Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Section 24 Statement of

John Hurley

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JHU01B05-V

JHU00005-001

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

Response to the Written Statement of Frank Browne

Preliminary

1. Arising from the Committee's correspondence dated the 2nd and 8th October 2015, this response should be read together with my replies of even date to Document 1 Questions attached to the Committee's letter dated the 2nd October 2015.

2. In my written statement to the Committee dated the 23rd April 2015 and in my subsequent evidence on the 9th June 2015, I informed the Committee that I was not aware of contrarian views within the Central Bank, which differed in substance from the Bank's overall assessment in its Financial Stability Reports. I again confirm these views to the Committee. Other witnesses have also indicated that such views were not raised at Central Bank Board meetings. These meetings were often attended by the most senior economic staff of the Bank.

3. Mr. Frank Browne did express strong views on the implications of the growth in the Euro money supply in monetary policy briefings in preparation for ECB meetings in Frankfurt. My comments on his views in this regard are set out at paragraphs 34 to 37 below.

4. Much of the appendix to Mr. Browne's witness statement refers to discussions which took place at Committee meetings operating at levels below me in the Bank. The minutes of the Financial Stability Committee meetings, which were seen by me, do not show dissent being expressed. If there was any unhappiness with the draft minutes themselves this could have been dealt with in accordance with the normal procedure as the minutes of the previous meeting were discussed and approved as the first item on the agenda of the subsequent meeting.

5. Meetings between me and the key staff involved in preparing and developing the draft Financial Stability Reports, including Mr. Browne, were held prior to documents being finalised for presentation to the joint board meetings. I have never known a meeting in any organization in which I worked, where some variation in opinion or in emphasis did not arise. The Central Bank was no different in this regard though any amendments made did not affect the substance of the drafts. The purpose of convening meetings of the kind being discussed here is normally to iron out differences and to come to conclusions taking all views into account. This has to be done in all organisations. This is precisely what happened at the meetings chaired by me. As amendments were finalised I do not recall any serious disagreement on any of the changes made in the drafts being presented including the draft summaries. I accepted the drafts presented for discussion as the agreed assessment of those attending and was given no reason to believe the contrary. As I have stated it would be expected that if senior members of staff had a different view they would say so at those meetings. This did not happen.

6. In my preparation for giving evidence to this inquiry and to the earlier inquiries I have not seen any document which would indicate that a view other than that contained in the draft reports was proposed either by the Financial Stability Unit or Economic Department. If such a view was held it could be expected that a proposal would have been put forward in relation to additional guidance on policies or principles (under Section 33D) of the 2003 Act which might have been given to the Financial Regulator. That this did not occur suggests that at the time there was no disagreement with the approach adopted in the reports. No reference to any such document or proposal was ever made at the meetings I chaired on the draft Financial Stability Reports.

7. In my experience of heading up a number of public service organisations, the function of a head of a line department, who was always regarded as a senior manager, was never confined to analysis

alone. Such managers were expected to make proposals emanating from that analysis if the situation warranted it. Proposals from the Financial Stability Unit could have been made in the first instance to the Chief Economist who would have pursued them in the appropriate fora or indeed by the Chief Economist himself who was an Assistant Director General. They could have been made directly to the Financial Stability Committee or to the meetings chaired by me or raised at the Board.

Responses by Mr. Browne to Specific Lines of Inquiry

'Soft landing' for the housing market

8. So far as Mr.Browne's comments on a 'soft landing' for the housing market are concerned, I would make the following points.

9. The issue of a future downward adjustment in house prices was the subject of much analysis and discussion in the context of the preparations of the various Financial Stability Reports. The central question was whether the adjustment would be gradual or abrupt. Taking all the evidence into account, it was, so far as I was aware at the time, the consensus view of the Bank that a gradual decline in house prices or soft landing was the most likely outcome though it was always acknowledged that there were downside risks to this outcome that could make for a more difficult adjustment path. The financial stability reports contain lengthy studies and articles on the state of the Irish housing market that supports this view and which the Committee has.

10. The Bank, in making its assessment on financial stability risks facing the Irish financial sector, drew on all the economic expertise of the Bank in the Financial Stability Unit itself and in other departments such as Economic Analysis, Research and Publications. Not to have done so would have omitted key evidence that was important in the Bank's

assessment. At the end of the day, as in all organisations, final decisions had to be made by the Board. The decisions made by the Joint Board Meetings on the content and tone of Central Bank documents inevitably involved compromises. It goes without saying that the emphasis decided upon doesn't always fully satisfy everyone and this may not be expressed though I have no recollection that at meetings I chaired there was any serious disagreements.

11. So far as the documents to be presented to the Joint Board Meetings are concerned, if Mr. Browne at the time had a strong view that he was not in agreement with the overall risk assessment in the drafts being prepared, as head of the Financial Stability function in the Bank, he should have said so at the meetings chaired by me and directly to the meetings of the Joint Boards. He did not do so at the time.

12. As I stated in my earlier evidence to the Committee two factors which could have a positive bearing on the adjustment outcome were the phasing out of property tax incentives and increases in interest rates.

13. In October 2004 because of the continuing growth in property prices and also the growth of the property sector in the Irish economy the Central Bank raised the issue of tax incentives in the pre-budget letter to the Minister for Finance. In the event a review of tax incentives was announced in the Budget in December 2004 with an expectation it would lead to a phasing out of such incentives. The review was completed in 2005 and the Budget in December 2005 announced their phased withdrawal.

14. Contrary to the view expressed by Mr. Browne at page 32 of his Appendix, the Central Bank at the time expected that a new ECB interest rate tightening cycle, which would have a strong psychological impact on investors and house buyers, would start in 2005. As a member of the Governing Council of the ECB I had a good insight into the prospects for future increases in interest rates. The McQuinn 2004

research paper (The Irish Housing Sector: A Financial Stability Assessment) published in the 2004 Financial Stability Report stated that the housing market was liable to be highly sensitive to any significant interest-rate change.

15. In my earlier evidence to the Committee I indicated that public statements had been made by the Bank about the likelihood of future interest rate increases and their effect on retail mortgage levels. This message was given at the launch of the Bank's Spring Bulletin in February 2005 as well as at the press conference on the Summer Bulletin in May 2005.

16. A further message to the same effect was given at the time of the Financial Stability Report in 2005 with extensive coverage by the media. The Central Bank had already pointed out in the course of the Roundtable discussions with the financial institutions in December 2004 that the equilibrium rate for retail mortgages was approximately 6% and that while it could take time to reach that level it was twice the then prevailing level. While the interest rate increases started later than expected because of changed economic circumstances in the Euro area, there was aggressive monetary tightening starting from December 2005. Rates were increased between then and mid 2007 from 2.25% to 4.25% with consequential adjustments to retail mortgage rates. This was viewed as a positive development which would assist the gradual decline in house prices.

17. It is also relevant to state that papers by academic economists, acknowledging the importance of increases in interest rates for the future path of house prices, predicted that the necessary adjustment in the property sector could be made over a number of years, and in one case around 8 years was mentioned.

18. That the adjustment outcome turned out to be abrupt rather than gradual was due to the severity of the international recession

interacting with Ireland's domestic vulnerabilities. The Bank's assessment that the more likely adjustment would be gradual was wrong not because of any lack of analysis but rather because of the severity of the worst downturn in 80 years.

2006 article by Morgan Kelly on house prices and his report the ESRI Summer Bulletin 2007

19. Morgan Kelly's article was briefly reviewed at a Financial Stability Committee meeting on the 9th January 2007. It was also discussed, as Mr. Browne states, at a Financial Stability Committee meeting held on the 15th May 2007. The content of the May discussion was reflected in the draft 2007 Financial Stability Report. The relevant insert would, I believe, have been prepared either by the Financial Stability Unit itself or the Economic Department. To the best of my recollection the matter also arose at the regular discussion chaired by me in finalising the 2007 draft financial Stability Report for presentation to the joint board meeting. The main conclusion of the insert was that the behavior of nominal prices was regarded as more important from a financial stability perspective than real prices. This view was included in the final report (Box C page 30 titled 'The Economic Literature on International House-Price Cycles'). This view from internal Bank research is also referred to by Mr. Browne in his statement. Morgan Kelly spoke of falls in real prices in his article.

20. Morgan Kelly published a further article entitled 'Banking on very shaky foundations' in *The Irish Times* on the 7th September 2007. I attach a copy of a memorandum of the same date on this article prepared in the Financial Stability Unit (MPFS) and sent to the Chief Economist. It is clearly critical of the views presented by Morgan Kelly. My memory is that Mr. Browne was very unhappy with other comments made by Morgan Kelly either at or following a meeting of the Irish Economic Association of which he was Vice-President at the time. It may be that it was those comments made in the article which had been published in

The Irish Times on the 7th September 2007 that he was concerned about.

Appendix 1 of Mr. Browne's Statement

21. Mr. Browne makes a number of points in his Appendix that I wish to respond to. As indicated earlier, many of his comments relate to discussions at committees of the Bank not attended by me.

Empirical evidence

22. Mr. Browne states that extensive empirical evidence was made available to senior management and the Board and went unheeded. He also states that senior management were reluctant to countenance any dissent from the right message. The purpose of the Financial Stability Reports, the process that led to their finalisation and approval, was to present evidence available within the Bank including relevant evidence from other economic departments and to make the best assessment on the risks posed to financial stability and to publish those findings. This is what was done by the Bank. It is clear from all of the reports, and the 2004 report in particular, that there were risks posed by developments in the Irish property market and the Bank gave its best assessment of those risks taking all evidence into account. In doing this as I indicated in my earlier evidence to the Committee I fostered and welcomed open discussion in an attempt to reach the best assessment of the risks. These meetings chaired by me were wide-ranging. Some amendments were made to the drafts including the draft overall conclusions and summaries before finalisation. I do not recall any serious disagreement on any of the changes made at that stage. If senior economic staff had different views then those views should have been put at the time. This did not happen. Final decisions on the content and risk assessment were made at the Joint Board Meetings as appropriate and public comment by myself and Bank staff including economic staff was made on the basis of those decisions.

Articles by economic staff in Economic Analysis, Research and Publications Department

23. In a number of comments in the Appendix Mr. Browne appears to express annoyance that research from other areas of the Bank was taken into account in the Bank's overall assessment. Examples include:

- The Irish Housing Sector: A Financial Stability Assessment by Kieran Quinn of the Bank's economic staff (2004 Financial Stability Report);

- The implications of a Construction Sector Correction by Maurice McGuire (Head of Economic Analysis, Research and Publications, Department) and Diarmaid Smyth (economist in that Department) (2005 Financial Stability Report).

24. As I stated earlier it was incumbent on the Bank to assess all evidence available in reaching its conclusions on the assessment of risks. Consideration of the above articles seem to me particularly appropriate. Again no mention by Mr. Browne of his reservations concerning this research or any other research conducted by the Economic Analyses, Research and Publications Department was ever voiced to me at any of the meetings chaired by me which Mr. Browne attended.

2005 statement to the Board

25. Mr. Browne is critical of my statement to the Board in June 2005 that the continued high rate of credit growth and indebtedness levels were the primary risk to financial stability at the time and said that this suggested that the earlier analyses in relation to the property market

was wrong. This was not my view. At the time, as the 2005 Report states, there was evidence of a slowing in house price growth which mirrored a trend seen internationally but it also stated that the risk identified in the previous report could not be dismissed though the risk had receded somewhat. The issues referred to earlier in relation to property tax incentives and impending increases in interest rates also had to be taken into account in any assessment. In any event the questions of credit growth and growth in property prices are interrelated. Again, if Mr. Browne held these views at the time he did not communicate them to me. The report was published after further consideration at a Joint Board meeting in November 2005.

Interest rates

26. Mr. Browne's comments on interest rates and in particular the equilibrium interest rate which was almost double the average variable interest rate at the time are responded to earlier. He says that the equilibrium rate acting as a magnet for the actual rate was not taken seriously by the Bank. This is not in fact correct. The Bank raised the question of the likelihood of increases in interest rates at a very early stage as I indicate in my comments in paragraphs 15 and 16 above.

Tone of 2006 Report

27. Mr. Browne is critical of the tone of the 2006 Report and that important messages did not feature in the Overall Assessment or in the Executive Summary of the Report. Again, every effort was made to canvass all views at meetings chaired by me on the draft report including on the Overall Assessment and Executive Summary. I am surprised at Mr. Browne's comments as I considered the 2006 Report to be a very strong report and believed until now that he did also. It was written against the background of an acceleration in house price increases after a period of moderation and also against the background of a significant increase in Euro area interest rates. It contained the

messages that it was not obvious that the earlier property price acceleration was driven by fundamentals, regarded at the time as a strong statement buy a Central Bank, and that fundamentals cannot continue to support the kind of growth rates in mortgage credit being experienced. It included the results of stress tests and clearly set out their limitations and published key articles on the role of income and interest rates in determining Irish house prices as well as on concentration in property-related lending. The Report was central to the subsequent Roundtable discussion with the financial institutions held later. The messages in the report received widespread media coverage.

Level of overvaluation

28. Mr. Browne refers to the absence of the update of the McQuinn/O'Reilly Model in the 2007 Financial Stability Report. I have no recollection of this update being mentioned at any of the meetings I chaired leading up to the finalisation of the 2007 Financial Stability Report nor have I any recollection that it was referred to in any of the documents I received at that time. It was my understanding from the Honohan Report that this update was undertaken in April 2008 after the publication of the 2007 Financial Stability Report.

29. That there was overvaluation in house prices in 2007 was not in question in the Central Bank. There were, however, serious doubts about its extent because of the wide range of overvaluation results emanating from the various models used. As I have mentioned earlier, the 2006 Financial Stability Report stated, in relation to the increase in property prices in 2006, that 'it is not obvious that the earlier reacceleration was driven by fundamentals'. A research article by McQuinn/O'Reilly published in the 2006 Report showed possible overvaluation of 15% at the time. The article states that it had the benefit of comments from senior economic staff in the Bank: Mr. Tom O'Connell, Maurice McGuire and Karl Whelan.

30. Whatever the level of overvaluation in 2007 a gradual decline over time was expected. The McQuinn/O'Reilly article stated that "the gap between actual and fundamental prices has tended to dissipate over time without any major decline in actual house prices'. Morgan Kelly had suggested a possible fall in average real prices of 40-60% over a period of around 8 years. That the gradual decline in house prices expected by the Central Bank did not happen was, as stated by me to the Committee, due to the interaction of the very serious international financial shock with our domestic vulnerabilities. Time that would have allowed overvaluation to dissipate gradually was taken away and an abrupt adjustment followed. Documentation I saw before I retired from the Bank showed the Financial Stability Unit at the time as agreeing with this view.

Commitment to the Financial Stability Function

31. In his comments Mr. Browne states that he did not believe that at senior levels in the Bank there was much sense of the importance of financial stability. This is simply not true. The financial stability function was regarded as a very important function in the Bank and its work was taken extremely seriously. A great deal of attention was given to the preparation of the reports and every effort was made to assess all the available evidence and not just evidence from the financial stability function itself but from across the bank and to set out the appropriate risk assessment based on all the information available. The Financial Stability Report, which was introduced as a stand alone report by the Bank to emphasise its importance, was the main instrument for assessing financial stability and was communicated to all key stakeholders in the manner set out in earlier evidence. The key risks were also set out in the Bank's pre-budget letters to the Minister as well as in the Quarterly Bulletins and Annual Reports. The latter were on the Government Agenda each year.

32. In my evidence to the Committee I have acknowledged that the Financial Stability Reports underestimated the risks facing the Irish financial system. The scale of the international crisis, the worst since the 1930s was not anticipated by any institution, domestic or international.

Tone of the 2007 Report

33. As regards the tone of the 2007 Financial Stability Report, I mentioned when I was before the Committee that there was evidence of an easing of both property price growth, of credit growth and of other aggregates through 2007.The Central Bank had to be balanced and prudent in its assessment in the 2007 Financial Stability Report which was published in November of that year. It was attempting to avoid provoking a more rapid adjustment than was already underway and exacerbating the instability evident in the latter part of 2007. To the best of my knowledge Central Banks elsewhere adopted the same approach. In his evidence to the Committee Governor Honohan emphasised the importance of achieving the appropriate balance in public statements. He said that the Bank had to 'avoid frightening the horses'. This was particularly the case in late 2007.

Growth in the money supply in the Euro area

34. Mr. Browne says that in the course of a briefing for a monetary policy meeting in Frankfurt that I didn't want to hear any more of what he was saying regarding the implications of strong growth in the Euro area money supply. While I do not recall this specific comment at some eight years remove it is possible that time was short on a particular day and Mr.Browne's views were already well known from earlier meetings. However, I gave a great deal of time to an assessment of the growth in monetary aggregates in the course of these briefings. The reason for this is that monetary policy decisions in the ECB are based on a comprehensive analysis of the risks to price stability organized on the

basis of two complementary perspectives of the overall Euro area economy. These perspectives centre around an "economic analysis" (which was the primary pillar) and a "monetary analysis" (termed the monetary pillar). I would be expected to speak on both at meetings in Frankfurt. In his role in relation to monetary policy Mr. Browne regularly briefed me and others on developments in relation to the monetary pillar in preparation for ECB monetary policy discussions in Frankfurt. He had strong views on the monetary pillar and emphasised the impact of the growth of the money supply on inflation including asset price inflation in the Euro area. Despite the fact that this view was not a widely accepted view at the time, it was taken into account by me with those of others in my preparation for monetary policy meetings in Frankfurt. It is clear from my evidence to the Committee that the Bank was very much aware that a slowdown in credit growth and property prices was highly influenced by the path of interest rates. As mentioned earlier this was a key finding of the McQuinn research published in the 2004 Financial Stability Report.

35. Mr.Browne's briefing note on liquidity referred to in Annex 1 to his statement was used by me in my preparation for the discussion in Frankfurt on the draft 2006 Financial Stability Review. However, the views of the main proponents of this approach, White and Borio of the BIS were regarded as contrarian at the time and their views were not adopted by the BIS itself nor to the best of my knowledge by other international fora. Neither did the ECB adopt their view. Mr. Browne has complained that he received no comments on his note from me nor an acknowledgement of having received it. It was not my practice nor I believe that of earlier Governors to issue acknowledgements of receipt of briefing notes. Briefing notes from Central Bank departments were expected to be prepared as a normal part of the job.

36. Having regard to the constraints of the legal and statutory confidentiality and professional secrecy provisions which continue to apply to me after my retirement, I cannot discuss the details of ECB

meetings but the outcome of the meetings so far as the Financial Stability Review is concerned is set out in the ECB's review itself which is a public document. So far as monetary policy is concerned the outcome of ECB deliberations is set out in the ECB's Introductory Statements issued after each monetary policy meeting. These are public documents also and include the ECB's Governing Council views on the monetary pillar. As I have indicated in my earlier comments there was aggressive monetary tightening by the ECB starting from December 2005 with regular increases of a quarter per cent each bringing rates from 2.25% to 4.25% by June 2007. In making its decisions in each case the ECB cross checked its economic analysis with its monetary analysis and set out its assessment of the medium to long term risks to price stability emanating from this monetary analysis based on the necessary data from all euro area countries including Ireland. As the ECB's mandate is price stability, interest rates were set for the purpose of maintaining its inflation target which was 'below but close to 2%'.If the ECB took money supply growth fully into account in the course of its cross checking this would have required much higher interest rate increases than would be necessary to meet its primary objective which is containing inflation.

37. So far as domestic implications were concerned the Financial Stability Reports indicated that rapid credit growth and asset price inflation were key risks for Ireland. The assessments set out were developed in the Financial Stability Unit for inclusion in the reports and considered by the Financial Stability Committee in the normal course. The reports also contained articles on the role of liquidity in financial stability as well as on developments in asset prices and liquidity despite, as I have indicated earlier, that the views outlined were not mainstream opinion at the time. In my discussions on the draft financial stability reports which included senior economic staff including Mr. Browne, I have no recollection of any proposals being made to include further material on this topic in the body of the reports themselves.

Other comments attributed to me by Mr. Browne

38. Mr. Browne also says that I told him that I did not agree with his analysis of financial stability. I have no recollection of making such a comment. It was always my view that the draft reports presented to me and discussed at the meetings referred to by me above were agreed by all participants including Mr. Browne and I was given no reason to believe otherwise. After discussion I accepted this analysis in substance and presented it to the Joint Board meetings for final consideration.

39. Mr. Browne refers to a briefing for an Oireachtas Committee hearing at which in the normal course preparation would include colleagues posing the difficult questions that might arise. Again I have no memory of the comment Mr. Browne says I made to him "whose side are you on anyway" but if such a comment was made, it seems to me, it could well have been a lighthearted comment made more in jest than anything else because of a difficult question Mr. Browne posed. The purpose of the exercise, after all, was to prepare for difficult questions.

John Hurley
23rd October 2015