Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Section 24 Statement of

Liam Barron

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

Response to the statements of Mr. Frank Browne

Preliminary

1. I was Director General of the Central Bank from December 2000 to August 2007.

2. While the following is a response, which I make entirely voluntarily, to Mr. Browne's statement, I consider that as Mr. Tom O'Connell was Mr. Browne's superior (and was also a member of the Bank's Management Board my response is equally applicable in the context of Mr. O'Connell's evidence to the committee.

3. In the context of this response, my written statement to the Committee dated the 30th July 2015 is also relevant.

4. I wish to emphasise that when I use terms below such as "major analytical failure" it is in the context of responding to the revisionist tone and substance of Mr. Browne's statements. I believe that at the time all the analysis and work produced (which I refer to) were of the highest quality, including Mr. Browne's work. It is most regrettable that he has chosen not to defend his work rather than making statements which I consider to be unfounded and baseless.

5. In this submission I categorically refute Frank Browne's central narrative which alleges senior management of the Central Bank were warned about the problems, including the property bubble, in the pre-crisis period (and which then materialised in the context of the greatest recession since the 1930's) and ignored these warnings. This is a grave accusation and appears to have the effect of protecting his own reputation while questiong the reputations of others, all now in retirement.

6. Frank Browne's suggestion is patently incorrect and factually unsustainable. I believe that consideration of the chronology and true factual position applicable at the time supports my view that Frank Browne is incorrect. Indeed, it is unfortunately the case that Frank Browne's statements amount to revisionism based on what appears to be self-serving hindsight and echoes other similar commentary along the lines of "certain contrarians in the bank warned about the impending disaster" and "higher echelons in the Bank refusing to listen".

7.

Having read Frank Browne's statements, including the statement in Appendix 1, his observations are, I believe, selective, vague, and the subsequent confusion replete in his comments render them difficult to address. For example, reference to terms such as "bad news was not favourably received" are replete in Frank Browne's narrative

8. Indeed (as I mentioned above), I believe, that based on the evidence available in the pre-crisis period, the work produced by Frank Browne and other economists in the Bank was of the highest quality. In my view, the quality of the FSRs was of a high standard compared with those of peers. The Bank was the first in the Euroarea to produce FSRs and our FSRs were about 50% longer than the average.

9. Analysis is the bedrock of financial stability and if aspects of it were wrong (which they were) the actions that followed from it - and the communications based on it – would be, *a fortiori*, less effective. It was major analytical failure that caused the Bank's communication in the Financial Stability Reports (FSRs), etc. to be too sanguine. Unfortunately, Frank Browne now seeks to disown the FSRs, in which he played such a constructive central role.

10. In a broader context (and so far as I am aware) most governors of central banks in countries that suffered a systemic crisis (and there were about a dozen) accepted that they significantly understated the risks in the face of the worst recession since the 1930's. In a similar manner, in his evidence Governor Hurley acknowledged, that like other central banks, the Bank underestimated the risks. Importantly, he pointed to many mitigating factors that suggested that the evidence available at the relevant times did not provide the basis for meaningful regulatory action. I share that view.

Mortgage Indebtedness

11. I totally disagree with the manner in which Frank Browne deals with his study on **Mortgage Indebtedness** (at page 46 to page 49 of his submission). It was the most important study in the pre-crisis period and it provided one of the most important foundation stones for the Bank's view that there was no property bubble (this was the mainstream view, both domestically and internationally). In effect, Frank Browne now seeks to disown his own ideas on mortgage te to the postThere is no question that it was Frank Browne's position, based on a solid analytical foundation, that the growth in total indebtedness and mortgage indebtedness over the previous decades could be largely accounted for by fundamentals. The following extract from the Study shows that it was extremely positive in the light of subsequent events (P75 paragraph 2 FSR05) "*excluding these variables the structural model can still account for the vast bulk of the increase in indebtedness over the last 20 years. It is also noteworthy that almost all of the variables which appear as <u>significant</u> in the estimated model point to rapid growth in mortgage credit over the last 10-15 years........this mirrors the conclusion arrived at the Bank's FSR04 that there was no conclusive evidence of overvaluation in the housing market. The risks posed for financial stability, therefore, come in both cases either from a potential deterioration in potential driving forces following one or more shocks to the economy or from <u>future</u> misalignment from fundamental driving forces.*" (Frank Browne's study

on mortgage indebtedness is available under "financial stability" on the Central Banks web site (www.central bank.ie)).

12. At a meeting of the Financial Stability Committee (FSC) in September 2005 Frank Browne stated in his presentation that "*the analysis suggests that a large number of supply and demand factors both structural and fundamental can account for a significant portion of the growth in mortgage indebtedness over the past two decades*".

13. The FSC would have taken considerable reassurance from that statement, especially when it confirmed the no overvaluation results of the two major studies on house prices in the 2004 FSR. That Study became highly embarrassing for Frank Browne and it is easy to see how he is trying to disown it retrospectively. For example, he says that "I was asked to draft it by the Board, and I was asked to regard it as reflecting the position of the Bank". The reality is that Frank Browne, or any other economist, would consider it a compliment for the Board to accept a paper as Bank policy.

14. Unfortunately it appears that Frank Browne is being disingenuous when he implies that the Board would coerce him into turning a personal article into a Bank position. He could have refused. The views expressed in the Study on Mortgage Indebtedness emanated from Frank Browne and from him alone.

15. No member of senior management would have had the capability to carry out the work involved in such a technical article. His comment that, "I did it under severe time constraints during the Summer", is another vague attempt to disown the essence of the Study.

16. In a matter of such overwhelming importance, the Board and senior management of the Bank would have given him all the time he needed if he had requested it. While Frank Browne is indicating that he felt rushed in preparing the article, he should however, have revisited the

issue later. That he never did so, strongly implies that he was happy with his work (that is until the crash).

17. Frank Browne sets out a number of caveats at page 47 of his submission. There are two points concerning these. First, the text does state that the work was preliminary and tentative. This makes it all the more inexplicable that he did not revisit the subject matter. Secondly, he mentions a number of caveats in page 30 paragraph 3, but he did not import them into the text of the article. Again, arising from these important caveats, it is even more inexplicable that Frank Browne did not revisit the issue either to confirm or negate the conclusions of the exercise. The fact is that Frank Browne left that Study on the public record for the remaining pre-crisis period.

18. Frank Browne, on his own initiative, embarked on a major research project (that was analytically brilliant) but which the subsequent global recession proved to be totally wrong. He should have accepted this fact. His efforts to retrospectively try to exculpate or disassociate himself while attempting to push a responsibility onto the Board and senior management is grave and lacks any credibility. Frank Browne is seeking to retrospectively evade responsibility for the relevant study because it had the most profound negative consequences. As is evident from the extract quoted above the study provided false comfort- especially to the markets- on the increase in indebtedness over the previous 20 years and mortgage credit for the previous 10-15 years. It reinforced this by the conclusion that the analysis in the Study mirrored the results of the two FSR04 Studies that found that there was no conclusive evidence of overvaluation in housing. Frank Browne's work could have provided a strong basis for senior management to soften the warnings on both aggregate credit and mortgage credit in the FSRs. That it did not do so completely undermines Frank Browne's assertion that senior management liked to put a positive slant on the analyses in the FSRs. More seriously, the Study could have weakened the impact on the markets of the Bank's warnings. In the

circumstances, it is inexplicable how Frank Browne could possibly seek to maintain a suggestion that senior management and the Board were informed about the property bubble or that they tended to water down the results of the analyses.

19. Frank Browne's Study on mortgage indebtedness is a celebration of the market liberalisation - now being reversed - that took place in the decades leading up to the crisis. (It is notable that when this article was written, property prices were close to peak.)

20. The following extracts demonstrate the upbeat assessment of financial stability in this Study:

(a) "A demand-side manifestation of this wave of liberalisation and financial innovation affecting the loan market in Ireland is **increasing loan-to-value ratios**. The loan-to-value ratio is assumed to capture the gradual relaxation of liquidity constraints facing borrowers in the loan market as agents availed of the more liberal conditions in the loan market to build up to their target levels of indebtedness. Starting from a situation in the mid-1990s in which there is likely to have been **substantial pent-up demand** for mortgages, financial market liberalisation would have allowed households to give vent to that demand. The loan-to-value ratio is used as a proxy for the effect of this liberalisation on the demand side of the market. It should therefore have a positive effect on the mortgage loan stock." (P66, para 2.1.2) The reference to substantial pent up demand is ironic. Rather than pent up demand the world was experiencing the greatest credit-fuelled bubble in history;

(b) Developments in public debt are employed to show that Ireland's aggregate indebtedness was stable at around 160% for the previous 15 years. The article states "with reduced need for Government debt, households are now finding it more affordable to fund growing private sector indebtedness." (P67, para 2.1.4). The public sector debt is included in the regression equation;

(c) Demographic effects are also positively invoked. (P72 para 2.2.1). The article states that "It is clear that in about the mid-90s this ratio began to increase more rapidly. It is noteworthy that this increase commenced more or less at the same time as the credit and house price boom began";

(d) The article also states "Financial liberalisation involves the removal of regulations and controls from financial markets, thus allowing the free interplay of supply and demand to determine the appropriate outcome in each market. Credit controls, interest-rate controls and exchange-rate controls for example tend to create an environment of financial repression where participation in financial markets is constrained. Removing such regulations and controls allows banks and other participants in financial markets more freedom to participate in these markets";

(e) The article also cites the following, as positive explanatory factors in relation to mortgage credit growth: portfolio behaviour of lenders; funding base of lenders; declining credit default risk; and the reduction of the liquidity rations;

(f) The most remarkable passage in the Study relates to **product innovation** in the context of global financial liberalisation. The Study states that product innovation "can be seen for example, through the introduction of products such as "interest-only mortgages" and the newly introduced "100 per cent mortgage" (P71 para 2.6);

(g) The article then goes on to state "credit institutions are now offering mortgages with longer maturities than in the past,(up to 35 and 40 yrs in some cases) and are willing to lend at higher debt-to-income ratios than previously. Unfortunately, it is not possible to capture such a nebulous phenomenon as financial innovation in a single variable that could be included in an econometric analysis"(P72 para 2.2.6);

(h) The article also states that "the result, based exclusively on demand- side factors can explain over 99% of the total variation in the real mortgage stock". (section on model returns, P72 para 2);

(i) The Study also states that: "The gradual liberalisation of the loan market, as proxied by the loan-to-value ratio, would seem to be a significant factor behind the expansion of the mortgage market". The foregoing suggests that Frank Browne may have regarded high LTVs - including in particular 100% mortgages - as a positive in the pre-crisis period. This may explain why he never suggested any restrictions be applied to them. It seems that he considered that as a proxy for financial liberalisation the higher the LTV the better. Frank Browne's position is of significance in light of the fact that restrictions on LTVs were probably the most suitable (as evidenced by their adoption by the Central Bank now) regulatory measure that could have been applied in the pre-crisis period. (Measures relating to capital were constrained by superequivalance in the context EU Directives);

(j) The article also states: "Therefore, excluding all non-fundamental and endogenous forces the vast bulk of the variation in the real mortgage stock can still be accounted for in terms of the remaining fundamental variables";

(k) The conclusion (P74-75) contains passages in terms of positivity that subsequently proved to be so misplaced. The Study indicates that there was a widespread impression that the Irish economy had embarked on a borrowing binge and that the issue to be addressed was whether this rapidly escalating mortgage indebtedness was a cause for concern from a financial stability perspective. It then quotes the negative assessment of the IMF that rapid rates of credit growth had in the past been a leading indicator of future financial fragility. Most significantly, the text goes on to state "*this conclusion must be tempered by the observation that not all credit booms in the past had the same consequences. Some had just fizzled out.*" The conclusion also states that "*however, excluding these variables, the structural model can still account for the vast bulk of the increase in **indebtedness** in Ireland over the last 20 years. It is also noteworthy that almost all of the variables which appear as "significant" in the estimated model point to rapid growth in mortgage credit over the last 10 to 15 years.*" I do not in any way blame Frank Browne for any of the foregoing. It was the orthodoxy of the time which I shared. My issue is with the attempt at revisionism.

21. Apart from indebtedness the most significant conclusion in the Study is that this (i.e. the study) mirrors the conclusion arrived at in the Bank's FSR of 2004 that there was no conclusive evidence of over valuation in the Irish housing market. To reinforce this conclusion the Study states that "the risks come from a future misalignment from fundamental driving forces". The Study concludes with the positive point that "..... the rate of growth of mortgages should slow over the medium term..."

22. Frank Browne is now presenting himself as a pessimist which I never considered him to be in the past despite his views on global liquidity. Rather, as the Study shows, Mr. Browne tended to be upbeat and optimistic and his belated pessimistic approach appears to be aimed at emphasising a forensic yet retrospective approach which seeks now to accentuate the negatives to the exclusion of a vastly greater number of positives.

23. Frank Browne states in page 34 paragraph 3 (final 2 lines) that "our presentation slides note ***sardonically*** that house prices will have now

apparently have a soft landing and the primary risk seems to have shifted." [Emphasis added] The reference related to the shift from house prices being the main risk to international risks. I believe that it is likely that this suggestion came from Frank Browne's department, not senior management, but if it did it would have been soundly based. It was analytically predicated on Frank Browne's article which objectively justified the shift in emphasis that occurred. His use of the word "sardonically" is therefore entirely refuted.

House Price Valuations

24. Page 29 of Frank Browne's submission states that "my efforts to home in on the elusive fundamental house price relied on the well accepted and respected finance-based indicators, that is P/E & PV ratios". He omits, however, to add the major qualification that these ratios are not valid for owner-occupied properties, which represented the bulk of residential property. This is clear from page 60 at paragraph 4 of FSRO4 which states that the P/E & PV models looks at the demand for residential property only from an investment perspective. The text goes on to suggest that a more encompassing approach is, therefore, needed to take account of the demand while also accommodating investment demand.

25. Paragraph 6, page 51 makes essentially the same point with somewhat different language. Section 7, page 69 makes the following very positive assessment of house valuations. It states that " most comments so far have been about price developments relating to owner occupation. The assessment here is that it is not at the moment a cause for concern for the financial stability perspective". The foregoing is a clear refutation of the claim *now made* by Frank Browne that he accepted the P/E & PV models of housing valuation.

26. This refutation is reinforced by reference to Frank Browne's reaction to Professor Mogan Kelly's views in December 2006. Had Frank Browne

been an adherent to the P/E & PV models he would have agreed with Morgan Kelly. There is objective evidence on the public record in Box C P30 of FSRO7 that he totally disagreed with Morgan Kelly's views. Moreover, I never heard Frank Browne say at the time that he had agreed with Morgan Kelly or indeed any other contrarian; the opposite was the case.

27. The significance of the foregoing is that Frank Browne is now reliant on the P/E & PV models to support an allegation that senior management and the Board were informed about the overvaluation of residential property in time to take action. That is simply not correct. Indeed, I believe that the foregoing provides overwhelming and objective evidence that Frank Browne did not accept the P/E & PV models in the context of residential property, a large proportion of Irish property and furthermore seriously undermines the credibility of Frank Browne's submission in the core area of housing valuations. This objective evidence is fully in accord with my own recollection that Frank Browne never represented the P/E & PV ratios to be superior to the alternative models. Discussions during the pre- crisis period almost exclusively referred to models other than the P/E & PV models.

28. Further, it negates most of the detailed points on housing valuations in Frank Browne's submission. As I observed earlier, it is also very relevant that Frank Browne made no reference to commercial property. This is of major importance because virtually all of the costs to the tax payer will be in respect of commercial property, not housing. Frank Browne fails to refer to the lack of any risk assessment – and its consequences – of commercial property in the pre-crisis period.

29. Senior management at the Central Bank were not informed that there was an overvaluation of house prices, based on the structural models chosen by the Bank. They were told nothing in respect of commercial property with the implication that-because of correlations between the two sectors-there was also no overvaluation in commercial property. In

the light of the problems that emerged in relation to commercial property, this is a serious analytical failure.

30. Thus, the failure was twofold: a failure to identify overvaluation both in commercial property and residential (housing). This explains why the wording of the FSRs proved retrospectively to be too sanguine. It was not due to overcautious drafting. I totally reject and refute Frank Browne's unfounded allegations against senior management of the Bank on the issue of property valuations, both residential and commercial. Frank Browne did not warn of the risk of bubbles in property. Two major studies in the 2004 FSR concluded that there was no evidence of misalignment. Significantly, Frank Browne's own study of mortgage indebtedness in the 2005 FSR concluded that the bulk of the mortgage indebtedness over the past 15 to 20 years could be accounted for by fundamental factors. This was seen in 2005 as confirming the no overvaluation conclusions of the two 2004 Studies. To conclude the Study provided justification for the decision by the bank not to take any action at that time.

<u>Frank Browne's criticism of the McQuinn model</u>

31. In relation to Frank Browne's criticism of Kieran McQuinn, it appears from his submission that Mr. Browne now interprets Kieran McQuinn's work as an intrusion into his area of competence and responsibility. I do not accept any such criticism. It is entirely unwarranted. I always encouraged economists in various areas to contribute signed articles for the FSRs. From an organisational point of view it was important to have a cross-check and the work of the FSD is such a critically important area as property valuation. Additionally, I note that Kieran McQuinn, who holds a Doctorate in Economics, is now a Professor at the ESRI. The fundamentals approach (as opposed to the P/E and PV models) adopted by Kieran McQuinn in the 2004s FSR was also the approach adopted by Frank Browne in that same FSR. Both studies had similar results.

32. Senior Management obtained major reassurance from the fact that analyses (both implying the fundamentals approach) conducted in two separate areas of the Bank, and without contact with each other, essentially came to the same conclusion, namely, there was no evidence of overvaluation in the housing market.

33. In his criticism of Kieran McQuinn's involvement in housing valuations, Frank Browne *inter alia* states *that: "financial stability is mostly focused on the exceptional high impact events occurring in the tail of the distribution"* However, in an internal document produced by Frank Browne's Department sometime in the post crisis period (probably 2009) states that *"financial stability is focused on identifying the potential sources of risks and vulnerability in any of the components of the financial system as well as potential shocks both domestic and external that might trigger these vulnerabilities."* The document also states that it is impossible to attach any estimate of the probability of such shocks being realised. The second quotation from the internal memo is a typical description of the financial stability functions conducted internationally.

The origins of the phrase "soft landing"

34. The soft landing arises in the context of the December 2004 Roundtable.

35. In his submission (page 38) Frank Browne states that "I presented ***my*** paper on house prices" [Emphasis added]. This was a major study running to 22 pages. Aside from the caveats, the central message conveyed in the study was that based on structural models there was no evidence of overvaluation, (P 51 FSR 04). Specifically, in relation to owner-occupied property (a large proportion of total property), the Study states at page 69 that "the assessment here is that this is not at the moment a cause for concern from a financial stability perspective"

(page 69 FSR 04). The overall positive assessment in the Sstudy would have given a lot of comfort to the Banks' representatives, especially as some observers were starting to question housing valuation at that time. Given that the central message was quite positive it was only a matter of how it should be described. It could, for example, be described as "that it was unlikely that there would be a crash", or "it was not likely that there would be a hard landing". Analogous wording "soft landing" was used and the analysis in that study justified that description. Therefore, the drafter of the Note on the Roundtable would have been fully justified to indicate that there was a consensus around the CBFAI's view of a soft landing, and with downside risks being stressed.

36. In his submission Frank Browne states that the wording "soft landing" had **obscure** origins. This was not the case, as it was fully justified by the paper (based on the text of the 2004 FSR) that he presented to the Roundtable. Pages 38 and 39 of Frank Browne's statements are, I believe, selective and misleading. There is no reference to the structure or model described in the study that gives no evidence of overvaluation. Frank Browne seems to be now trying to disown the structural models in the Study. In his statements, Frank Browne criticises the concept of a Roundtable with the banks before or after the publication of the FSRs. I found this surprising since he seemed to be an enthusiastic supporter of the Roundtable format and he and his staff made extensive presentations at them. The primary benefit of the Roundtable was to reinforce the messages in the FSR's but they also provided the Central Bank an oppportunity to hear the banks' views. The Financal Stability Committee (FSC) was receptive to the idea of meeting the banks representatives before publication of the FSR's and my recollection is that Frank Browne was also in favour of that.

37. Due, I presume, to workload considerations, I do not think that we managed to meet the banks before publications of FSRs in my time. One of my motivations in initiating the Roundtables in 2004 was related

to the division of the Bank in May 2003. In contrast to the past, the Banks' side of the organisation had much reduced contact with the banking community, with the risk that it would be perceived as an ivory tower, with bureaucrats thinking that they had the monopoly of wisdom. The apparent position adopted by Frank Browne in his statements apears to be that any kind of consultation with the banks would influence in a negative way the Central Bank's views on various matters. However, the refusal to even exchange views smacks of an ivory tower attitude. Consultation with banks is routinely conducted by central banks. It is notable, for example, extensive consultation with the banks was conducted by the Central Bank last year before the implantation of the LTV & LTI rules.

The views of Professor Morgan Kelly

38. Professor Kelly made a prediction in December 2006 that house prices would fall by 40-50% over the following 8 or 9 years. He did not say that a crash was imminent so his views were balanced and moderate compared with what subsequently transpired. Frank Browne totally dismissed, in the strongest of terms, Professor Kelly's views. He invoked the IMF's view that past experience of house price crashes would not be repeated in the more benign conditions of the 1990's. This view reflected the conventional view that "This Time is Different" as described in a book of the same title by Rogoff and Reinhart. That belief was shattered by the crisis. Frank Browne also cited a number of reasons in his rebuttal of Morgan Kelly's views. For example, his reference to Professor Kelly being wrong to use real house prices and that there was no experience of nominal house crashes in the past. He also made the point that in over half of the housing bubbles in the past there were no subsequent crashes.

39. The views expressed by Frank Browne in December 2006 are set out very clearly in Box C page 30 in the 2007 FSR that was published at the end of 2007 (when, incidentally, property prices were very close to

being, or were, at peak). There was very little discussion at the FSC on Morgan Kelly's views. Frank Browne's dismissal, invoking the respected views of the IMF meant that there was little to say. However, I recall that there was a lot of discussion in the Bank on Morgan Kelly's views which were so controversial. However, these discussions were muted because of Frank Browne's strong rebuttal on sound analytical grounds. Frank Browne's position was understandable at the time. If he agreed with Professor Kelly's views he would have accepted that his and the Bank's position, that there was no overvaluation in house prices, was wrong. It would also mean that he accepted that his own study on mortgage indebtedness was wrong.

40. It is important to stress that the Bank's views, including those of Frank Browne, on property prices were mainstream. There were only a few contrarians (and they were late in the post-crisis period) of which Morgan Kelly is the most prominent. The relevance of Morgan Kelly's views in the context of Frank Browne's submission is that it provides further evidence in writing (box 3, page 30 FSR 2007) that Frank Browne was not a proponent of the P/E and PV models of property valuation. If he was, he would have agreed with Morgan Kelly's views because, even though he didn't employ the P/E and PV models, his views were in line with their results. There is, therefore, a retrospective invocation in his statements of the P/E and PV models. The basis of Frank Browne's alleged timely warning of senior management about a bubble in property prices would have to have been at least as far back as 2004. This simply did not occur. The evidence is in writing in the FSR's that they did not; indeed, rather than warning about the property price bubble, they did the opposite and they based their conclusion on solid analytical work in the FSR's 2004, 2005 and 2006. The approach which is apparent in Frank Browne's statements is to assemble a large number of (negative) extracts (mostly without giving context) that would give a negative impression of senior management. The reality,

however, is that Frank Browne did not warn about the bubble but rather provided reassurance that there was no evidence of a bubble.

The Production of FSRs

41. Page 26 in the text is misleading. Frank Browne rightly states that prior to 2004 the FSRs were largely departmental work but of course the Bank would own it ultimately. This practice was common in central banks generally. For example, while the Swedish Central Bank was the trail blazer in producing the first FSR in the late 90's, it only began to bring their FSRs to the Executive Board in about 2009 post-crisis. (See Kansas Federal Reserve Bank Study referred to in footnote 100 in the Honahan report).

42. In 2004 I decided to raise the organisational profile of the FSRs in a significant manner. This made the Central Bank something of an exception in terms of comprehensiveness of the financial stability process amongst central banks internationally. My clear recollection is that Frank Browne did not like this radical organisational change and would have preferred the status quo in which he had more autonomy. The more comprehensive treatment which was required in respect of the FRSs did indeed mean that it would require much more work on the part of administrative staff producing those reports, and I am surprised that Frank Browne would use the word 'tedious' to describe critically important administrative work. The reason for constant drafting was due to the fact that numerous comments were sought on a bilateral basis, including Board and Regulatory Authority members. Back up staff were responsible for ensuring that the different tasks of the lengthy FSRs remained consistent. In fact the editing by senior management was solely aimed at the transmission of a coherent message.

43. Frequently the drafts going forward were quite diffuse which is why at one stage I decided that more precise and focus summaries were needed.

Liquidity

44. I have a fundamental problem with the manner in which Frank Browne deals with liquidity.

45. I consider the matter to be simple in so far as it pertains to practice. The Bank had no control over liquidity in Ireland. I believe that Frank Browne should have stressed this fact. The fact that he did not do so is highly relevant. By not doing so, it allows him to make vague but very serious unfounded assertions against senior management. The issue was as follows: given that the Central Bank had no control over liquidity what could be done in practice from a financial stability prospective.

46. Without exception central banks in the Euro area did not take action to influence liquidity in there economies in the pre-crisis period. Post-crisis a major effort is being made with the application of the new macroprudential framework that is still a work in progress. Frank Browne was a Senior Executive and it was not sufficient for him to point out, at the conceptual level, risks associated with excess liquidity. If he had practical ideas it was his duty to formulate concrete proposals for action. He never did so, and I think with justification, because it was extremely difficult if not impossible to formulate practical proposals.

47. I take exception to the apparent disingenuous manner in which Mr. Browne deals with liquidity. He uses words like "senior management didn't like to hear about liquidity". The reality was that nothing much could be done about it as evidenced by the fact that Frank Browne made no proposals on the matter. In summary, I consider that the manner in which Frank Browne treats liquidity is unacceptable and I

totally reject it. Also, I note with regard to Anex I of his statement the fact that 7 of the 13 studies referenced relate to the *post-crisis* period.

48. At page 49, paragraph 3 Frank Browne states that he was not aware of any other paper domestically or internationally that flagged the possibility of the crash in advance of its occurrence. I note that the word "possibility" is not a prediction. I consider that his claim is quite exaggerated and selective. For example, in another major study on the decline in the volatility of output (P111 FSR05), it is stated that ".....periods of systemic stress are likely to be fewer and less severe. Lower output growth volatility over time reduced the probability of a recession occurring and when one does arise, the depth of the recession is likely to be less than in the past......Lower output growth volatility is in its own right likely to be supportive of financial stability". The study includes caveats.

49. Another major study by Frank Browne on future trends in banking (p63 FSR06) is overly positive in the light of the crisis. For example, one of the conclusions is that: "the picture that emerges for financial stability is quite positive" (P94 para 3 FSR06) it includes caveats.

50. In reading Frank Browne's statements I found it difficult to distinguish between three separate related issues: firstly, global liquidity; secondly, Euroarea liquidity as measured by M3 and; thirdly, funding from the Banking Sector. Each of these matters should have been addressed by Frank Browne separately as the manner in which they were treated by him is confused and therefore makes it difficult to address allegations of "no action etc" against senior management. It is in this general context of liquidity that I would have used on occasions such phrases as "riddled with bullets", Central Banks have mucked it up", and "this is highly political". I would have appreciated it if Frank Browne had made it clear that, when using this latter phrase, I was not referring to Ireland.

Stress tests

51. At page 79 paragraph 3, Frank Browne states that he was warning about a tail event in the context of the banking system. It was not so. It was insufficient for Frank Browne as a senior executive to point to potential problems at the conceptual level. Rather, his responsibility was to propose a concrete course of action for decision by senior management. It is very easy to make academic observations about a tail event but much more difficult to formulate action. Frank Browne did not propose any action. Even today, in the context of the Euro area and other currency areas there is a risk of a tail event. However, as far as I know, it is not possible to formulate and base policy on a very low probability event and the ECB and all other central banks are probably acting accordingly.

52. The invocation of the tail event is disingenuous. It would appear that the purpose of referring to it is to gloss over major analytical failure. Furthermore, it could also amount to failure at an executive level by Frank Browne if he considered some action was needed to be taken and did not promulgate options for action by senior management. (This was routine practice in all the other departments in the Bank). Senior management could not in isolation develop options as this required the highly technical skills that resided in FCD. This means that many of his criticisms of senior management are misplaced. He did not at any time prepare options for action, for example, a proposal to issue a formal guideline to the financial regulator under the provisions of the 2003 central bank act. It seems from Frank Browne's statements that he regarded himself as an academic economist like those in the ESRI, the banks and the universities; that was not the case because the primary responsibility of all departmental managers was executive.

53. Far from warning senior management about potential problems in the banking system, all the stress tests (both top-down and bottom-up) gave very reassuring results on the resilience of the banking sector.

54. Frank Browne has no justification in making the following statement in the last sentence of page 79 paragraph 4: "In retrospect, I would be willing, even in the light of the extraordinary event, to stand over these results". As in the case of his claim that he warned about the property bubble when, in fact, it was the opposite, the precisely same consideration holds with respect to the resilience of the banking system.

55. Again, I attach no blame to anybody in the bank (including Frank Browne) for setting adverse scenarios which, because of the unprecedented nature of the crisis, turned out to be far too mild. The same was true of the stress tests of all central banks who could not have predicted the crisis. Indeed, it was very late in the crisis- and after expenditure of enormous resources- that stress tests emerged which were credible to the markets.

56. I believe that Frank Browne could have produced strong support for the scenarios used. For example, they were as stringent as those used by the Bank of England and more stringent than those used by the Bank of Spain and the Bank of Finland. This again underlines my point that rather than criticising senior management, Frank Browne could have provided a good argument in favour of our stress tests. While they were, in my view reasonable in the light of the available evidence, they represented a major analytical failure in the light of the crisis.

The Equilibrium Mortgage Rate

57. At page 49, paragraph 2 of his statement there is an assertion by Frank Browne that the 6% equilibrium mortgage rate was "not taken seriously by senior management". This assertion is without foundation. Senior

management considered that the analytical work on the equilibrium mortgage rate to be excellent. When discussing it, for example, at the Roundtable, it was very helpful to be able to base our views on analysis rather than opinion. It is important to note that in our comments on the 6% rate we did not add the major qualification in the analysis which was "that unfavourable increases in mortgage rates were unlikely in the short term.... and that it was something that would happen in a longer timeframe (probably 3 to 7 years from now)" (P 136 last paraFSR05). The Governor and I did not refer to that major qualification (with its very positive import). This was because the ECB was 'behind the curve' compared with the FED and the Bank of England in late 2005. We knew that, based on the experience of the previous ECB tightening cycle that once it started to raise rates it would do so aggressively, as so happened after the first rate increase in December 05.

The Financial Stability Framework

58. I consider that for a correct perspective to be given, Frank Browne should have stated in his submission that in the pre-crisis period, the financial stability framework normally practiced internationally moral suasion, was the only instrument employed. The financial stability framework has now been radically altered to include actions as well as moral suasion.

59. Regarding the issue of senior management toning down the language in the FSRs, there was a serious issue which Frank Browne fails to point out. That is the delicate trade off that must be achieved in the financial stability function between positively influencing the markets and destabilising them, for example, by precipitating a property crash or a run on a bank. Thus any changes to the text of the FSRs were made by senior management in that context. They represented a professional judgement which they were statutorily obliged to make.

Frank Browne was always aware of this delicate balance but he ignores them and adopts a populist posture in his submission.

60. In so far as the monetary policy function in the Bank is concerned, Frank Browne was not responsible for advising the Governor on the interest rate stance – the main pillar of the ECB framework that related to inflation targeting. Rather, his role related to the monetary pillar M3 which had been relegated to the status of cross check on the interest rate stance of the ECB. In constantly referring to the excess of M3 over benchmark, the implication was that the ECB interest rate stance was wrong.

61. In retrospect Frank Browne's position proved to be wrong. Even with M3 at well in excess of the benchmark, the ECB very successfully met is 2% inflation target throughout the pre-crisis period. It was an outstanding achievement for a newly established Central Bank. The interest rate policy of the ECB proved to be correct. Frank Browne's position in relation to M3 was far too inflexible.

62. In fact, in the 70's and early 80's when I was a member of the Foreign Exchange Committee of the Bank for International settlements, it is very clear to me that the Bundesbank was very pragmatic in relation to the money supply and I think even the target was changed from time to time. The Bundesbank ethos was reflected in the ECB's tolerance for M3 being well above target for much of the time in the pre-crisis period. It may be noted that the membership of the Governing Council included the Governor of the Bundesbank and an ex-Bundesbank member was the Executive Director in charge of monetary policy.

63. It could be argued that it was implicit in Frank Browne's attitude that the Governor should have advised the Governing Council to adopt much higher interest rates. If, hypothetically, the Governing Council accepted such views the result would be to breach the inflation target

on the downside, with the resulting negative impact on an already sluggish Euro area economy.

Liam Barron
26th October 2015