Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Section 24 Statement of

Tony Grimes

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

Response to the document described as 'Appendix 1' appended to the Witness Statements of Frank Browne furnished to the Inquiry

Summary of Response

1. **Having examined Mr. Browne's Appendix in detail, I arrive at the following conclusions: his statement contains numerous errors of fact; there are some inconsistencies between his actions (or lack of them) at the time of the crisis and the views he now claims to have held at the time; these views also seem at odds with those of the staff members of his own department who worked on the FSR; he is very selective in his focus on one house price overvaluation estimate (39 per cent) at a time when there was another estimate of only very minor overvaluation (4 per cent) from the same Bank author; he attributes too much policy significance to any particular measure of over-valuation, given the wide variation in such estimates, using a variety of methodologies and sources, and the fact that house prices were falling at a moderate pace in autumn 2007; his argument about evidence for a 'hard landing' is at odds with the macroeconomic forecasts and various risk measures examined in September and October 2007; and the policy conclusion he arrives at (that more preparatory work could have been carried out had the higher estimate of overvaluation been accepted) is inconsistent with the substantial crisis management work undertaken both within the Central Bank and by the DSG which intensified from the Autumn of 2007.**

2. The following is a response to the issues raised by Frank Browne in the Appendix to his statements ('Appendix 1') to the Banking Inquiry. I have confined my response to the period after August 2007 when I took up my position as Director General of the Central Bank. This material is covered between pages 39 and 63 of Appendix 1. Specifically, it covers the section of the Appendix on the preparation of the 2007 FSR and the post-August 2007 part of the section on Crisis Management Procedures. I also refer to my response of even date to the issues raised by the Inquiry in its letter of 2 October 2015.

3. I held the position of Director General for only the last three months of the six month 2007 FSR process, by which time the text and commentary had been almost entirely written: this was after a first discussion by the joint meeting of the boards of the Central Bank and Financial Regulator in June 2008. I chaired only one meeting of the Financial Stability Committee (FSC), that of 13 September 2007, at which the draft FSR was discussed. The joint meeting of both Boards on 27 September 2007 was the first that I attended as Director General.

Preparation of the 2007 FSR

4. It may be recalled that August 2007 was the start of the global financial crisis, leading up to the failure of Northern Rock in early September. On my return from leave in mid-August and the taking up of my new position as Director General,

my focus was largely on monitoring the implications of global events for domestic banks. This is evident in the number of Ad Hoc FSC meetings called in late August to mid-September the purpose of which was to discuss emerging developments. The idea that any estimate of possible overvaluation of house prices, taken in isolation, would have been of immediate policy consequence at that time is not tenable. In fact, the Bank, in the 2006 FSR, had already published estimates showing a range of possible house price overvaluations of up to 70%.

5. Mr. Browne's comments in this section seeks to suggest a concerted policy of misleading readers of the FSR by suppressing information on an update of the McQuinn/O'Reilly (McQ/O'R) model for estimating house price overvaluation. I reject the assertion that there was any attempt to suppress information. I have no recollection of having been personally put on notice that a new estimate of the McQuinn/O'Reilly model had been produced sometime in the summer/autumn of 2007. A recent major search of all relevant sources of information by the Central Bank has revealed no memo, document or research paper setting out the results of an update of this model. Similarly, a search of documents of all relevant committees of the Bank has revealed nothing. In particular, there is no reference in any minute of the FSC meetings held in 2007 of any such update: it is surely inconceivable that a formal update of the model would not have been mentioned given that the authors of the update (or their superiors) attended all these meetings as a matter of course. I can only assume that the model was informally re-estimated by the authors sometime in the summer of 2007 and that this became known to the drafters of the FSR who included the overvaluation number in the version of the FSR circulated on 12 September. I can categorically state that I issued no instruction to delete a reference to the 39% overvaluation figure from a draft of the Overall Assessment section of the FSR.

6. A careful reading of the section in the draft of the FSR of 12 September 2007 in which the overvaluation number is referred to puts the entire process in context and illustrates that Mr. Browne was selective in his concentration on one estimate of 39%. It is worth quoting the relevant section from the draft in full:

> *...Persistent deviations of actual house prices from price levels that could be justified by economic fundamentals result in uncertainty for market participants and therefore instability in the financial system. A significant misalignment also increases the likelihood of a future correction. The difficulty, however, lies in correctly estimating a fundamental price. There are many approaches, differing in complexity that can be adopted to approximate a fundamental price and the size of any deviation. These measures therefore yield a range of overvaluation as opposed to a single definitive estimate. At the current juncture, the recent slowdown in house price*

increases may have helped to reduce any possible overvaluation.

In the FSR 2004, statistical techniques that relied on historical levels of price-earnings ratios and simple discounted cash flow analysis were developed to estimate a fundamental house price for the Irish market. Such approaches treat housing solely as an investment asset. The level of overvaluation estimated by these techniques varied from 4.2 per cent to 77 per cent in 2007Q2. In the FSR 2006, the corresponding range was from 14.2 per cent to 75 per cent and referred to developments in 2006Q2.

In an attempt to capture both the consumption and investment element of housing demand, more sophisticated measures of overvaluation have been developed. A wide array of fundamental economic variables such as disposable income, interest rates, demographics and supply factors are taken into account. As at 2007Q1, this model yielded misalignment of just 4 per cent. A recently developed model of house prices in the Bank, based, inter alia, around the borrowing capacity of house buyers points to an overvaluation of the order of 39 per cent in the first quarter of 2007...

7. Thus, by referring only to an estimate of 39% and not 4% (or indeed any of the other estimates) Mr. Browne is clearly being selective. Moreover, he fails to mention that both the 4% and the 39% estimates were produced by the same economist using different models. He also fails to mention that, using the same methodology, the estimate of 4% overvaluation in 2007 follows an estimate of zero overvaluation in 2006 as published in the 2006 FSR.

8. At a more general level, there is a risk that any particular estimate of house price overvaluation is accorded far too much significance:

   - first, as noted above, a wide range of such estimates is common, depending on the methodology used. It is notable that the ESRI published an overvaluation estimate of 15% for the housing market only a few weeks after the publication of the 2007 FSR (a figure that was reduced to 10% in June 2008). And, as we have seen, even the same expert using a different methodology arrived at markedly different estimates of overvaluation. Also, the 2007 FSR contained Box C which criticized technically the methodologies employed by the OECD, the IMF and Morgan Kelly in estimating the degree on overvaluation in the Irish housing market. This box was prepared by the Central Bank's Economic Services and illustrates that the Bank's economists were actively engaged in providing arguments as to why some of the external estimates of overvaluation were not reliable. Box C, in turn, was criticised in the Honohan Report on technical grounds. These examples illustrate that, from a policy point of view, any particular estimate of overvaluation should be treated with a great deal of caution;

- second, evidence of overvaluation does not, in itself, imply that any overvaluation need by unwound in a disorderly manner; rather it is the period over which the overvaluation is to be eliminated that is critical for financial stability (See IMF World Economic Outlook, Spring 2008). This is also relevant in interpreting the conclusion of the Morgan Kelly article in the Summer 2007 ESRI Quarterly Bulletin. Morgan Kelly estimates on the basis of historical experience that house prices in Ireland were overvalued by 40% to 60% but concluded that this could be unwound over a period of 8/9 years – surely a definition of a 'soft landing'.

9. Mr. Browne's Statement (pp. 43-45) contains a rather confusing narrative on the various drafts of the 2007 FSR during August and September 2007. An examination of the relevant official documents reveals the following:

(i) The Overall Assessment document sent to the FSC on 12 September did contain a reference to a possible overvaluation of house prices of 39%;

(ii) Given that there was no inconsistency between the *analysis* in the Overall Assessment and the Executive Summary, both assuming a 'soft landing', he is incorrect is finding any inconsistency in the conclusions between these two documents; it should be recalled that Mr. Browne's own departmental staff drafted both papers;

(iii) Bank records show clearly (contrary to the assertions on p. 45) that Board papers numbers 111 and 112 (the latter containing a reference to the overvaluation) were distributed to Board members on 21 September: it is simply incorrect to state (as he does, bottom of page 44) that the version seen by the Board was somehow manipulated on the morning of the Board meeting to exclude the reference; Thus, the Board discussion took place with full awareness of the various overvaluation estimates;

(iv) Thus, it is also incorrect to quote Tom O'Connell's testimony to the Inquiry (p. 45) that this information did not reach the Board. It most certainly did.

10. Mr. Browne's view, as set out in the Appendix to his Statement, that house prices were significantly overvalued in mid-2007 is difficult to reconcile with his other actions at the same time. For example, the FSC meeting held on 15 May 2007 at which Mr. Browne was present, discussed possible reasons why estimates of overvaluation produced by Professor Kelly, the OECD and IMF may have

exaggerated the extent of overvaluation; this discussion was led by many of the Central Bank's most senior economists, including the Head of Economic Services. The substance of this discussion formed the subject matter of Box C in the 2007 FSR. The conclusion of the discussion was that 'a fall in nominal prices is by no means an inevitable follow-on to a housing boom'. The minute of the meeting does not record any objection by Mr. Browne to this conclusion. Moreover, an article in the Irish Times of 7 September 2007 by Professor Kelly concludes with a description of an intervention by Mr. Browne at a recent meeting of the Irish Economic Association, as follows:

> *...At a recent Irish Economic Association discussion of house prices, the Central Bank official in charge of financial regulation (whose publications with the ultra-libertarian Cato Institute strongly oppose any form of bank regulation – a real case of an atheist being appointed an archbishop) stopped the proceedings to announce that the view of the Bank was that, as long as the international markets were happy to buy debt issued by Irish banks, there could be no problem with their lending policies....*

11. In a memo of the same date (copy attached), the Monetary Policy and Financial Stability Department, headed by Mr. Browne, strongly objected to the Morgan Kelly analysis concerning the exposures of Irish banks to the property market both in terms of the accuracy of the data used in the article and the robustness of the banking system. This seems to indicate that, at that time in September 2007, Mr. Browne shared the view regarding financial stability set out two months later in the 2007 FSR published in mid-November.

12. These examples show that, in mid-2007, Mr. Browne did not appear to hold the views regarding overvaluation of house prices that he subsequently outlined in the Appendix to his Statement.

13. The above arguments showing the wide variation of estimates of overvaluation and the difficulties in interpreting them, in my view, undermine Mr. Browne's contention that, had a 'true' figure been adopted, a different policy response could have been put in place. In reality, contingency planning for a financial crisis intensified during the final quarter of 2007 and, short of having a Special Resolution Regime in place, the authorities were probably as well prepared as possible at that time. Moreover, given the stressed conditions in international markets it is highly unlikely that any domestic bank could have raised additional capital during the early months of 2008.

Further Responses to issues raised in Appendix 1

14. The following are further responses to some detailed issues raised in the Appendix:

(i) The reference (p. 42) to not being included in the invitation for a meeting of the FSC on 28 August is difficult to understand since the invitation would have been issued by the Secretary of the FSC who worked in Mr. Browne's department and reported directly to him.

(ii) It is inconceivable that an invitation issued for an Ad Hoc meeting on 28 August would deliberately set out to mislead the 17 invitees as to the real purpose of the meeting. The attached copy e-mails in relation to the Ad-Hoc meetings of 22 and 28 August, from the Secretary to the FSC, make clear that their purpose was to discuss recent market developments. To suggest that the real purpose of the meeting was to discuss 'how to manage this very awkward issue' is far-fetched as it would have involved many of the most senior staff in the Bank (including the Secretary of the FSC who, as already stated, reported directly to Mr. Browne).

(iii) Mr. Browne's espousal of the P/E approach to estimating house price overvaluation is referenced throughout the Appendix. He appears to cast serious doubt on the model based approach as opposed to the P/E approach and clearly casts doubt on (until 2007 at least) the estimates produced by the model which were carried out in another department of the Bank. As far as I know, model based methodologies were the standard method used by the OECD, the IMF and the ESRI when preparing estimates of overvaluation, including for Ireland over the relevant period.

(iv) Further, to suggest (p.43) that the discussion at the FSC meeting on 13 September 2007 deliberately excluded consideration of the Overall Assessment because of concern about a newly-discovered overvaluation estimate is unconvincing. The bulk of the meeting was devoted to consideration of the implications of the global crisis which had just started to emerge. The emergence of such an estimate at a time of unprecedented global turmoil is to greatly exaggerate its importance, especially since, as noted above, there was a simultaneous estimate of only 4% overvaluation and, as already stated, the 2006 FSR had put much higher estimates of possible overvaluation into the public domain. Moreover, the relevance of any measure of house price overvaluation was reduced at a time when house prices were in decline (having fallen by 3% in the first seven months to September 2007) and when other risk indicators (growth of credit etc) were showing signs of improvement.

(v) The decision (p. 43) not to proceed with Mr. Browne's paper on liquidity issues was, I contend, fully justified at a time when liquidity problems were at the source of tensions in international financial markets and domestic banks were experiencing some liquidity pressures.

(vi) I strongly contest that the conclusion (p.44) of a 'soft landing' was 'almost beyond belief'. For the reasons why the conclusion of a 'soft landing' was considered appropriate at the time of the publication of the 2007 FSR in November 2007, I refer to the following extract from my Statement to the Inquiry dated 29 April 2015:

> …FSRs do not attempt to predict future adverse events. Rather, their approach is to use economic analysis aided by stress tests to identify and assess areas of risk for the banking system. Using this methodology the 2007 FSR assessed that, on balance, financial stability risks had increased since the publication of the last report. However, the overall conclusion was that the Irish financial system's shock absorption capacity remained robust and that the system was well placed to cope with emerging issues. In the event, the stress tests used bore little relationship to the scale of the crisis a year later. Thus, I fully accept that this FSR, in its assessment of financial stability risks, did not anticipate or communicate the serious crisis that befell the Irish financial system culminating in the guarantee decision at end-September 2008 and the subsequent need for extensive bank recapitalisation.
>
> In considering the reasons for this unduly favourable assessment of risks facing the financial system in November 2007, I would point to a number of factors that may explain why the risks identified did not lead to a better preparation for the crisis:
>
> First, macroeconomic developments have a major influence on asset values. At the time of the publication of the 2007 FSR in mid-November, there was virtual consensus among both domestic and international forecasters that the Irish economy, while slowing somewhat from the growth levels recorded in recent years, would still record robust growth in both 2007 and 2008; second, the global recession and financial market meltdown that followed on from the events of September 2008 were not anticipated by virtually any commentator, at least in terms of its unprecedented magnitude. For example, the ECB increased interest rates in July 2008 just before the latest phase of the crisis. It is generally

agreed that these events had a major impact on valuation of the assets of domestic banks in the following months and years; third, many of the risk indicators (credit growth, house price increases, growth in private sector indebtedness and the banks' funding gap between private sector deposits and loans) that had been of concern earlier had begun to moderate at the end of 2006 and throughout 2007 and thus made the so-called soft landing for the property sector appear somewhat more likely; fourth, evidence of an overvalued property sector does not necessarily imply a disorderly adjustment. The IMF's World Economic Outlook of Spring 2008 can be paraphrased as stating that although a significant house price gap might be expected to be corrected over time, a decline in nominal prices is only one way for this adjustment to occur. Moderate inflation and support from the fundamental variables driving real house prices may also help close the gap over time (IMF, Spring World Economic Outlook, Box 3.1, page 113). A number of papers by academic economists suggested that the adjustment could occur over a period of years; finally, issues which subsequently proved decisive for the solvency of banks, such as risk management practices and collateral quality were not known to the Central Bank.

Although a number of financial market indicators were showing signs of stress, economic forecasts made as late as the summer of 2008 were still anticipating, at worst, a relatively mild recession in 2008 followed by a return to growth in 2009 and beyond. Moreover, price declines were not accelerating in either the residential and commercial property sectors and rents were either increasing, had stabilised or declined only marginally in both sectors, depending on the data source.

Clearly, the scenario outlined in the 2007 FSR is not what materialised. In reviewing internal Central Bank thinking for the period just before the guarantee, a picture emerges that recognized that financial stability risks had increased significantly but, like most commentators, the Bank does not conclude that serious economic and financial disturbance is imminent. This suggests that the confluence of increasing domestic vulnerabilities and international events following the failure of Lehmans and subsequent events in the US and

European markets had a major impact not only on the timing but also on the depth of the crisis in Ireland. This view about the impact of the international crisis appears to be shared by Mr. Regling and Professor Ahearne in their evidence before the Inquiry. Thus, while there were always going to be significant problems as the economy adjusted to a much smaller construction sector and as property prices returned to more sustainable levels, it is conceivable that, in the absence of the worst international recession in 80 years, the necessary adjustments could have been made over a period of years with a reduced cost to the banking sector, to the Exchequer and to the economy and society as a whole...

(vii) The same issue is raised by Mr. Browne in the Concluding Remarks (p.60).

Crisis Management Procedures

Design of the Crisis Simulation Exercises (CSEs)

(viii) The CSE conducted under the auspices of the DSG in December 2007 was largely designed by staff of the Monetary Policy and Financial Stability Department headed by Mr. Browne. Therefore, it is unusual to read that Mr. Browne states that (p.53) it looks like a missed opportunity not to have progressed many of the issues identified in feedback from the domestic CSEs more expeditiously. These relate to the issue of uncertainty regarding the solvency of a bank, the legal issues identified by him as well as testing the procedures and crisis committee structures. Mr. Browne had the capacity and, indeed, the responsibility to ensure the comprehensive testing of all these issues.

Crisis Management Committee Structure

(ix) It is stated (p.54) that Mr. Browne was appointed to only one of five committees set up by me on my appointment as Director General, the implication clearly being that he should have been appointed to some or all of the others. This gives a totally inaccurate picture of reality. First, the Domestic Standing Group was not set up by me but rather by EU mandate in early 2007. Mr. Browne's immediate superior represented the Bank, at a level of seniority consistent with the other members. Second, the working group on liquidity was made up of experts with daily hands-on contact with the banks, which was far removed from the work of the Monetary Policy and Financial Stability Department headed by Mr. Browne. Third, the working group on the Deposit Guarantee Scheme was made up of mainly operational staff with a payments or accounting background, and was chaired by Mr. Browne's immediate superior. Fourth, Mr. Browne was appointed to the Crisis Standing Group. However, as Mr. Browne states, the particular organisational response to a crisis will vary from case to case. In the event, the nature of this crisis as it evolved, and especially the need for a coordinated response across the Bank, the Financial Regulator and the Department of Finance, meant that much of the crisis management work carried out after the crisis started was under the aegis of the DSG. Meetings of the DSG were frequent and documented. In fact, in early October 2008, Mr. Browne was actively involved in discussions with the NTMA on the pricing of the bank guarantee. Fifth, the responsibility for keeping Mr. Browne 'in the loop' should have been carried out by his direct superior, the Assistant Director General for Economic Services, who was actively involved in all the preparatory work. Finally, any suggestion of unfair treatment of Mr. Browne can surely be discounted by the fact that I promoted him to the level of Senior Advisor around the end of 2007.

The Special Resolution Regime

(x) The need for an SRR was fully articulated in one of the first meetings of the DSG in early 2007. It was also recognised that the responsibility for a SRR lay directly with the Department of Finance and not with the Central Bank. At a meeting of the DSG in the summer of 2008 the Department of Finance stated that a SRR involved constitutional issues which could not be easily resolved. And indeed this proved to be the case, as the version of an SRR ultimately introduced in 2010 was much less comprehensive than in other countries.

The Scope of the Guarantee

(xi) Mr. Browne (p.57) states that, in the June 2008 paper on Crisis Resolution Options, his view was that any guarantee should be confined to deposits, which are the payments media in the economy. However, this ignores the legal constraint in Ireland which ensures that there can be no distinction made between deposits and senior creditors. This constraint is acknowledged in page 149 of the Honohan Report. Thus, contrary to Mr. Browne's assessment, the coverage of the guarantee could not legally be confined to deposits.

(xii) Another aspect of this issue also deserves mention. This refers to the assessment in the Honohan Report that only new and not existing liabilities should be covered by the guarantee. Given the legal equivalence of deposits and senior debt, this logically requires that only new deposits should have been covered in September 2008 and not existing ones. However, such a measure would have been extremely dangerous in that all existing deposits above the Deposit Guarantee Scheme limit of €100,000 would no longer be protected, thus almost certainly provoking a significant, if not critical, loss of liquidity for the system. It had been estimated by the Central Bank that the bulk of deposits fell above this limit. This effect would have been exasperated by the fact that all corporate deposits fall outside the scope of the Deposit Guarantee Scheme, thereby also losing protection.

Additional Contributions

(xiii) I have no recollection of receiving the notes mentioned on page 59.

Tony Grimes
23rd October 2015