most conservative of all the Irish banks. A further example of the absurd mania at its height was the fact that a small site in Ballsbridge was acquired for €174 million and purchased not so long ago for €22 million, a fall of 87 per cent.

<u>Independence of the Central Bank</u>

As you know, the Central Bank's independence is established in law, essentially as a result of the EU Treaties and the ECB Statute. There is a reason why central Banks are legally independent - so that they can take tough, unpopular decisions when required without regard to populist government priorities. This applies in particular in regard to monetary policy issues. However, it has to be asked how independent the Central Bank was on other matters. Patrick Honohan in his report stated that the authorities displayed undue deference to the banks. In my view, this applied equally to the authorities' relationship with Government. Was the Central Bank going to act independently, and to possibly take unpopular decisions, if the Governor was always appointed by the Minister with whom he had worked intimately for many years prior to his appointment, and with the Secretary General of the Department of Finance always serving on the Board of the Bank? Further, the Boards of the Central Bank and Financial Regulator were heavily weighted with political supporters of Government. In practice, it was my experience that any concerns or issues raised by staff for airing in the public arena were invariably watered down so as not to reflect adversely on matters of concern to Government. That was an undesirable state of affairs. While vested interests may be cheerleaders for asset prices, the authorities have a duty to be unflinching, straight and upfront on these matters.

Governance Arrangements

I think that it would be useful for me to reflect on the governance arrangements in the Central Bank. The decision-making entities in the Bank in my time were the Board and the Governor. The staff provided reports and advice to the Board and Governor through the Director General and Deputy Director General, i.e., through what we economists described as the 'kitchen cabinet'. Some time ago, Dr. T. K. Whitaker, perhaps Ireland's most eminent public servant, regretted the passing of the stage where public servants gave their advice and opinions objectively without reference to political or populist issues or to anticipate what might be welcomed by the Minister. In the Central Bank it was difficult to get views through that might impinge on vested interests. For example, as land and property prices escalated to bizarre and absurd levels, I had written, in a low key way for the Bank's Comment in its Quarterly Bulletin, that there was a need to consider the issue of rezoning more land for building in order to increase housing supply - incidentally, an issue of continuing relevance at present. That was blocked from reaching a higher level in the Bank in the light, in my view, of political and property interests on the Bank's Board. Of course, as the demand mania for property took off against the background of restrictive zoning which limited the supply of housing, the inevitable result was huge property price inflation.

I think that I should also say a few words about the relationship between the Central Bank and IFSRA – at least from the perspective of the Economics function in the Bank. While at the operational level, the Bank interacted with the banks through market operations, etc., there was little or no contact on major policy matters. As far as I could see, contact with banks was primarily effected by IFSRA. This was such that at a certain point – towards the mid-noughties - the Governor began to arrange high-level meetings with the main banks at occasional intervals to discuss the big issues. Further, in the Bank, we had no knowledge of the large exposures of the banks to individual developers; such data were rigourously concealed from my level in the Bank. Of course, we were aware that banks' aggregate lending was increasing enormously and was concentrated in the property sector. Anecdotally, it may be of interest that on one occasion I had a discussion with one of the consultants that was brought into IFSRA after the crash. I mentioned to him the name of one large developer. He in turn asked me how much I thought they might have outstanding in borrowings. I suggested €1 billion; he said that I could triple it. That, and newspaper reports that 15 borrowers from Anglo-Irish bank had borrowings in excess of €750 million each, together with the disclosure at the Banking Inquiry that 20 developers had total borrowings of €21 to €22 billion, were news to me.

Assessing the Emerging Crisis

It is sometimes said that nobody seemed to know that a property boom / bubble was developing. That is completely incorrect. You will recall, for example, that, in his evidence to the Banking Inquiry Committee, Peter Nyberg himself, the author of a report on the collapse, asserted that it was obvious that a property lending mania was afoot. At the decision-making levels in the Bank, either people were unaware of what was happening, despite the clear evidence, or they were aware and chose to do nothing. Either way, it all seems quite incomprehensible.

While the Central Bank in its public utterances presented a low-key assessment of what was happening, that is not to say that it was not fully aware of the major excesses. The annual Financial Stability Reports (FSRs) reviewed comprehensively what was happening. Patrick Honohan's report acknowledged that the three major excesses were well recognised in the FSRs: the huge increase in bank lending, the concentration of this lending in the property sector, and the very large reliance by the banks on potentially volatile wholesale funding (Chapter 6). The main body of the FSRs set out extensively how almost all indicators were pointing massively in the wrong direction. By contrast, the overall assessment and tone which reflected the views of the two Boards tended to be reassuring – talking of a soft landing, etc. (In fact, I should say that one member of the Board did have grave doubts about what was happening; his words ring in my ears to the effect that 'it was all a house of cards and would all end in tears'. However, his views appear not to have had any impact on policy-making in the Bank.) Notwithstanding that director's views, it was probably necessary to present such a rather hopeful overall assessment in public since the Central Bank could hardly conclude that the banks were about to collapse. However, whatever the published assessment, the authorities should have been working assiduously behind the scenes to curb the huge excesses and reckless lending of the banks – egregious risk-taking, as Patrick Honohan termed it recently.

As another instance of the Bank being aware of the risks of a property bubble even it was more coy about it in public, each Autumn the Governor customarily writes to the Minister of Finance setting out his views and concerns regarding the economy as the Minister prepares his Budget. These letters of September 2002 and 2003, for example, clearly set out the great concern with the runaway development in bank lending and in property prices. The Government itself, through the Department of the Environment, had earlier requested three reports from the economist Peter Bacon to assess what could be done to alleviate rising property prices. (In fact, as property prices really took off later, the bizarre fact was that no further formal assessments seem to have been commissioned by Government.) Around that time, a memo was sent from the Economics function in the Bank to the then Governor recommending that bank lending to the property sector needed to be reined in; for many years in the past, the Central Bank had imposed credit ceilings on banks in the interest of prudence. The response to the note was that the Governor would have to consider bringing the proposal to the Board. However, at the top of the note were the words, evidently added subsequent to the first comment, 'That is out of the question'. (I have a copy of that memo.)

Other specific responses given to me in reply to my pleas to rein in the banks were, verbatim: 'The Central Bank is not going to disadvantage the Irish banking sector', and ' The Central Bank is not going to collapse the construction sector'. I might add that I, sometimes with the Governor, met high-level delegations from the Construction Industry Federation – they prudently were hoping for a more gradual expansion of the construction sector compared with what was actually happening. On another occasion, when bank lending to the property sector was increasing at the astronomical rate of 65 per cent year on year, I urged a very senior member of the Financial Regulator staff that bank lending to the property sector needed to be curtailed. The response that I was given was that the lending was secured on property – true also in all other property-related banking crashes that proved to be worthless when property prices crashed from unsustainable levels. I was also specifically prevented from bringing forward to the Bank's Financial Stability Committee data on house price levels across Europe that showed the extraordinary heights prices had reached here relative to elsewhere save for central London, that being a special case; the powers-that-be preferred to adopt an ostrich-like approach to the massive problem.

I will give three further random examples of the great unwillingness to accept that anything was amiss:

- when the OECD published its view that Irish property prices were greatly overvalued around the mid-noughties, I was instructed to contact the authors of the report to retract their published views – clearly an absurd thing to have to do;

- when around 2005 Prof. Alan Barrett had expressed the view in an ESRI Quarterly Economic Commentary that the banks were in a rather fragile state, I was instructed to request the Director of the ESRI to ensure that such comments were not published in future;

- in the 2007 Financial Stability Report, a deliberate decision was taken to delete the conclusions of a research study updating the extent of the overvaluation of Irish property prices.

More generally, at the staff level in the Bank, people were fully aware of the huge excesses of the property mania; some of this I have reported in my Irish Independent article of 3 February 2011. As I have said, the Honohan report acknowledges fully that the three major risks relating to the Irish banks were set out in the annual Financial Stability Reports; these were the huge increases in bank lending, the very large concentration of this lending in the broad property sector, and the increasing reliance on potentially highly volatile wholesale funding by the banks. In addition to the red flags in the Financial Stability Reports, a financial expert has reviewed the Annual Reports of the Central Bank over the years in the journal Studies of Spring 2009 and has come to the same conclusion that the authorities were well aware of the dangerous situation that was developing. What Peter Nyberg, the author of the Banking report, kept asking me was: ‘Why did nobody do anything?’ I am afraid that the answer has to be that the authorities did not wish to do anything. Actually, Peter Nyberg also asked me why I did not publish a newspaper article myself on the bubble. I said to him that that would have been highly unorthodox, and would be unlikely to have had an effect in any event at a time when the then Taoiseach was saying that anyone who questioned the sustainability of what was happening should go and commit suicide. In the event, when Professor Morgan Kelly wrote about the probability of a crash, he was derided and literally shouted down at an

Economics conference where he was presenting his views on the property market.

One also has to ask whether there was any appreciation in the commercial banks that things were getting out of hand. On the face of it, it would seem that certain divisions of the banks – perhaps the Capital Markets divisions - were in fact well aware that we were experiencing a property bubble. Why else would the two main banks have decided to sell off their headquarters buildings and major landmark branches at colossal prices at the height of the bubble? Was it the case that their lending colleagues in the banks were at the same time even financing in whole or in part the acquisition of these premises? From the perspective of the Central Bank, how did it see the erosion of the banks' deposit base being halted as the Central Bank pumped increasingly vast amounts of liquidity into the banks to prop them up? Was there going to be a miraculous reflux of their deposit base?

The Role of Economists in the Bank

I think that it is relevant for me to say a few words about the role of economists in the Central Bank. During the critical period 2000 to 2007 when the property mania was at its height, none amongst the top 3 executives in the Bank was an economist – not that economists are the fount of all wisdom. This would have been less of an issue if there was a willingness to listen to the views of economists. The Canadian expert, Rob Wright, has noted the relatively small number of economists employed in the Department of Finance, 7 per cent of staff being economists compared with 60 per cent in Canada's Department of Finance. This aversion to economists carried over to the Central Bank.

In addition, the Financial Regulator employed very few economists. A member of top management in the Bank put it to me on one occasion that the Bank wants economists and other specialists to be ' on tap but not on top'. (That rather recalls the episode in the early 1920s when the Governor of the Bank of England Montagu Norman said to the chief economist: ' You are not here to tell us what to do, but to explain to us why we have done it'.)

However, it is the norm now in almost all central banks for economists to occupy the great majority of the top decision-making positions for the obvious reason that central banks are primarily concerned with issues in the areas of macroeconomics, monetary policy and financial economics. On the other hand, in Ireland the top positions in both the Bank and

Financial Regulator were filled traditionally by general administrators and accountants. Accountants by their work and training are concerned with detail, but do they always see the bigger picture? The clean bill of health given by external auditors to all the banks right up to and even beyond the crash would suggest otherwise. It would seem to me that accountants tend to have a more backward-looking perspective on a balance sheet, whereas examining a balance sheet from an economic perspective would entail a more forward-looking consideration. Perhaps, in the wake of the crash, it could be argued that the type of appointments has lurched too far in the other direction with economists predominating at the top of the Bank and Regulator. In my view, there should be a diversity of skills and backgrounds at the highest levels of the Bank and Financial Regulator.

Bank / Property Crashes Elsewhere

Having said that, it is quite extraordinary – and one didn't have to be an economist to observe it - that, at the highest level, there seemed to be a blindness to the fact that there had been a whole series of recent property-related bank crashes - Japan, Finland, Sweden, the Savings and Loan sector in the US, Norway, the Lawson mini-boom in the UK, etc. Of course, the sub-prime crisis in the US itself and the related securitisation of mortgage assets that led to massive losses for many international banks was also a property-related phenomenon. In the years leading up to the crash, the BIS, of which Ireland is a shareholder, had also been warning consistently for some time about the runaway evolution of asset prices with wholly inadequate attention being paid to risk. Despite all of that, there seemed to be little interest in such experiences elsewhere with the implicit belief that they had little relevance for Ireland. This was a manifestation of a closed mind and an unwillingness to learn. While economists were well aware of these banking debacles, their relevance to Ireland did not seem to register at a level where it should have done. The view seemed to be, as the cliché has it, that this time is different or we are experiencing ' a new paradigm'.

Seeking a Scapegoat

Some apologists suggest that it was the collapse of Lehmans that brought down the Irish banks. That event didn't help, as Lehmans' failure did greatly affect liquidity flows, interbank lending, etc. However, as the

UCC economist Seamus Coffey noted in a radio interview some months ago, Ireland's crash derived from developments between 2002 and 2007. Ireland's problem was that we had a pre-existing property bubble, and, related to the fact of the enormous increase in bank lending, Irish banks were significantly dependent on borrowing from the wholesale markets. Countries that had no such bubble - small countries like Belgium, the Netherlands, Finland, etc. – experienced some problems associated with the failure of Lehmans, but nothing on the scale of Ireland's banking crash and collapse in GDP/ GNP. Our problem was a banking insolvency one – as Professor Honohan's report put it, the source of our problems was essentially home-grown. Those who suggest that Lehmans brought us down are almost wholly wrong, and are merely seeking an external scapegoat.

It is also suggested that, being in the eurozone, we were the victims of huge capital flows to Ireland. This is also a thin argument. Ireland participated in a quasi-monetary union with the UK from 1825 to 1979 when Ireland joined the EMS. We had plenty of experience of living in a monetary union. We also joined the euro with our eyes open. If monetary conditions were not particularly optimal from Ireland's point of view, the corollary was that other policies should be used to deliver the appropriate economic conditions. This would have meant, inter alia, restrictive fiscal policy, as well as a tightening of bank regulation. However, that would have run counter to the naive populist policies of the then Government.

In summary, it was crystal clear that, from about the turn of the millennium, and even before, that Ireland was experiencing a major property bubble – a world-beating one in Professor Honohan's words. It is not credible that those who ought to have been aware of what was happening were in the dark. One can only surmise that, as Professor Alan Ahearne has said in evidence to your Committee, too many people were benefiting from the boom-time for prudent, avoidance measures to have been taken. Such necessary measures would not have been popular, but that should not weigh with those whose duty it was to ensure that the country did not experience the catastrophe that we have so painfully and unnecessarily suffered.

Some Lessons from Ireland's Banking Collapse

What lessons can be learned from our debacle? I think that we should usefully focus on at least four points:

- First, while financial markets are far from being infallible, attention should be paid to important indicators. In particular, sharp movements in bank share prices and in credit default swaps may be early warning indicators of trouble ahead. Of course, as our own and international experience has made clear, high rates of increase in bank lending, particularly where much of it is being extended to the property sector, should be of particular attention.

- Secondly, the proper mix of people with the appropriate background and skills should be on the Boards and in top management positions of key institutions,

- Thirdly, there has to be a greater willingness to listen to different and contrarian views in institutions – it should not be a question of uno duce, una voce,

- Fourthly, while the Central Bank here is now legally independent, it is of fundamental importance that it exercises that independence without regard to whether actions taken may or may not find favour with various interest groups.