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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Mary Harney

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Statement by Mary Harney to the Joint Committee of Inquiry into the Banking Crisis

Introduction:

I appreciate the opportunity to assist the Committee in its work. I have attempted in this summary to deal with the specific lines of inquiry requested of me but am of course ready to help the Committee in whatever way I can. I have been asked to refer to the period from 1997 onwards during which I served as Minister.

The strategic focus of these governments was to stimulate employment by increasing the competitiveness of the economy, to reduce unemployment and long-term unemployment in particular and to raise living standards in a sustainable way. There were significant successes in this regard but ultimately a failure to read and respond to the signs of the impending crisis.

I am proud of the economic and social achievements over that period. Unemployment was brought down from close to double-digit levels to around the 4-5% range for many years – ensuring, in broad terms, that the vast majority of people who wanted a job could get one. Net emigration was replaced by net immigration. Take-home pay grew significantly. The national infrastructure was improved beyond all recognition, perhaps most visibly seen in the new motorway network. Investment in science and technology was ramped up to help sustain growth into the future. Social expenditure, pensions and other welfare payments grew notwithstanding the absolute reduction in unemployment. The Exchequer ran a budget surplus in every year bar one from 1998 to 2007, shrinking the national debt. And the tax burden on individuals was sharply reduced, while spending on public services grew rapidly (perhaps too rapidly, I will come back to that point later).

But those governments also made mistakes, which I certainly regret. I would identify three principal errors.

1. We did not foresee the enormous explosion of cheap credit from the early part of the last decade – an explosion which in large part was the result of the adoption of the euro, which brought interest rates down to extraordinarily low levels by Irish standards and also vastly increased the potential supply of credit in Ireland. A more careful assessment of risks and consideration of new policy instruments was needed following introduction of the euro.
2. More proactive monitoring/reporting mechanisms to Government/Oireachtas giving regular assessment of financial stability could have helped to raise awareness of risks. While the Central Bank/Financial Regulator had powers to rein in excessive credit growth, especially by domestically regulated credit providers and respond to inappropriate concentration of that credit in certain sectors, government and Oireachtas oversight of these independent institutions was not vigourous enough. I believe that as a Government we had undue confidence in the new financial regulatory

regime and stood too far at arm's length when there were serious signals to be read in the economy. That was clearly wrong

3. Finally, we allowed public spending to grow too quickly on the back of unprecedented tax growth, and we underestimated the multiplier effect of excessive and unsustainable construction activity and property transactions on the economy as a whole and the public finances in particular.

That, with some notable exceptions, the general commentary through the years up to the crisis was benign perhaps helps to explain some of these errors. It does nothing though to ease my regret that we as Government had a heavy responsibility for not digging deeper, asking harder questions and taking (unpopular) decisions before we did from 2008 onwards.

Appropriateness of macroeconomic policies (R1c and R2b and R5c):

A broadly consistent macroeconomic stance was adopted through the course of the 28th, 29th and 30th Daileanna. It is necessary however to distinguish the period before and after Stage III of EMU in 1999. Low interest rates in the Eurozone with ready access to large sources of cheap finance clearly affected the path of the economy from 2000 to 2008 and question marks certainly hang over our policy response to the emerging situation.

Macroeconomic policy during the period had the following features:

- Widening of the tax base accompanied by reductions in tax rates
- Very large growth in capital spending on infrastructure and similar projects
- Substantial growth in day-to-day government spending,
    - much of it in the form of public sector pay;
    - welfare payments;
    - health care; and
    - other public services
- A focus on competitiveness issues that would generate employment and in particular that would make Ireland an attractive location for international businesses to access the single European market.
- Diverting some of the large Exchequer surpluses of the time into what was effectively a "rainy day fund", the National Pension Reserve Fund.

In my opinion these were the correct set of policies up to the time we joined the Euro. With the benefit of hindsight it is clear that some significant policy adjustments were needed from about 2001 onwards. A healthy export-led success began to turn into a property/construction-led boom that sowed the seeds of crisis.

Rapid economic growth was generating large government surpluses.

It made sense to invest these funds in infrastructure projects not least because Ireland's infrastructure was lagging far behind our competitors at the time – e.g. the lack of a motorway network of any kind.

It also made sense to set aside some of the surplus to go into the NPRF, but the reality was that the 1% of GNP that was set aside for that purpose was the maximum feasible as there were many other calls on the government surplus.

It made sense to reduce the very high income tax rates that were being paid, particularly by middle income earners.

It also made sense to widen the tax base by reducing various incentives that had been in place to encourage, for example, property investment in urban renewal and tourism development.

And yes it made sense to increase day-to-day government spending particularly in areas like pensions and welfare, education, health and innovation. However spending was allowed to increase too rapidly as the economy overheated with continued growth and the exchequer finances becoming over-dependent on construction. But no one in the political arena was calling for the kind of restraint that in hindsight we can now see could have eased the later pain.

So in overall terms I believe that the broad thrust of macro and indeed general economic policy of the time was correct but it needed the imposition of a heavier hand of restraint from the early 2000s onwards (notwithstanding the relatively modest budgets of 2003 -2004 in the context of an international slowdown). Given the absence of control over interest rates which up to then was under domestic control, the key relevant and potentially effective policy instruments would have been fiscal and incomes policy. What was done was within the constraints of the political system. Some might argue that it would have been more prudent to run up even more massive budget surpluses during that period, increase taxes, reduce the national debt even faster and give nothing back in terms of welfare payments, spending increases or tax rate cuts. But that just does not reflect reality and I am not aware that any political party – indeed any economist? – was advocating such a policy at the time.

Prudential Policy (R2b):

I have commented on Government's lack of awareness of the growing risks in relation to Financial Stability in the lead-up to the crisis – an omission that one hopes is unlikely to be repeated given the huge focus on regulatory implementation since then.

It would be appropriate for me to deal here with my role, as Minister for Enterprise, Trade and Employment, with policy on financial regulation, in particular, the re-organisation of the Central Bank and other regulatory authorities over 2001-2003.

A wide range of investigations were initiated by me from 1997 onwards into financial institutions including Guinness Mahon, Irish Intercontinental Bank and the National Irish Bank – all providing evidence that regulation was not effective. I was of the view that a new, more effective form of regulation was required.

I was also keen to ensure that regulation of the insurance sector and of Credit Unions, which was a responsibility of my Department, was not isolated from broader financial sector regulation and that a consistency of treatment and expertise was applied across the industry. There was a trend towards banks getting more involved in areas like life assurance and pensions. I was also concerned about consumer protection issues, which had clearly been deficient in the Central Bank's regulation.

My concern in this was to ensure that there was better, stronger and more effective regulation in the public interest. Indeed I also moved to strengthen the oversight of Company Law by establishing the Office of the Director of Corporate Enforcement at that time.

The Government agreed in 1998 that in principle there should be a single financial regulator. A majority of the group set up to review options (chaired by Michael McDowell SC) recommended that there should be a "greenfield" new organisation to regulate the financial sector. The Central Bank and Department of Finance disagreed. They were of the view that the Central Bank itself should be the new single financial regulator. A compromise arrangement was also mentioned in the report.

Discussions followed with the Department of Finance. A compromise structure emerged. The Department of Finance was clear that if an operationally independent Financial Regulator was to be set up within an over-arching structure including the Monetary Authority, the Governor in person – not the Central Bank - would have to have the authority to issue binding instructions to the Regulator when a matter of financial stability arose. This was because "the Governor was a member of the ECB".

It was agreed with the Minister for Finance that we would both propose the new structure to the Government with this power for the Governor included. The Government agreed in February 2001. It was enacted in legislation two years later.

Advice (R4a an R4c and R5b):

I was not involved in the selection of expert consultants/advisors to Government (nor had any interaction with them) around the time of the Banking crisis so I cannot usefully comment on that issue.

With regard to contrarian advice, this is always a most difficult issue for government ministers. On the one hand, is one supposed to take the advice of one or two external experts who profer advice that is completely at odds with the advice issued by the relevant government departmental staff, with all the expertise and experience that the civil service can offer on the issue? On the other hand, should one really ignore external views simply because the official civil service has a different view? The truth is somewhere in between, of course. It is important to have regard to external contrarian advice and to use that advice, for example, to frame internal discussions and pose questions to internal advisers. In my time as a government minister I frequently took external, often contrarian, advice on many issues and in some cases I overruled internal officials as a result. However, this would normally be confined to my own department as it would be even more difficult to dismiss internal advice coming from another department, in practice.

In fact, there was in any case very little external contrarian economic advice during the run-up to the crisis. Dr Morgan Kelly did raise some challenging issues, but I did not at the time take his arguments on board – even if he did say it was too late to avoid a crash when he published in 2006.

With regard to the internal advice and expertise available to the government, this obviously came in the main from the Department of Finance, which presumably took input from other (more or less independent) bodies such as the ESRI, the Central Bank, the European Commission, etc. The Department was always extremely thorough in its analysis of proposals from other Departments and the interaction between its officials and those of Departments for which I was responsible would very often deliver greater clarity and useful amendment. There was a difficulty with this advice at times as the Department of Finance saw itself (correctly, I believe) as the "guardian" of public finances in the sense that it approved the spending (and taxation, if applicable) proposals of all other departments and was charged with maintaining budgetary discipline. This meant, unfortunately, that it very rarely welcomed new initiatives or policies that had budgetary implications, or that involved a degree of risk, however small.

I believe that it is right and proper that the Department (or some Department at any rate) has that budgetary oversight role, but the reality was that it "coloured" the perception of their advice. There was almost an expectation that the Department of Finance would always be against any proposal involving spending, and so its advice – in some sense – was devalued. It seems to me that in an ideal world the economic advice received by the government would come also from a separate source from that of the main budgetary oversight department,

and in that regard I welcome the establishment of the Fiscal Advisory Council and the separation of the Department of Finance into two departments as enhancements.

In reviewing material in preparation for this Committee I looked over my copy of the ESRI "Medium Term Review 2008-2015" (published in May 2008). The Baseline forecast was for Ireland to rebound to its "medium term growth path" of about 4% from 2005-2010. Even in its examination of a worst-case type scenario (final one of four alternatives) with an international credit crunch the expectation was that the resilience and flexibility of the economy would, with appropriate management, see a return to reasonable growth by 2010 notwithstanding a few difficult years. I cite this example to try to convey how hard it was for an extremely contrarian view to gain credence. The ESRI is still a very respected and credible institution but the best forecasters can get it wrong. The lesson is that Governments must challenge the consensus – we did not and therefore failed to pursue the hard remedies that may have avoided some of the pain that ensued.

Oireachtas oversight (R5a):

In truth, the quality of Oireachtas oversight of banking and economic policy was very poor prior to the crisis. Oireachtas committees that could have had a role were low profile and in my opinion did little real analysis of economic policy and none at all on banking policy. There were of course debates on Budgets and on National Development Plans but these are one-off opportunities for the Oireachtas and do not provide an ongoing forum for oversight of the kind required. I may be wrong of course – but if meaningful and real oversight was being performed by the Oireachtas I was not aware of it and nor, I would suggest, was the general public. Well-resourced Committees have demonstrated the potential to enrich the work of the Oireachtas.

A somewhat related issue was the influence of Social Partnership as it developed over the years. From a relatively straightforward model in the late eighties it had evolved into a very comprehensive set of commitments entered into by Governments with an ever-widening group of partners. Indeed it almost provided a proxy for debates and discussion that should have taken place in the Oireachtas. There were many positive outcomes from Partnership but the model became all-embracing and, to an extent, undermining of the role of the Oireachtas.

Relationships (R5d):

With regard to the banking sector, I certainly do not think that the relationship between the banks and the government was anything other than appropriate. The remarkably successful setting up and development of the IFSC is a case apart and the focus here was to foster high value employment and spin off wider economic activity in what was seen as an opportunity for Ireland to enhance its reputation in a modern industry. Apart from this I do not think that

government policies were particularly favourable to the banking sector (for example the banking sector was the only industry to have its own industry-specific tax in the form of the banking levy, and it also had considerable administrative burdens imposed on it via a range of legislation ranging from the collection of DIRT to money-laundering regulations). As stated earlier in my own role as Minister for Enterprise, Trade and Employment I instigated very rigorous investigations into the activities of a number of banks (Guinness and Mahon, Irish Intercontinental Bank, National Irish Bank) and some of the key staff of these institutions.

With regard to the property sector, in truth with the benefit of hindsight perhaps it is true that the property sector had excessive influence, particularly in the early years of the last decade. There are reasons to understand why this may have happened – in particular, the construction sector is extremely employment-intensive and so helping that sector was seen as one of the most efficient/least costly ways of generating employment growth. A very large proportion of construction output is based on indigenously sourced materials. There was also the sheer 'visibility' of construction projects - the public could see at a glance the impact that a given project, whether that was inner city renewal or a new motorway, had on its locality.

Furthermore the economic multiplier effect of construction must (even instinctively) give pause to any proposal to curb the activities of the sector. That said, it should be noted that, even before the crisis hit, the government was taking strong measures to rein in many of the property incentives that had been in place for some time.

Policy appraisal regime – role of advisors including crisis management options) (C2b):
I did not have direct interaction with the advisors retained by the Government/Department of Finance to advise on policy options and crisis management so I cannot comment on this with any degree of first-hand knowledge.

Effectiveness of Department of Finance actions during crisis – increase in deposit guarantee scheme (C3a):
My direct technical knowledge of this matter is limited. That said, my sense is that the old deposit insurance limit of only €20,000 was very low to begin with – it had not been updated since 1995 I believe. So raising that to a more substantial figure of €100,000 (where it remains to this day) was a useful signal, it seemed, of support for the banking system. I do not believe that there was or indeed is much controversy about that matter but it was of course quickly overtaken by events.

Effectiveness of Department of Finance actions during crisis – bank guarantee decision (C3b):

I was not involved in an economic Department, having moved to the Department of Health in 2004. I was also an independent TD, without a party, and so was far less at the centre of decisions like this than I would have been in the past. That said, as a member of the Cabinet I was of course briefed in the usual way on various aspects of the global financial crisis and the implications for Ireland. There was a short discussion on the liquidity issues in the banks at the cabinet meeting on Sunday 28th September 2008 but the main focus of this meeting was to deal with decisions required for the imminent Budget.

The Minister for Finance called me at about 9pm on the night of Monday 29th September 2008 and asked me to stand by for a call during the night as Government had to deal with the very serious position of the banks. I felt obliged to inform him that my husband and I jointly owned bank shares and therefore it would not be appropriate for me to participate in whatever decision was arrived at that affected AIB or Bank of Ireland. I went on to say that I would of course support the decision the Government arrived at.

With hindsight, it seems to me that the guarantee was the correct thing to do at the time, especially given the knowledge we had then. I note that even after seven years there are still very conflicting opinions about this, and I do not claim to offer any particular expertise on the issue beyond what the committee has already heard. One thing I am sure of is that whatever decision was reached that night, there would have been severe criticism afterwards. The ultimate judgement was not to nationalise Anglo Irish Bank and I have no expert knowledge as to whether nationalisation at that point (or shortly thereafter) could have resulted in a better outcome for the taxpayer. I remain to be convinced on the basis of all that I have heard or read that it would have made much if any positive difference. Indeed if we had decided to let Anglo fail, while supporting the other, bigger, banks, I suspect there still would have been a parliamentary inquiry, huge controversy and litigation – depositors, including pension funds, would have incurred great losses amounting, presumably, to many billions of euros. People would have lost their life savings (over the €100,000 guarantee cap level) and many businesses would have failed, and of course there would have been, without a doubt, considerable contagion to other banks and a severe reputational impact from allowing a fairly sizable bank to go bust. I am not saying the consequences would have been worse than what actually happened, but I am pointing out that whatever we decided, there was no easy option. The decision to guarantee the banks was made for the right reasons, by officials and ministers doing what they believed to be the right thing.

Finally I can offer no direct personal insight into the question of the restraining influence of the ECB in relation to dealing with bondholders in the banks

Decision to nationalise Anglo- Irish Bank and review of alternatives (C4a):

Once again I should remind you that I had no direct involvement in the detail of this action. What may be useful for the committee is to frame the context of that decision and explain why it appeared to me, as a Government Minister, to be the sensible option.

Events moved quickly from end-September 2008 (the guarantee decision) to mid-January 2009. It became apparent that what had appeared for some time to be a liquidity crisis in Anglo was actually a solvency crisis. The bank was essentially bust. In addition, serious reputational damage had been done to the bank by its involvement in certain issues which are now before the courts.

It was clear that there were in reality only two choices for Anglo: liquidate it or nationalise it.

Liquidation seemed both pointless and dangerous. The liabilities of the bank were guaranteed by the government so there would have been an immediate (within days) requirement to pay out huge amounts of cash to depositors and bondholders. [The assets of the bank would have been collected in over a period of years, while the guaranteed deposits and bonds would have to be paid out immediately]. And in addition the spectacular failure of an Irish bank would have made headlines around the world, and surely would have caused yet further problems for the Irish government and Irish banks on the borrowing markets.

Nationalisation, despite its clear drawbacks, appeared to be the only alternative. It also had the benefit of allowing the government to appoint a new management team and board. It would also buy some time (which was badly needed at the time). It was always possible, though not necessarily fully intended, to liquidate the bank at a future date (as of course happened in 2013) when the crisis had abated to some extent, and not all liabilities were guaranteed. But to repeat, the worst possible time to liquidate the bank was when all liabilities were government guaranteed AND during a severe financial market crisis.

Decision to recapitalise Allied Irish Bank, Bank of Ireland, Educational Building Society, Permanent TSB and evaluation of alternatives (C4 c):

Again I am not in a position to offer expert opinion on these decisions. My recollection is that the first tranche of recapitalisation was to bring capital ratios into line with what was then deemed necessary across Europe and was consistent with Government policy to begin to position the banks to function fully in the economy and ultimately to repay the taxpayer's investment. Investor interest in the Irish Banks was clearly not a realistic alternative as public offerings were shelved in the face of share price collapses (and the recent need to nationalise Anglo Irish Bank). Further tranches of capital were a direct consequence of the write-downs as loans were transferred to the National Asset Management Agency and losses were crystallised. The process of working this out over the period, particularly during the course of 2010 was complex and difficult (in the midst of a market that was still in turmoil and full of

uncertainty). This was a very fraught period for prospects for any recovery of the Irish banking system and with it the ultimate recovery of living standards and the economy. Viable alternatives even at this remove are hard to imagine. Market perceptions became seriously sceptical of Ireland as estimates of loan loss ratios were raised at the same time as the 2008 guarantee expired – and the EU-IMF Programme became inevitable.

Credit institutions (Stabilisation) Act (C4d):

I have no particular comment on this legislation other than to agree that it was necessary and useful in the circumstances that applied. The CISA conferred necessary powers on the Minister for Finance to deal with bank restructuring in the rebuilding process that was required. The transfer of deposits from Anglo Irish Bank to Allied Irish Bank and from Irish Nationwide Building Society to Irish Life and Permanent was effected under the provisions of the CISA in February 2011 as part of the "cleaning up" process of the banking system. As I understand it the CISA was used to good effect in this and other restructuring actions during the period. The Act was used to effect the merging of the Educational Building Society with Allied Irish Bank and Irish Nationwide Building Society with Anglo Irish Bank following the appointment of the new Government in 2011. The CISA was extended in December 2012.

Role and Influence of the ECB (C6d):

I am not in any position to comment with any expertise on this as I had no direct involvement. I am of course aware that the strong view of those involved is that the ECB, while providing significant support for Ireland throughout this very difficult period, exerted pressure at all points to ensure that decisions taken here would not raise risks of contagion across Europe.

Mary Harney

23rd June 2015