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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Joan Burton

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Joint Committee of Inquiry into the Banking Crisis

Witness statement by the Tánaiste and Minister for Social Protection Joan Burton TD regarding her role as Labour Party Finance Spokesperson from 2002 to 2007.

24th June 2015

Theme and Lines of Inquiry

The specific theme that I have been asked by the Committee to give evidence on is:

"Clarity and effectiveness of the Government and Oireachtas oversight and role"

Covering three related lines of inquiry

- Effectiveness of the Oireachtas in scrutinising public policy on the banking sector and the economy.
- Analysis of the key drivers for budgetary policy, and
- Appropriateness of relationships between Government, the Oireachtas, the banking sector and the property sector.

I am happy to deal with this theme and these lines of inquiry in detail here. In addressing them I will follow the precedent set by both the Regling and Watson Report (2011) and the Honohan Report (2011) by framing the key Irish decisions and events that caused the crisis in an international context. In particular, I will emphasise the failure of the Fianna Fail/ Progressive Democrat Government to adapt its budgetary policy and financial regulation to the challenges of operating in a single currency area. However, we are not talking about an international crisis here but a "home-made" crisis with "the imprint of global influences" (Regling and Watson 2011).

Introduction

The economic crisis, of which the banking crisis was an integral part, can be viewed as a tragedy in three Acts. Act I covers the period from 1997 to 2007 and the 2002 to 2007 period in particular, when Fianna Fáil\ Progressive Democrat governments held office. In this period, the key decisions that propagated the crisis were made by the Government, the banks and the Financial Regulator.

In Act II came the dénouement of these disastrous decisions with the unravelling of the solvency of the banking system. In this period the Fianna Fáil/Green Government made the fateful decision to guarantee the liabilities of the Irish banks. This was the most damaging and expensive decision in terms of the costs of dealing the crisis. Finally Act III covers the post 2008/2009 period when the true horror of the crisis in social and economic terms became apparent.

The Guarantee

Labour opposed the Guarantee because given its scale, covering liabilities of approximately €440 billion in an economy with a GDP of less than €189 billion in 2008; it posed a real risk to the solvency of the Irish State. As a mainly niche lender to property speculators, we never accepted the Government's assertion that Anglo was a systemic bank.

As Labour Party Finance Spokesperson from late 2002, I became increasingly concerned at the extraordinary growth in bank lending which was fuelling an equally extraordinary rise in property prices. The property bubble was squeezing the living standards of ordinary people and loading them with an unsustainable debt burden while simultaneously enriching wealthy individuals and companies who availed of a huge range of property-based tax shelters. The series of scandals at local government level where the common thread was speculation in building land, rezoning and the associated corruption was also a factor.

This is the context in which we approached the debate on the blanket bank guarantee. It is a matter of record that the Labour Party stood alone in its opposition to the guarantee. All the other parties voted in favour – Fianna Fail, Fine Gael, Sinn Fein, the Green Party, the Progressive Democrats.

While there was clear evidence at the time pointing to significant risks to the solvency of the Irish banking system, I did not expect the losses to be as large as they were. But as the Dail debate evolved and as the full extent of the banks' exposure to reckless lending to the property sector became apparent, it became clear that what was portrayed as a liquidity problem was clearly a full-blown solvency crisis. In retrospect this is not too surprising since, historically most bank solvency crises have evolved in this way.

The costs of the crisis

For a full understanding of the scale of the losses, it is necessary to see the banking crisis as part of a wider financial and economic collapse where the component parts reinforced each other to accentuate the social and economic costs. The following list provides an indication of the scale of the losses:

- Direct State injections of capital into banks amounted to €64.1 billion
- Public debt increased by almost 100% of GDP, from 23.8% in 2006 to 123.2% in 2013.
- The general government balance deteriorated from a surplus of 2.8% of GDP in 2006 to a deficit of 32.5% in 2010

- GDP declined from its peak in 2008 Q1 to the trough in 2009 Q4 by 13.9%. Over the same period GNP declined by 16.6%.
- Employment declined by 327,500 or 15 per cent from its pre-crisis peak in 2008.
- Unemployment more than trebled from 4.5% at the end of 2006 to 15.1% in the first quarter of 2012.

In a 2012 Working Paper, the IMF compared all systemic banking crises internationally since 1970 on the basis of three criteria – (1) direct fiscal costs associated with bank bailouts, (2) the increase in public debt due to direct costs and to second round effects due to the consequent economic collapse, and (3) the loss in economic output as a result of the crisis.

The IMF noted *"Ireland holds the undesirable position of being the only country currently undergoing a banking crisis that features among the top-ten of costliest banking crises along all three dimensions, making it the costliest crisis in advanced economies since at least the Great Depression"* (IMF, 2012).

This is a far cry from *"the cheapest guarantee in the world so far"* as it was described by Minister Lenihan in October 2008 (Irish Times 24 October 2008.

The main actors in the crisis

It is important to be clear about the roles of the various parties in this crisis. Clearly given the importance of Government policy decisions in propagating the crisis, the then Fianna Fáil–led Governments, particularly from 2002 on, must accept the leading role. The other leading actors are the banks and the Central Bank and Financial Services Authority of Ireland (CBFSAI).

The reckless lending practices of the banks fed the property bubble which itself was inflated by extraordinary property-based tax breaks for the wealthy. This fatal combination led inevitably to the subsequent collapse of the domestic economy and the biggest banking crisis in the western world since the great depression.

Light-touch regulation facilitated the banks in their reckless behaviour. The light-touch approach did not appear out of nowhere - it was consistent with embedded Fianna Fáil/Progressive Democrat Government policy. As late as September 2007, when the true extent of the horrors of the sub-prime lending scandal was emerging, EU Commissioner Charlie McCreevy was still extolling the virtues of light-touch regulation. In a speech to the European Parliament Committee on Economic and Monetary Affairs on 11September 2007 he said *"We believe that "Light touch", principle-based regulation is the best approach for the financial sector".*

On the opposition benches, the Labour Party highlighted the risks to the economy from these tax shelters for the wealthy, the inequity of the wealthiest individuals using these tax shelters to pay virtually no tax and proposed positive action such as constitutional change to control the cost of building land. Ultimately, however, while the opposition including the Labour Party held it to account, the Government made the decisions.

Naming the crisis

On one level the Irish banking crisis can be characterised in very simple terms: the Irish banks lent too much money to the property sector which was underwritten by grossly overvalued property assets. Both the Regling and Watson and the Honohan reports from 2011 characterise the crisis in this way. Regling and Watson describe a *"plain vanilla property bubble, compounded by exceptional concentrations of lending for purposes related to property – and most notably commercial property"* (Regling and Watson, 2011). While Honohan noted: *"The...difficulties of the Irish banks – whether in terms of liquidity or solvency – are attributable to their over-lending for land and property investment, much of it through heavy short-term wholesale foreign borrowing"* (Honohan, 2011).

However, this does not fully capture the multifaceted nature of the unprecedented economic catastrophe that hit this country. It reflected a failure of economic policy, both in design and implementation, encompassing chronic failures in financial regulation, budget policy and in the overall management of the economy.

To view the crisis as a banking crisis which led to an economic collapse is to see events in the wrong order. The correct order is the following: a series of catastrophic economic policy decisions by the Fianna Fail/Progressive Democrat Government created a huge distortion in the structure of the Irish economy, destroyed our competitiveness and, in the process, inflated the biggest property bubble in any advanced country in modern times. The bursting of this bubble and the associated collapse of the domestic economy led to the banking crisis. To put it bluntly, I warned time and again against the property –based tax breaks fuelling this bubble.

A domestic crisis with global influences

It has been convenient by those most culpable to assign the entire blame for the crisis on external factors. However, this is not just self serving, it is also grossly inaccurate. While the acute phase of the Irish crisis coincided with a dramatic external global economic shock and, in particular, the contagious aftermath of the failure of Lehman brothers, the crisis was predominantly domestic both in its origins and effect.

The Honohan Report concluded that *"although international pressures contributed to the timing, intensity and depth of the Irish banking crisis, the essential characteristic of the problem was domestic and classic".* The Regling and Watson report notes *"the clear imprint of global influences"* on the Irish banking crisis but concluded that *"it was in crucial ways "home-made".*

While accepting the dominant role of domestic factors, it is important to consider the role of global developments as enablers. In addition, the international evidence provides examples of countries facing similar pressures to those faced by Ireland that chose to adapt their domestic policies to changing international circumstances.

Two such examples are Canada and Spain. In Canada, a strong regulatory regime prevented the emergence of a property bubble, similar to the one developing across the border in the US. In Spain, the application of anti-cyclical capital rules helped to mitigate the impact on their banks of a damaging property bubble, similar in scale to the Irish bubble. While some

Spanish banks got into difficulty, the relative scale was much less than in Ireland.

Governor Honohan divides the pre-crisis decade into two phases. In the first half-decade, the Celtic tiger period, economic growth was very much export driven and Ireland caught up rapidly with the more mature high-income economies in Europe. The second half of the decade was characterised by credit driven domestic demand where a hugely inflated construction sector led the way. This period roughly coincided with the adoption of the Euro and the two developments are closely related.

The policy failures that led to the crisis were almost exclusively made in this second period and reflected a failure in general to adapt to the new regime. These policy failures turned a successful export led economy that the Rainbow coalition with Ruairi Quinn as Finance Minister, bequeathed to the incoming Fianna Fail government in 1997 into a credit driven property bubble that collapsed in a mountain of debt in 2008.

From 2003 to 2007, the headline growth figures still looked impressive although not as strong as in the previous five years. GDP growth in 2003-2007 averaged 4.7 % compared to 7.9% in the previous five years. However, when you looked below the top line growth figures the underlying picture looked much weaker.

Export growth which had led the world on the previous five years had slowed to a trickle. The balance of payments which had been in a healthy surplus when the Rainbow Coalition left office deteriorated to a large deficit by 2007. The structure of the economy had become very unbalanced. Fuelled by a huge build-up in debt, the construction sector had grown to about 20 per cent of GDP at its peak in 2006. It was way beyond the typical size in the rest of Europe and was completely unsustainable.

The inflation rate, which had been below the European average in the second half of the 1990s, was now consistently higher. By 2008, the price level for consumer goods in Ireland was 33 per cent above the average in the rest of the EU.

Boom time revenues associated with the construction sector accounted for almost one-third of tax revenues compared to about 8 per cent of revenue in 1987.

An early indication of the underlying weakness of Ireland's fiscal position came in 2002. The deficit in 2002, although relatively small, at 0.3%, represented a dramatic deterioration from the very large surplus of 4.8% of GDP just two years earlier in 2000. This deterioration should have been an early warning of the fragility of the Irish public finances. Rather than addressing this fragility, government policy over the following five years made things worse by persisting with tax breaks for the wealthy that continued to feed the construction boom and with other avoidance mechanisms such as relating to stamp duty.

In the previous year, the EU Commission had censured the Government for the failure of the 2001 budget to meet the requirements of the Broad

Economic guidelines. The reaction of the Government and Minister McCreevy was one of angry protest rather than constructive engagement.

In the 2002 to 2007 period, the Irish economy was like an athlete on steroids. What had been a healthy economy with sound public finances, strong export led growth, full employment and a healthy balance of payments position was now an uncompetitive, high price economy driven by a credit fuelled housing bubble that would eventually crash and burn. This transformation didn't happen by some accident. It was not caused by some external force that we couldn't resist but was entirely home- made, caused by bad government policies.

The policy failures that propagated the crisis

A failure of light-touch regulation

The adoption of the euro led to a significant decline in interest rates giving a huge stimulus to the Irish economy that was at that point operating at close to full employment. The already significant incentives in place to invest in housing and commercial property set the scene for this increased demand to be focussed almost entirely on that sector.

In the eurozone, Irish banks had full access to European wholesale financial markets, where excess savings from countries such as Germany could fund an increase in lending far in excess of the growth in the Irish deposit base.

This set in train an increasing reliance on short-term funding by Irish banks which would leave them dangerously exposed when wholesale markets dried up from mid-2007 in the wake of the sub-prime crisis.

Irish banks responded to this change in regime by increasing lending dramatically. Credit growth accelerated to close to 30 per cent per annum - well in excess of the income growth of borrowers. Credit standards eased significantly with ordinary borrowers borrowing increasing multiples of their income over increasing durations. Mortgages of 35 or 40 years in duration and of over 100% of the value of the house became common place.

A more proactive regulator would have responded to these developments by taking action to slow the growth in credit and to prevent banks from lending beyond safe limits. No action was taken in an environment where regulation was officially principles based and light-touch.

The preponderance of 100 per cent mortgages and excessive loan to income ratios should have been tackled head on with pre-emptive rules. While there was some action very late in the day to attach additional capital requirements to this type of lending, it was a case of too little too late.

The persistently high rates of credit growth should have been warning enough that trouble was brewing. It is basic common sense that if credit continues to grow at a multiple of the growth in personal and corporate incomes, the burden of debt will become intolerable for both households and firms.

However, in addition to its rapid overall growth, credit was becoming increasing concentrated in loans to the property sector in general and to the commercial property sector in particular, where exposures to a small number of developers were dangerously high. This level of concentration was at the very least a breach of basic regulatory guidelines. Again, the Regulator should have taken pre-emptive action but again nothing was done.

The failures of regulation were essentially ones of omission; it was a case of carrying on existing weak and ineffective practices and behaviours. Significant institutional change was put in place in 2003 with the restructuring of the Central Bank and the creation of an independent financial regulator within the new organisation. The existing practice of light touch principles based regulation continued within this new institutional framework when clearly a new activist approach was needed.

One issue highlighted by Governor Honohan was the potential conflict in assigning responsibility for both regulation of the financial sector and its promotion within the same organisation. These conflicting responsibilities together with the regulatory culture, in particular the excess deference towards the regulated entities and the reliance on good governance within the regulated entities rather than an intrusive style, contributed to the bad outcomes that followed.

Failures in budgetary Policy: Analysis of the key drivers

The Rainbow coalition left office in 1997 with the budget in surplus. It remained in surplus in every year from 1997 to 2007, with the exception of

2002. But positive headline number masked underlying problems. In the aftermath of the crisis, the IMF estimated that the underlying position was very weak - the estimated structural deficit in 2007 was 8 ¾ % of GDP and was 4 to 6% of GDP in the run up to the crisis.

The large disparity between the apparently healthy headline figures and the true underlying position reflected the large and growing reliance on tax revenue related to the construction bubble – stamp duty, capital gains tax, elements of VAT. The large cuts in income tax, year after year, which generally favoured the better-off tax payers, seemed affordable because the exchequer was being boosted by these essentially temporary boom-time revenues. By 2006, these revenues accounted for 30 per cent of total tax revenues.

The cause was clear: the boom in these revenues was driven by the boom in construction which was in turn being driven by the failure of regulation and also by specific government tax incentives which were generating a feeding frenzy among wealthy investors and speculators.

Most of these schemes were introduced with sun-set clauses but from his very first Budget in 1998, Minister McCreevey established a practice of extending these deadlines. In addition, new schemes were introduced. In retrospect, possibly the most risky and damaging of these was the Rural Renewal Scheme for the Upper Shannon Basin. This scheme provided generous capital allowances for house building in this region. However, the only shelter provided in this case was a tax shelter for wealthy landlords who wanted to shelter their rental income in Dublin and other urban areas. Many of these houses remained empty from the day they were built. A look at the census returns shows that Leitrim, for example, had a vacancy rate of almost 30% in 2006.

Acute housing shortages in urban areas were being made worse by the diversion of building away from the areas of greatest need. Government housing policy was simultaneously generating excess demand in general, supply shortages in areas of greatest housing need and excess supply in areas with limited underlying demand. This outcome would have been bad enough in itself but it was also playing a lead role in inflating a gigantic housing bubble.

In our neighbour the UK, there was a more conventional housing bubble being generated, albeit a much smaller one than in Ireland. The pickup in house prices in the UK can be clearly linked to supply constraints and a resultant excess demand. In the UK in 2007, house completions were 3.6 per 1000 population. In the same year in Ireland we built 18 houses per 1000 of population. Housing output had in fact peaked in the previous year when 88,000 units were completed in Ireland compared to just over 200,000 in the UK, a country with a population about 20 times bigger than Ireland's.

However, because of government incentives, most of the housing was being built in areas of relatively the low underlying housing need while acute housing shortages persisted in the main urban areas.

When the bubble burst, the value these houses collapsed. The areas of the country where the phenomenon of ghost estates was most acute at the height of the crisis and where the greatest problems in terms of mortgage distress currently exists are the very areas that were targeted by the Rural Renewal Scheme. This outcome was not an accident; it was a direct consequence of Government decisions.

Oireachtas scrutiny and oversight

The Oireachtas oversight and scrutiny came into play at key moments such as the annual budget, in the Finance Acts, in the scrutiny of key legislation such as the Central Bank and Financial Services Authority of Ireland Act and through the regular use of Dail questions.

Over the period 2002-2007, the Labour Party consistently challenged the Fianna Fail/Progressive Democrat Government on its overall policy approach to the economy. Labour was prominent in its criticism of Government policies which in retrospect were central to the propagation of the crisis. For example, the Labour Party continually highlighted the effect of tax shelters and in particular property based incentives in eroding the tax base and facilitating tax avoidance for the wealthy. The Labour Party opposed tax avoidance and special arrangements in respect of construction, pensions and stamp duty and a variety of tax shelters

Labour Party spokespeople set out a number of practical solutions to address property speculation, close property-based tax incentives, address tax evasion, and strengthen financial regulation.

To cite a number of examples, in 2003 my colleague Eamon Gilmore published a specific Bill to cap the cost of development land to assist local authorities in the cost of land for the provision of services. This was based on the implementation of the Kenny Report that had been published in the 1970s, but never implemented.

During the Dail debate on that Private Members Bill in October 2003, I specifically highlighted the manner in which developers were benefitting from the value of land with little or no revenue being recouped by the State through various tax incentive schemes.

"I want to speak about the experience in Fingal and Dublin west. Last year's census shows that Dublin north and Dublin west, particularly Fingal, have undergone and will undergo in the future extraordinary levels of house building. The land, which is close to the city, is available. There is a clear argument that tens of thousands of people should find homes at reasonable prices in both Dublin west and Dublin north. What has happened in Fingal is that a profit of more than €300 million has been made as a result of land values being held by landowners and developers. That profit is not subject to any form of taxation. Through the system of options, split ownership, management companies etc. little of it is subject to capital gains tax even at the low rate introduced by the Minister for Finance."

In the debate on the enabling legislation to set up the Central Bank and Financial Services Regulatory Authority of Ireland (CBFSAI), the Labour Party set down numerous amendments and supported others to strengthen the role of the regulator, particularly in the area of consumer protection emphasising the need to separate the roles of prudential regulation and consumer protection and to discourage and where necessary prevent irresponsible lending.

Labour is on record in questioning the relevant minister in relation to the emergence of sub-prime lending and 100 per cent mortgages.

When the Government made the decision to guarantee the banks in September 2008, the Labour Party stood alone in opposing this reckless decision.

Relationships between Government, the Oireachtas, the banking sector and the property sector

The key relationships under this heading were between the Government and the banking and property sector. The important point here is the impact of these relationships on Government behaviour. Lobbying of government is normal in a modern democracy. It is reasonable that interested parties make their views known to Government in advance of decisions that affect them. In the run up to the annual Budget, for example, the Government receives numerous pre-budget submissions from interested parties. On July 3rd next, the Department of Social Protection will host a Pre-Budget Forum providing a platform for transparent open debate of such submissions.

Where a problem arises however, is when such relationships stray from their more formal settings to become less transparent. It seems clear that such relationships had a significant impact on Government decisions during the run-up to the crisis. A number of examples could be cited.

Property-based tax incentive schemes had sun-set clauses built in to ensure that they did not persist beyond their useful lifetime. However, as early as the first Budget of the Fianna Fáil / Progressive Democrat Government then began a process of extending these deadlines and introducing new schemes.

Although the Minister for Finance set up a review of these schemes in 2004, by 2006 most were still in place and deadlines were still being extended.
In a series of Dail questions, I continually pressed the Minister to get information to ascertain the full costs in terms tax forgone from these schemes but, particularly for earlier years, no accurate figures were forthcoming.
In November 2004, I commented that the Government was losing over €8 billion in revenue through these tax avoidance measures. I identified 28 schemes that were in existence that allowed many wealthy people to avoid paying tax through various measures. Many of these schemes were property based, and were available almost exclusively to the well-off. The oversight of these schemes was also inadequate, as the Revenue Commissioners were unable to give a full costing of the value of a further 33 separate reliefs. At the time I specifically criticised the then Minister for Finance for failing to police these schemes adequately and the subsequent loss of revenue to the State.
I raised the issue of stamp duty avoidance and mitigation with the minister for finance time and again but it seems that lobbying by interested parties behind the scenes and out of public view prevented any reform.

Part 5 of the 2000 Planning Act allowed for the setting aside of 20 per cent of a development site for social and affordable housing. Following intense lobbying from developers, the application of the measures was watered down in 2002 by the Environment Minister to allow developers to effectively avoid the measure by payment in kind or by building on other cheaper sites.

Summing Up

The economic crisis that hit this State from 2008 was, according to the IMF the costliest crisis in an advanced economy since the Great Depression. While the crisis had an international element it was primarily a domestic affair. In many respects, it was a failure to adapt domestic policies to life in the single currency. Regulatory policy failed to rein in bank lending which was growing, throughout the period, at several times the growth in incomes. The government added fuel to the fire by pumping up the property bubble with a range of property based tax incentives that allowed the rich to shelter their incomes, in some cases paying no tax at all.

The main actors in this tragedy were the Government, the banks and the Financial Regulator. Throughout the period Fianna Fáil was in Government taking decisions and implementing policy. Labour was in opposition, highlighting the deficiencies of Government policies and suggesting practical solutions. Inevitably, however, as an opposition party we could propose but not dispose -that privilege was left to Government, led by Fianna Fail ably assisted by the PDs and subsequently the Green Party.

In conclusion, I want to nail the lie of the last Fianna Fail led Government that we were all responsible for the national bailout crisis. This is absolutely untrue. The Irish people were victims of the crisis and continue to pay a heavy price. Those responsible were the Fianna Fail led Government, the boards of the banks, the Central Bank and the Financial Regulator.

As Spokesperson on Finance for the Labour Party from 2002-2007 and beyond, along with my colleagues, I offered a consistent and strong critique of the policy direction taken by Fianna Fail and the Progressive Democrats. This concentrated on measures to address rampant property speculation; highlighting the series of tax avoidance and incentive measures in place; and calling for a far more active and stringent financial regulatory framework.

Following our opposition to the blanket bank guarantee that exacerbated the effects of the property collapse on the wider economy, the Labour Party entered government in 2011 to fix a broken economy that was the legacy of 14 years of Fianna Fail and Progressive Democrats economic mismanagement.

That we are now in a position where we have regained control of our own economy and put it on a sustainable footing; where unemployment has fallen below 10%; and where confidence in our country has returned at home and abroad, shows the progress we have made.

The Irish people suffered a great deal during the economic downturn and deep recession. And they have made enormous sacrifices to get our country back on its feet.

The work of this Inquiry is vital in ensuring that the policy direction that was pursued by successive governments and ultimately led to the collapse cannot happen again.

Supporting documentation

I am supplying in PDF format the following supporting documentation referenced in my statement:

1. A copy of the Irish Tines article which references Minister Lenihan quote "the cheapest bailout in the world so far".
2. Speech by Minister McCreevy to the EU European Parliament Committee on Economic and Monetary Affairs on 11September 2007.
3. IMF Working Paper W/P/163: Systematic Banking Crises Database: An Update by Luc Laeven and Fabián Valencia
4. Construction and Housing in Ireland 2008 Edition

I hereby declare that these documents are, to the best of knowledge, true and correct. These documents are in the public domain.