Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Allan Kearns

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[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

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Statement by Allan Kearns
to the Joint Committee of Inquiry into the Banking Crisis

INTRODUCTION

On 15 July 2015 I was directed by the Joint Committee of Inquiry into the Banking Crisis ("the Joint Committee") to make a statement in writing on the list of questions furnished to me by the Joint Committee relating to lines of inquiry relative to my role as Economist, Deputy Head Eurosystem Coordination and Deputy Head Risk Division in the Central Bank of Ireland.

I believe it would be helpful at the outset of my statement to provide some detail in relation to my role at the Central Bank of Ireland ("the Central Bank").

I joined the Central Bank as an economist in 2002 working on financial stability issues. At that time and in similar fashion to many other central banks, the Bank was in its infancy in developing a financial stability capacity and progressing towards the publication of financial stability reports. The first such report was published by the Central Bank in 2004. The Financial Stability area was situated within the Economics directorate reporting to the Assistant Director General Economics.

My broad responsibilities as an economist were primarily analytical with a view to understanding developments affecting the wider financial system (by looking at trends affecting the banking system (not individual banks), households, corporates, and the wider macroeconomy); to publish research; to contribute to the publication of the financial stability reports, and to liaise with internal and external stakeholders.

I worked as an economist on financial stability issues until mid-2008, when I was promoted to a new role with responsibility for coordination of the Central Bank's engagement with the Eurosystem. I subsequently transferred in 2011 to support the establishment a new internal risk function for the Central Bank. During my tenure within the Central Bank, I have never worked within a financial regulatory area.

Having regard to the foregoing, I regret that I am unable to respond to some of the questions which have been put to me by the Joint Committee.

Q1: Do you believe that the FR and the IFSRA Boards had sufficient powers to take direct action against banks - if it became necessary to avoid a financial stability crisis? Can you assess how these powers were used and whether in your belief, their use was effective?

Response:

I refer to my introductory remarks; in particular, I did not work in a regulatory area and my interaction with the FR/IFSRA boards was minimal. I do not know whether the FR/IFSRA boards had sufficient powers or how effective was their implementation.

Q2: One of the statutory objectives of the CB was 'the promotion of the financial services industry in Ireland'. In your view was there a conflict between this objective and the Financial Regulator's responsibility for prudential supervision?

Response:

I refer to my introductory remarks; in particular, I did not work in prudential supervision. I do not know whether there may have been a conflict between this objective and the Financial Regulator's responsibility for prudential supervision.

Q3: The Financial Regulator proposed a number of initiatives to impose more explicit requirements on banks (e.g. the Director's compliance Statements, Corporate Governance Guidelines and the Fit and Proper Requirements). These proposals were not or not fully successful. What was your view of these initiatives and can you describe the circumstances in which the Financial Regulator chose not to implement the original proposals these initiatives?

Response:

I refer to my introductory remarks; I cannot comment on these initiatives as I was unaware of them and did not work in the regulatory areas.

Q4: In your opinion, did the Financial Regulator, as suggested by Patrick Neary at his Hearing, have the power to stop banks to pay out dividends? If so, would it have been appropriate for the Financial Regulator to use these powers in view of the potential market impact? And why?

Response:

I refer to my introductory remarks; I do not know what powers were at the Financial Regulator's disposal during this period.

Q5: Apart from the publication of Financial Stability Reports, how did the Central Bank ensure that the Government was at all times well informed about the current macro economic situation and trends?

Response:

Financial Stability Reports always included a concise macroeconomic update (both domestic and international) to set the context and to highlight key macroeconomic risks facing the key constituents operating within the Irish financial system (e.g., the banking sector, households and corporates).

In addition to Financial Stability Reports, my recollection is that the Central Bank conveyed its opinion on the macroeconomic situation through a combination of:

(i) *Publication of the quarterly economic bulletins (these had significantly more detail on the macroeconomic situation than financial stability reports);*

(ii) *A concise overview of economic developments contained within the Central Bank's Annual Report and which is addressed to the Minister for Finance and delivered to the Department of Finance. My understanding is that the Minister in turn brings the Annual Report to cabinet and lays it before the Houses of the Oireachtas;*

(iii) *Issuance of advice to the Minister for Finance in the form of a letter prior to the formulation of the Government's annual budget, and*

(iv) *Meetings with senior government representatives.*

Q6: In your recollection, what were the reasons for the CBFSAI Board/Department of Finance in favouring a soft landing scenario for the property market over a hard landing? Were these reasons ever discussed in detail? Honohan points out that the FSR cites no quantitative analytical evidence for this conclusion

Response:

I refer to my introductory remarks; my experience relates solely to the CBFSAI board and I therefore do not know what perspective was held by the Department of Finance.

The term "soft landing" was first used by the Central Bank in the 2006 Financial Stability Report (FSR). My recollection is that there were arguments for and against a "soft landing". Prior to outlining these respective arguments, and by way of context, I believe the following points are relevant:

(i) *The outlook for the residential property market was a key discussion point since the initial publication of the FSR in 2004. For instance, there was a special feature in the 2004 FSR entitled "The Irish Housing Market: Fundamental and Non-fundamental Influences.";*

(ii) *Analysis of the property market generally was hampered significantly by a lack of real time, sufficiently granular and comprehensive price and transaction data. The analyses in the FSRs had to rely on a patchwork of data (e.g., PTSB House Price Index, Department of Environment, Data published by Estate Agents) and no one source covered the property market comprehensively and in sufficient detail; and*

(iii) *The discussions by the Board of the Central Bank on a soft landing were considered in the main in the context of what message to publish in the FSR. This is an important piece of context; as it introduced an assessment of what could be said on the outlook for the property market that would convey the Central Bank's concern, but would not cause the very risk that was a key concern – namely the possibility of a hard landing. It was a reasonably widely discussed limitation of financial stability reports generally at that time, namely, whether any central bank could publish a forecast of the materialisation of a key risk (e.g., that the property market faced the possibility of a significant hard landing) without triggering a materialisation of that risk.*

By way of general context, if may be useful to review a research article investigating the usefulness of Financial Stability Reports in Financial Crises at https://www.kansascityfed.org/Publicat/Econrev/pdf/10q1W_S_C.pdf

Over the period when financial stability reports were published (2004-2007) during my time within Financial Stability, as with most economic analyses, there were arguments for both a hard and soft landing. My recollection is that the main arguments for each were as follows:

Hard landing:

(i) *An IMF (World Economic Outlook 2003) publication noted that sharp increases in house prices are typically followed by sharp declines about 40% of the time. A similar message was conveyed in publications by Morgan Kelly (2006/2007);*

(ii) *By 2006, it was noted that the affordability of residential property was deteriorating given the trends in prices and mortgage interest rates at that time (Box D: Financial Stability Report 2006);*

(iii) *Some of the overvaluation models suggested that prices could be overvalued by as much as 75% (See Charts 14-17 and associated commentary in FSR 2006); and*

(iv) *Prices across different segments of the property market were likely to be correlated. For instance, Kearns and Woods concluded that the rates of change in prices across different segments of the Irish property market have tended to trend upwards and downwards in a broadly similar fashion over the last thirty years, particularly during those periods of relatively slower economic growth. (See FSR 2006 Kearns and Woods "The Concentration in Property Related Lending – A Financial Stability Perspective).*

Soft landing:

(i) *There appeared to be some qualifications to the analyses of previous house prices booms and busts as published by the IMF and Morgan Kelly (e.g., See Box C FSR 2007);*

(ii) *It was deemed that some of the increase in house prices was warranted by improvements in fundamental factors (demographics, income growth) and it was difficult to apply quantitative analyses to be definitive with respect to exactly how much was based on fundamentals; and*

(iii) *There was no single model to determine overvaluation. There were a suite of models and these indicated a range of overvaluation (a range of 14% - 75% cited in the FSR 2006 Page 34), and at that time it was not obvious which overvaluation model should be given priority.*

Q7: Could you describe the nature and extent of the co-operation and exchange of information between economists in the Department of Finance with colleagues in the Central Bank, ESRI and other external economic forecasters during your tenure at the Central Bank/Department of Finance?

Response:

I refer to my introductory remarks. I have not at any time worked in the Department of Finance, the ESRI or any other external forecaster.

From my perspective and my position within the Financial Stability area (2002-2008), I have no recollection of any significant contact with economists in the Department of Finance. I do not know what may have been the level of contact that might have arisen in the Central Bank's other economic areas (such as macroeconomic forecasting, international relations, statistics etc). My recollection in terms of financial stability issues is that contact with Department of Finance officials (not necessarily economists) occurred mostly through (i) the domestic standing group (comprising the Central Bank/Financial Regulator and the Department of Finance), and (ii) involvement in crisis management exercises (where the management of a simulated crisis within a bank was practised).

Q8: Can you give us your perspective on the solvency of the banks in 2008 in the context of the capital injections that followed?

Response:

Our primary focus in financial stability was on the analysis of capitalisation of the banking system (average or median capitalisation), and we were not involved in assessing the solvency of individual institutions.

Prior to leaving the financial stability area in mid-2008, I have no recollection of issues raised with respect to the solvency of the banking sector generally. My recollection at that time is that the overarching concerns of the Central Bank related to liquidity risk (arising from the US Subprime Crisis).

The information available in early 2008 suggested that solvency was not an issue. For instance, regulatory information published in late 2007 confirmed that Irish banks' capital ratios were in excess of regulatory minima (for instance, see Chart 47 in 2007 FSR) and non-performing loans remained at low levels (Chart 52 in FSR 2007).

Q9: Looking back to the period leading to the crisis, what is your view on what is called "Constructive Ambiguity"? Was it effective or did it possibly obscure the hard realities of the liquidity and solvency issues of the banks?

Response:

In terms of my role within Financial Stability, I am aware of the application of "constructive ambiguity" in terms of a central bank's lender of last resort role. In essence, a central bank can be deliberately vague about the conditions under which it will provide emergency lending support to banks, in order to mitigate the moral hazard that could arise whereby banks believe they will be saved from taking on excessive risk. My recollection is that during my tenure within financial stability it was the orthodoxy at that time for many central banks to be ambiguous in relation to its lender of last resort approach.

In the context of my role and this understanding of constructive ambiguity, I cannot see a link to the issue of obscuring the hard realities of liquidity and solvency issues of banks.

Q10: After 2004 the IMF, OECD and ECOFIN all clearly recommended a tighter fiscal stance and the building up of a 'cushion' for the time when income from property related transactions would fall. Can you discuss why in your view the Central Bank's recommendations to the Minister did not more forcefully alert to this issue?

Response:

I refer to my introductory remarks. I have not worked on fiscal issues (which were the responsibility of another area) during my tenure within the Bank and I do not have the experience or knowledge to discuss the Central Bank's recommendations on fiscal matters during this period.

Q11: Morgan Kelly published an article on a potential house price bubble in the Irish Times end of 2006 and later published a report on the same theme as part of the ESRI bulletin in summer 2OO7. Can you recall if any discussions were held at Senior Management level in Central Bank/Department of Finance afterwards? Were Morgan Kelly's concerns given serious consideration?

Response:

I refer to my introductory remarks; my experience relates solely to the Central Bank's considerations of this issue, and I cannot say what discussions were undertaken within the Department of Finance.

There were discussions of Morgan Kelly's views within the Central Bank. My division (the Monetary Policy and Financial Stability) prepared a memo for the Assistant Director General Economics about the Morgan Kelly article, and the article was circulated to the Central Bank's Financial Stability Committee.

At that time, while consideration was given to Morgan Kelly's concerns, such consideration was focussed on reconciling his position with the Central Bank's broader position on the financial system. In this context, the memo prepared by my division at that time noted the following in relation to the article:

- *The issues raised in the article had been published in the Central Bank's FSRs, but there was a different Central Bank view on the ability of the banking sector to withstand a shock;*
- *The article did not specify what might trigger the risk;*
- *Regulatory data on non-performing assets at that point in time did not reflect that many property related loans were already in difficulty (a fact which only emerged later); and*
- *There was a different Central Bank interpretation of some of the key figures within the article.*

According to the minutes, the Financial Stability Committee considered the article briefly, and the minutes indicate the Committee's concern in the light of both the Morgan Kelly and another article to monitor market developments that may indicate a change in sentiment towards the Irish banking system. (See the Financial Stability Committee Minutes of January 9th 2007). A box was published in the FSR 2007 (Box C) noting some limitations of Morgan Kelly's and other publications that used a similar methodology to examine house price cycles.

Details of the memo referred to in this response to Question 11 may be subject to Section 33AK of the Central Bank Act 1942 (as amended), and I have provided these details pursuant to subsection (5) (ahb) of Section 33AK. I provide these details without any waiver of any privilege which the Central Bank may have in respect of this memo.

Q12: Do you judge the lMF country reports and OECD reports as an important information instrument to aid in banking regulation, banking supervision and financial stability issues? lf yes, why, if not, why not?

Response:

In my time within Financial Stability, the visits by officials from the IMF and OECD were important opportunities to present our assessments, and to have those challenged by officials with a cross-country perspective. Significant comfort was taken from their respective assessments that essentially the analyses included in the financial stability reports were broadly accurate. To the extent that these respective institutions interpret their mandate as to challenge, and not overly to seek consensus with the local authorities, these reports can be an important instrument in assessing risks to financial stability.

Q13: The IMF Mission in 2009 referred to the lack of a resolution regime, can you explain the delays in initiating such a regime in lreland bearing in mind the UK implemented one by way of its Banking Act in March 2009?

Response:

I refer to my introductory remarks. I was no longer working in financial stability and was not involved in the IMF mission in 2009, and do not know what may have delayed the implementation of a resolution regime.

End.
12/8/2015