

# **A Preliminary Report on The Sources of Ireland's Banking Crisis**

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# Contents

<b>Preface.....</b>	<b>4</b>
<b>Executive Summary.....</b>	<b>5</b>
<b>I. Introduction.....</b>	<b>9</b>
<b>II. The Global and European Setting.....</b>	<b>11</b>
<b>III. The Crisis in Ireland.....</b>	<b>21</b>
<b>IV. Policy Lessons.....</b>	<b>43</b>
<b>V. Areas for Investigation.....</b>	<b>45</b>
<b>Appendix.....</b>	<b>47</b>

## **Preface**

This report was commissioned by the Minister for Finance of Ireland, Brian Lenihan, TD, who informed the authors that the report, once reviewed by the Government, will be forwarded to the Oireachtas and made public.

The authors would like to extend particular thanks to Members of the Joint Committee on Finance and the Public Service of the Oireachtas for their guidance and support.

They would also like to thank, without implication, the many officials and private sector representatives with whom they met both in Ireland and abroad. These included, in Ireland, present and former bankers, central bankers, consumer representatives, government officials, journalists, politicians, financial regulators, trade union representatives and members of the academic community. Outside Ireland, the authors met with officials of the Bank for International Settlements, the European Central Bank, the European Commission and the International Monetary Fund.

The authors were given a free hand regarding their approach to this task. They benefited from strong official co-operation and support. No attempt was made to influence their findings inappropriately.

The report discusses the role of markets, policies, and institutions, but not of individuals. No inference should be drawn about the legality or illegality of any of the actions discussed in this paper. Also, in many cases these events had more than one underlying cause. Where problems arose in institutions, these often reflected several factors, including a failing of checks and balances, which thus involved a number of actors within and indeed outside the institutions. Thus reputational inferences concerning individuals should not be drawn. The assessments made here have also benefited from the wisdom of hindsight.

During the preparation of the report, Nicholas Dove, Caroline Ko and Evghenia Sleptova of the UK consultancy John Howell and Co., Ltd. (of which Max Watson is Director of Research) as well as Geoffrey Minne of the consultancy KR Economics (of which Klaus Regling is Chairman) provided valuable assistance. The administrative support of the Department of Finance was highly appreciated.

## Executive Summary

Ireland's banking crisis bears the clear imprint of global influences, yet it was in crucial ways "home-made." This report aims to clarify how different factors – external and domestic, macroeconomic and structural – interacted to cause the crisis. On this basis, it seeks to draw policy lessons, and it also fulfils the mandate of identifying follow-up areas for the planned Commission of Investigation. It is thus a diagnostic rather than a forensic study; and it aims to complement the parallel report by Governor Honohan.

In the run-up to Ireland's crisis, global financial markets featured an extended period of high liquidity and low risk premia. Monetary conditions in the euro area were also easy relative to the levels of growth and inflation in Ireland. Financial integration in the euro area was deepening, and banks in Ireland had unprecedented access to cross-border funding. As in many smaller EU economies, moreover, the entry of foreign banks intensified competition in lending. Against this backdrop, it is not surprising that Ireland experienced a strong and extended domestic financial boom, accompanied by an influx of foreign savings.

This boom needs to be seen also in the context of Ireland's strong and extended expansion during the previous decade, when the economy caught up with and surpassed average EU living standards. This fostered expectations of a continued rise in living standards and in asset values. Another factor, with even deeper roots, was the strong and pervasive preference in Irish society for property as an asset, and the fact that Ireland had never experienced a property crash.

This was a setting in which official policies and banking practices faced key challenges. There was scope to mitigate the risks of a boom/bust cycle through prudent fiscal and supervisory policies, as well as strong bank governance – thus raising the chances of a "soft landing" for the property market and for society at large. In the event, official policies and banking practices in some cases added fuel to the fire. Fiscal policy, bank governance and financial supervision left the economy vulnerable to a deep crisis, with costly and extended social fallout.

While global and domestic factors thus interacted in mutually reinforcing ways, it is feasible to disentangle the main "home-made" elements in the debacle.

Fiscal policy heightened the vulnerability of the economy. At the macroeconomic level, it should have done more to dampen the powerful monetary and liquidity impulses that were stimulating the economy. Budgets that were strongly counter-cyclical could have helped to moderate the boom, and would also have created fiscal space to cushion the recession when it came. But budgetary policy veered more toward spending money while revenues came in. In addition, the pattern of tax cuts left revenues increasingly fragile, since they were dependent on taxes driven by the property sector and by high consumer spending. Ireland was also unusual in having tax deductibility for mortgages, and significant and distortive subsidies for commercial real estate development, yet no property tax.

As the boom wore on, some external and domestic commentators were critical of fiscal policy. The OECD flagged the case for greater prudence. The European Commission worried about pro-cyclicality in policy as early as 2001; and by 2007 it flagged clearly the fragility of tax revenues. Nonetheless, EU Council Opinions were favourable: with earlier fiscal reforms and the impact of the boom, Stability and Growth Pact commitments did not seem in doubt. Equally, the IMF was not strongly or consistently critical of the underlying dynamics of fiscal policy. In the event, when the boom ended, fiscal policy was left cyclically and structurally depleted. There was no room for

manoeuvre to support the economy. Indeed, the need to restore sound public finances left no choice but to tighten policy as output fell and unemployment rose.

In this macroeconomic setting, bank governance and financial supervision faced major challenges. Banks, moreover, were operating over the past decade in a setting of greatly increased wholesale funding opportunities, following adoption of the euro; and banks from abroad began to compete strongly in retail mortgage lending. Against this backdrop, strongly risk-averse reactions by banks in Ireland and their supervisors would have been needed to help dampen a very risky boom-bust cycle.

It appears clear, however, that bank governance and risk management were weak – in some cases disastrously so. This contributed to the crisis through several channels. Credit risk controls failed to prevent severe concentrations in lending on property – including notably on commercial property – as well as high exposures to individual borrowers and a serious overdependence on wholesale funding. It appears that internal procedures were overridden, sometimes systematically. The systemic impact of the governance issues crystallised dramatically with the Government statements that accompanied the nationalisation of Anglo Irish Bank. Some governance events are already under investigation. There is a need to probe more widely the scope of governance failings in banks, whether they were of a rather general kind or (apparently in far fewer instances) connected with very serious specific lapses, and whether auditors were sufficiently vigilant in some episodes.

The response of supervisors to the build-up of risks, despite a few praiseworthy initiatives that came late in the process, was not hands-on or pre-emptive. To some degree, this was in tune with the times. The climate of regulation in advanced economies had swung towards reliance on market risk assessment. Domestically, moreover, there was a socio-political context in which it would have taken some courage to act more toughly in restraining bank credit. The weakness of supervision in Ireland contrasts sharply, however, with experience in those countries where supervisors, faced with evident risks, acted to stem the tide.

Moreover, bank supervisors in Ireland were not called upon to deal with technically complex problems. Ireland's banking exuberance indulged in few of the exotic constructs that caused problems elsewhere. This was a plain vanilla property bubble, compounded by exceptional concentrations of lending for purposes related to property – and notably commercial property. Depending in part on the results of the parallel report by Governor Honohan, this is an area for further investigation to determine what degree of censure is warranted for the failures of supervision.

These supervisory problems, however, must be seen in conjunction with the absence of forceful warnings from the central bank on macrofinancial risks – given that supervisors relied almost entirely on the central bank for economic inputs. By mid-decade, the financial and property boom in Ireland presented features – both macro- and microeconomic – in which financial stability analysis should have sounded alarm bells loudly. Domestic financial stability reporting by the central bank failed in this regard. It noted worrying features; but it failed to trace their interactions vividly or to warn how severe were the emerging risks to bank soundness and, ultimately, to the living standards of the ordinary citizen. In fairness, external surveillance sources fared little better. The IMF's major Financial System Stability Assessment of 2006 did not sound the alarm, and there is no evidence that its private warnings did so either.

Thus it is clear that, in various ways, official policies and bank governance failings seriously exacerbated Ireland's credit and property boom, and depleted its fiscal and banking buffers when the crisis struck. On the basis of that assessment, the body of this report seeks to highlight both

broad policy lessons and also areas that deserve specific consideration when the planned Commission of Investigation further explores responsibilities. Nonetheless, the true burden of responsibility emerges as quite broad, and it extends to insufficiently critical external surveillance institutions.





## **I. Introduction**

This report discusses the global and national sources of Ireland's banking crisis, covering the period up to end-September 2008. The terms of reference were set out in a letter from the Minister for Finance of Ireland, which is attached as an Appendix.

The report analyses developments in global, European, and Irish financial markets over the past decade. It considers the influence of macroeconomic policies and conditions; deepening financial integration; bank management and governance; banking regulation and supervision; domestic financial stability reporting; and external surveillance of the economy. It seeks to put in perspective the role of both policy and market factors in triggering the crisis.

The report was also commissioned in order to identify areas for further follow-up by the planned statutory Commission of Investigation. In this and other respects, it deals with the contribution of policies, markets and specific institutions, but not the role of individuals. At all times, moreover, the disclaimer in the Preface concerning judgements about legality, as well as issues of reputation, fully applies.

The report was not requested to focus on the official strategy adopted to resolve the crisis. This would in any case have required access to documents covered by banking secrecy, in order to understand the trade-offs made in dealing with specific institutions. Thus, while the report does inevitably shed light on some events in the run-up to the guarantee decision taken in late September 2008, it does not assess the overall merits of that decision.

The authors of the report had a series of valuable exchanges with Governor Honohan and the team of experts assisting him with his parallel inquiry. This report is designed as far as possible to achieve complementarity, and avoid duplication, with that report. Specifically, this report is written from a "top-down" perspective, starting from global factors. It is not built up from the analysis of large numbers of internal documents. It is concerned not only with banking governance and regulation, but attempts to clarify the interaction between many factors – global and national, macroeconomic and microeconomic. The authors have thus sought to tap quite widely the assessments of both domestic and international experts, conducting interviews with them on an informal and non-attributable basis.

The report aims to set out these issues in language that is as straightforward as possible. Although it builds on the findings of many detailed papers, it is not conceived as a technical or academic document, loaded with references. Its goal is to clarify for the Oireachtas, for policy-makers, for the financial industry, and for interested readers in civil society, how the jigsaw of factors that caused Ireland's banking crisis may be seen to fit together.

The structure of the remainder of the report is as follows. Section II reviews the global and European setting. Section III discusses the crisis in Ireland. Some lessons for policy are summarised in Section IV. Finally, Section V suggests areas for further investigation.



## II. The Global and European Setting

The terms of reference for this report indicated that the events in Ireland should be situated in the context of the global financial crisis. In this respect, it is not sufficient simply to reference existing reviews of the crisis. First, it is important to highlight two factors that have been unevenly stressed in other reports but were very important in Ireland. These are:

- the degree to which adequate buffers were built into national fiscal policies, after allowing for the transient nature of revenues from the financial boom; and
- the implications for national fiscal and supervisory policies of life under the euro area's common monetary policy, and the policy implications of deepening financial integration in the EU.

Second, from a presentational perspective, it is useful to set out parallel analyses of global and national factors, so that readers can map easily from one to another in appreciating how far the Irish crisis was home-grown. By contrast, this report covers much more lightly those aspects of the global crisis – such as complex financial products and rating agency assessments – that are less relevant in understanding the direct sources of the financial crisis in Ireland.

### 1. Macroeconomic setting

Macroeconomic conditions in Ireland in the run-up to the banking crisis resulted from a mutually-reinforcing interaction of global developments and national policies.

From the late 1990s onwards, the world economy was characterised by relatively high growth, low headline inflation, strong liquidity creation, and low interest rates. The literature has named this period “The Great Moderation,” which can be explained by the positive effects of globalisation, technological progress and productivity increases, and the stronger credibility of most central banks around the world, which had become independent from political interference, facilitating a stabilisation of inflation expectations.

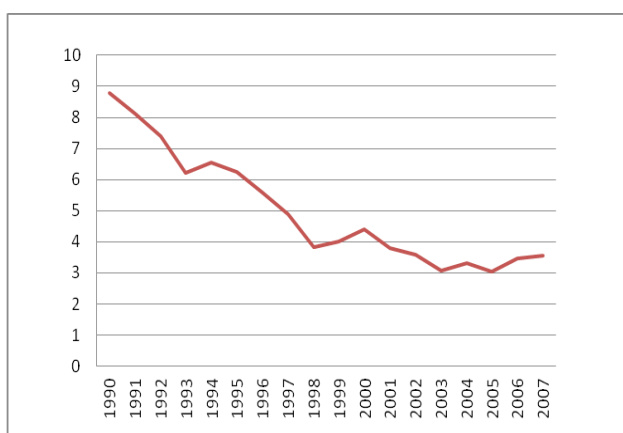
Many countries became more “open” during this period: the importance of international trade in their economies grew, which limited the scope for price rises at home. The integration of China, India and other emerging markets into the world economy increased competition and kept labour costs and thus traded goods prices low. In addition, a temporary surge in productivity in the United States and the European Union in the second half of the 1990s dampened the increase in unit labour cost in the world's largest economies.

This benign inflation environment led to monetary policy mistakes, particularly by central banks that followed explicitly or implicitly a policy of “inflation targeting”, ignoring developments in money supply, credit growth and asset prices. All major central banks kept interest rates too low for too long – as Raghuram Rajan, the former IMF Chief Economist argued already in June 2006 – creating ample liquidity.

One example is that the Federal Reserve postponed monetary tightening repeatedly from the late 1990s onward. Up until 2001, policy was always eased, or kept easy for good reasons: the Asian crisis and the Russian default in 1998, LTCM (the New York hedge fund that collapsed in 1998), Y2K (the expected computer problems entering the new millennium), the bursting of the dot.com bubble in 2000-01 were seen as legitimate reasons to postpone interest rate increases which otherwise might have happened. After the terrorist attacks on September 11, 2001, the Fed lowered its key interest rate to 1 percent, again for understandable reasons. But then interest rates remained low even as growth accelerated again. Real interest rates were negative for an extended period of time, not only in the United States but also in other major economies. In this environment, the ECB also delayed monetary tightening until December 2005.

**Chart 1: Monetary Conditions**

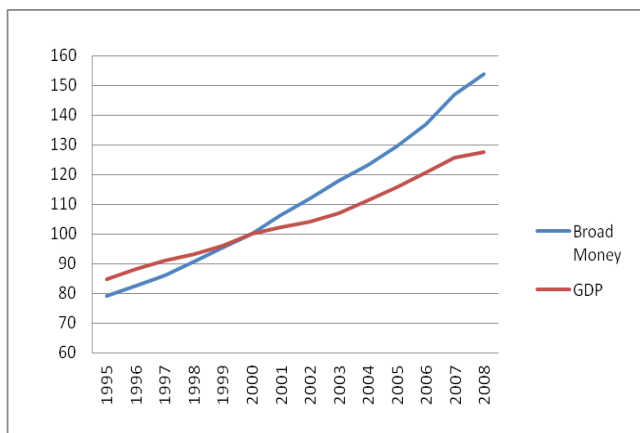
**Long-term interest rates in percent\***



Source: OECD

\*Long-term government bond yields (10 years).  
Weighted average of the US, Japan and Euro Area.

**Broad money and GDP\***



Source: OECD

\*Nominal GDP converted at constant PPP and broad money (M3) in the US, Japan and Euro Area.

Global liquidity creation was amplified by the exchange rate policies of major economies. China, the Gulf countries, and initially Japan, pegged their currencies formally or informally to the US dollar and intervened massively to avoid appreciation. The foreign exchange reserves of these countries skyrocketed. This fueled global liquidity again. Also, by pegging their currencies to the US dollar, booming economies such as China and the Gulf countries imported a monetary policy stance that was too loose for their economic circumstances.

As many countries around the world pegged their currencies to the US dollar, global imbalances – that is, current account surpluses in Asia and the Gulf, and current account deficits in the United States - soared. The surplus countries invested their growing foreign exchange reserves in deficit countries, adding to the downward pressure on interest rates and risk spreads.

The long period of high liquidity and low nominal and real interest rates resulted, not surprisingly, in a search for yield; low risk aversion among investors; compressed risk spreads; and a continued process of strong credit expansion and high leverage. Although headline inflation did not react for a

long time, for the reasons explained above, this monetary environment led to strong rises in asset prices in many parts of the world and a succession of bubbles in equity, bond, housing, commodity and credit markets. In the view of many economists, this was one key factor behind the global financial crisis that unfolded from mid-2007, together with the development of new, complex financial products and the widespread failure of financial market supervision and credit rating agencies (described below).

The other key macroeconomic problem behind the global financial crisis is to be found in failures of fiscal policy in many countries around the world. Looking at nominal fiscal balances, it would seem to be mainly countries outside the euro area that were excessively expansionary in their conduct of fiscal policy. The United States, the United Kingdom and Japan all had fiscal deficits of 2.5 to 2.8 percent of GDP in 2007, the last year before the financial crisis, after several years of above-trend growth and in a situation with sizable positive output gaps (that is, with the economy operating above its normal medium-term capacity). These countries had clearly conducted pro-cyclical fiscal policies during the period until the crisis hit, thus amplifying the effects of loose monetary conditions.

Looking at structural or cyclically adjusted fiscal balances, it is clear that the situation was even worse, also for most euro area countries. While the euro area as a whole had a rather limited nominal fiscal deficit of only 0.6 percent of GDP in 2007, the combined cyclically-adjusted deficit was almost 2 percent of GDP in the same year.

Moreover, it is recognised that available methods to calculate cyclically adjusted fiscal balances do not capture well the impact of strong asset price rises on revenue developments. Observers were surprised by strong revenue growth during the years up to 2007 and were not able to explain the apparent increase in tax elasticities (that is, every extra unit of GDP generated far more revenue than experienced in the past during economic upswings). Today we know that tax revenue benefited in many countries – temporarily - from the surge in housing prices, financial asset prices, the strong growth in the financial service industry. There was also a high share in GDP during this period of household consumption, which is tax rich. The conclusion seems clear, even if not all statistical tools are available to make precise calculations: fiscal policies were pro-cyclical in most advanced economies in the years up to 2007, thus contributing to the build-up of internal imbalances in these economies and making them more vulnerable to a crisis.

This was the macroeconomic setting in which Ireland found itself in the years until 2007.

## **2. Financial sector developments and policies**

There is a wide consensus on the microeconomic problems in the functioning of financial markets that built up over the past decade, including generic weaknesses in regulation and supervision. The key issues are set out, with nuances of emphasis, in the de Larosière Report, the G-30 Report, and the UK's Turner Report, among others. This section of the report sets out relevant global developments as a counterfactual to help highlight areas where Irish developments were unusual.

One set of financial market factors is under-played in some reports, yet deserves special emphasis in the backdrop to the Irish crisis. That is the role of deepening financial integration in the euro area and more broadly in the EU. This issue is therefore discussed first, below. Then, to help clarify responsibilities in Ireland, the remaining international financial market issues are discussed in terms of the principal institutions and their roles – that is, bank management and governance; rating agency inputs; financial regulation and supervision; and financial stability analysis by central banks and other monetary authorities.

### **a. Financial integration in Europe**

At the microeconomic level, an important influence on financial conditions in Europe during the past decade was the continuing rapid pace of cross-border financial market integration. The period saw an ever deepening interconnection of markets in different countries through cross-border flows, portfolio diversification, and the expansion of foreign-owned institutions.

Within the euro area, given the absence of exchange risks and the growth of common market infrastructures, it became easier to fund private and public sector deficits across borders through wholesale market borrowing. In the EU more widely, there was a strong growth in the number of cross-border banking establishments (mainly subsidiaries), notably in the “peripheral” economies. And cross-border portfolio diversification continued to increase.

These factors were present more generally in global markets; but integration was especially rapid in Europe. Of course, the process of deepening financial integration in Europe was not new; but the creation of the euro in 1999, and the major enlargement of the EU in 2004-7, gave it added impetus.

The integration of retail markets proceeded much more slowly, even in the euro area. However, the increase in the number of cross-border subsidiaries and branches, and the expansion of existing establishments, resulted in heightened banking competition in some domestic market segments.

The impact was often quite striking in mortgage markets, including peripheral economies such as the “new” EU Member States (and indeed candidate countries). There was a significant regional pattern: countries with less developed or less competitive banking markets experienced a growing share of lending by banks headquartered in neighbouring countries with more developed financial markets.

This growth in financial integration was seen by policy-makers as presenting major opportunities to support economic growth and also (through risk-spreading and portfolio diversification) financial stability. The concomitant risks commanded less attention. As highlighted below, and explored most trenchantly in the de Larosière report, cross-border structures of regulation and supervision in Europe did not keep up.

## **b. Bank management and governance**

The financial climate in Europe and the global economy during the past decade, coupled with rapid financial integration, was an environment that truly put bank management and bank governance to the test. In many economies, there were strong incentives to fight for market share during prolonged credit and asset price booms – while cross-border funding markets provided ever more ample liquidity to do so.

Many of the sea-changes that were taking place in financial markets and the real economy seemed permanent, presenting bankers with a perceived “new paradigm” that combined low inflation, a cheaper global supply of goods, and a drop in the risk premia required by lenders, with risks perceived as more widely and efficiently spread.

In peripheral EU economies, moreover, there was an accelerated catching-up of income (and in some cases productivity) which seemed to validate higher levels of debt among banks’ corporate and household clients. Some of these changes in the banking environment, of course, proved more durable than others. The banking market in Ireland was far from unique in these respects.

Faced with these changes, banks responded in three different ways, all of which involved expanding their balance sheet and/or off balance sheet activities, typically funded at the margin by a rise in wholesale market borrowing. Some favoured expansion in domestic market segments that were not yet highly competitive: lending on commercial and residential property was one candidate. Others found cross-border opportunities in neighbouring markets, often also in the form of plain vanilla property lending. (Austrian banks, for example, did this in their Eastern neighbours.) A third set of banks found no obvious outlets of these kinds: they bought large amounts of complex securities based on (for example) US mortgages, and placed them in special vehicles where they could minimise the capital cover that regulation obliged them to set aside (Box).

It is not a coincidence that property lending was a recurring theme in these bank strategies. A perceived “permanent” downward shift in real interest rates and an upward shift in asset prices – accompanied in many cases by strong growth in household incomes – made mortgages an instrument of choice for balance sheet expansion. Credit and property prices in many markets then chased each others’ tails skywards in one of those cycles that punctuate many periods of economic history, and are not generally recognised for what they are. The title of the 2009 book by Carmen Reinhart and Kenneth Rogoff, “This Time is Different”, says it all.

The management of individual banks in such markets thus faced a genuine dilemma. They could compete strongly through ever more aggressively priced and structured products; or they could find themselves shrinking in terms of market share – which many believed would also imply falling relative share prices and thus the risk of being taken over by a more aggressive bank. With hindsight, of course, a prudent stance in lending and funding would have left institutions ultimately in a more, not less, competitive position.

Some banks indeed remained relatively conservative. They contained their vulnerability to asset and funding risks, due in part to a sense of prudence among managers, reinforced by sound governance processes. The Canadian banks, though next door to the United States, were fine, for example: they did not experience major problems with toxic assets or funding vulnerability. But this was not entirely spontaneous: as discussed below, such banks frequently benefited from tough supervision, and/or from local macroeconomic policies that rowed against the tide of global financial ease.



### Box: Rating agencies, distribution models and crisis transmission

The core problem with rating agencies lay in their readiness to classify as Triple-A, or close to Triple-A, complex securities based on re-packaged assets. The risk characteristics of these securities were hard to evaluate and were assessed in part through esoteric quantitative methods. In some cases, rating agencies helped to design the products that they then rated. This was part of a wider picture of over-reliance by banks, investors, and regulators on complex risk models constructed in the financial sector.

Such ratings became crucially important in the transmission of the global crisis through their part in a chain of events. Mortgage claims and other debt obligations were originated by a bank or other financial institution; rated by an agency; and then packaged and distributed to other portfolios, with the originator frequently retaining no risk exposure to the product. Assets originated in the United States were bought quite widely by banks in some EU countries, at times being held off balance sheet in special purpose vehicles with low capital endowments. When the collectability of the underlying debts (such as “sub-prime” mortgages) came into question, there was great uncertainty about the value of these so-called “toxic” assets. Many banks’ balance sheets were known to be impaired, but to an extent that was unclear.

Only after the failure of Lehman Bros, however, did these balance sheet concerns trigger a drying-up and balkanisation of liquidity in different markets compartments – an event that no risk assessments or stress tests had imagined in an ever more integrated financial world. It was at this stage that the full force of the crisis was felt by countries (including Ireland) where banks were heavily exposed to wholesale money markets but did not hold many toxic assets.

So far, this account of events seems to diffuse quite widely the sources of banks’ governance and management problems. Regrettably, however, the story does not stop there.

Broad errors of economic judgement aside, some countries also saw lamentable failures of bank governance over lending practices – with a scandalous disregard for the adequacy and documentation of collateral, scant interest in borrowers’ incomes, and insufficient attention to the risk of falling collateral values. The most severe financial episodes seem to have featured such egregious errors. Clearly, one key goal of banking investigations is to pursue such cases, identifying the responsibility for these extreme governance failures.

It seems that it was not mainly structures of corporate governance in banking that were to blame (although the UK’s Walker Report usefully documents how these structures can be improved substantially). It was more often a question of how corporate governance was implemented, and the



incentive systems put in place for bank management and staff. Remuneration systems in banking have rightly been singled out as one key factor in this respect. Moreover, this sometimes concerned the incentives for loan officers to increase a bank's market share; it was not just a question of bonuses and stock options for a few corporate leaders.

A further influence on incentives were accounting conventions that implied constraints on risk management. In the early post-war period, banks served as risk buffers and cyclical shock absorbers in the economy, and their accounting regimes in some countries even allowed income-smoothing over a long period and even the constitution of "hidden reserves" to facilitate this role. In the period under review, financial accounting regimes reached the opposite end of the spectrum, requiring a "mark to market" approach for a wider range of bank assets and impeding the building-up of reserves in periods when risks were rising – a set of conventions for the financial sector that tended to amplify rather than buffer shocks to the economy.

### **c. Financial regulation and supervision**

From the early 1990s onwards, there was a debate in academic and policy circles about the ways in which regulatory structures and styles of supervision should be adjusted in the face of more complex financial institutions, more complicated financial products, and highly adaptive markets – markets which tended to find ways around any given set of rules.

This debate was not conclusive. Some countries decided to set up a separate unified financial regulator, while others preferred formulas that left banking supervision in the hands of the central bank. Some countries (including the UK, but not the US) shifted towards "principles-based" regulation – which de-emphasized specific rules that could be side-stepped. Some countries (including the UK) adopted less "intrusive" approaches, sometimes described as "light touch supervision."

With the benefit of hindsight, choices in regulatory structure did not map mechanically to greater or lesser success in avoiding a crisis. Neither did the decision whether to maintain rules-based supervision. However, a widely accepted lesson of the crisis is that "intrusiveness" into banks' risk management and governance had been set aside too lightly. Close and at times intrusive supervision, unlike "light touch regulation," had the potential to identify problems earlier and in some cases prevent or mitigate their effects. Cases such as Australia and Canada are often cited in this latter category.

Within the EU, the Bank of Spain deterred commercial banks from setting up "capital-lite" special vehicles for assets that in other cases proved toxic; insisted on high provisions while risks built in the boom, despite an unfriendly tax and accounting context for such an approach; maintained large permanent teams of inspectors in major banks; and discouraged innovative mortgage insurance programmes when a strong home loan boom was underway. Another interesting example is that, towards the end of the previous decade, Portuguese supervisors pressed banks forcefully to stretch out their cross-border funding maturities during the major boom in their economy, which had made it very dependent on short-term cross-border funding.

In terms of risk analysis, regulators and supervisors in most advanced economies were not entirely blind to the build-up of possible vulnerabilities. They were aware of risks in exposure to the property sector, if prices should fall steeply. But four key elements, among others, typically combined to dissuade them from taking forceful action to restrain the banks:

- They did not consider it their job to react to the macroeconomic component of the problems that were potentially building up. There was in any case no strong consensus among economists how much of the fall in global interest rates, the decline in risk premia, or the rise in local asset prices should be viewed as unsustainable (a debate typically carried on in terms of whether one can identify or puncture a “bubble”).
- Liquidity (as opposed to solvency) supervision had been off the core Basel agenda for decades; and few regulators, if any, performed stress tests that combined asset market with funding shocks. In the euro area, financial integration and interdependency were goals of policy, and the side-effects on vulnerability were not strongly emphasized.
- It was unclear to many supervisors what instruments to use to counter macrofinancial risks. A few acted to limit loan-to-value ratios; increased reserve requirements, where there was national autonomy to do this; imposed heavier provisioning as risks built up; or prevented a shift of assets to “capital lite” vehicles. But in a setting of strong cross-border competition, there was also a concern that such actions might just penalise locally owned banks.
- As noted above, many supervisors – faced with complex assets and operations, and with banks’ ability to work around specific rules – moved to rely more on banks’ own risk assessment systems and to supervise processes and principles, with some moving very far in the direction not just of “principles-based” but of “light-touch” supervision.

Experience shows that these generic concerns and changes of approach among regulators and supervisors allowed a serious build-up of vulnerabilities in some cases, which would have spelled problems for bank balance sheets even without the extreme shock to liquidity that followed the Lehman Bros episode. The major reports that followed the crisis, including notably in Europe the de Larosière Report, spelled out ways in which supervision should be strengthened, both nationally and in the field of cross-border co-ordination. These reports also featured a realisation that macrofinancial risks need to be addressed by macroprudential supervision.

But also, at the heart of the crisis in some of the worst-affected countries lay problems of a quite different order. As noted above, some banks and other financial institutions, riding on the back of a generalised property boom, engaged in lending practices that were simply dangerous in an old-fashioned way.

These were practices that did not require special supervisory imagination or moral courage to penalise. They were noted above in terms of serious failures of bank management and governance. The failure of supervisors to act strongly against such practices is much harder to understand, and is not much mitigated by the more broadly shared issues of supervisory culture cited above.

#### **d. Financial stability analysis**

Once a financial boom took off in any country, often triggered by genuinely positive local events, the combination of policy and market developments described above was something of an infernal machine in terms of financial stability vulnerabilities. The mutually-reinforcing nature of the risks was powerful.

First, the global macroeconomic and financial setting was easy for a deceptively long period. Second, booming economies in the euro area also experienced monetary conditions that (by the very nature of monetary union) were not matched to their cyclical situation, and the liquidity available to them through cross-border funding possibilities expanded. Third, fiscal revenues were boosted to an unusual (and temporary) degree by asset price and consumption booms, so the underlying stance of policy was mismeasured and was easier than intended – which in some cases compounded the problem of a fiscal policy that was lax even on conventional measures. Fourth, many banks – unsurprisingly, from a historical perspective – responded to these euphoric conditions by expanding their assets, financed by cross-border borrowing from other less buoyant economies. And in a search for yield amid very liquid markets they also plunged into riskier property assets and/or securitised claims that were hard to value and turned out to be very risky indeed. Fifth, rating agencies, the custodians of security assessment, dropped their guard, at best. Sixth, supervisors did not know what to make of the easy macro setting; and some were in the process of implementing less “intrusive” approaches to supervision.

This left one set of custodians, on the official side, to warn about the risks that were building up over the past decade: the financial stability reports issued by central banks and (in the form of Financial System Stability Assessments) by the IMF. It was indeed a period when more and more central banks moved to publish financial stability reports, following the path-breaking initiatives of the Bank of England and the Sveriges Riksbank late in the 1990s.

In discussing risks and transmission channels at the global level, central banks and the IMF typically emphasized external imbalances – such as the US current account deficit – as key risks in the global economy, and they focused attention on exchange rates as the main nexus of vulnerability. By contrast, the prevalence of low real interest rates and risk premia over an extended period was seen as benign: these were viewed as aspects of the “Great Moderation” referred to above; and they were attributed in significant part to the credibility of monetary policy regimes.

This analysis tended to underplay the build-up of domestic financial risks that was taking place through a rise in financial system leverage and in asset prices in many economies, and through the associated expansion of the non-traded goods sector including residential real estate (which was a counterpart of global payments imbalances). Thus critiques of policy did not focus very strongly on vulnerabilities arising from monetary conditions, or on macro- and microprudential responses to financial booms: they kept their focus more to exchange rates and the scope for deficit countries to tighten fiscal policy.

Central bank financial stability assessments did flag risks in the rise of credit and property prices in some countries, but they were typically unsure (or at any event unclear) whether these were durable developments or whether there were risks of a sharp reversal that could trigger banking stresses.

Macro – that is, system-wide – stress-tests in financial stability reports allegedly showed most banks to have sufficient buffers against extreme shocks; but typically these tests did not combine funding and asset market shocks. With the benefit of hindsight, moreover, it is clear that these, like the micro stress-tests of individual institutions, were much too mild. They were also relied upon for

insights that they could not deliver, and proved a rather frail support in capturing exposure to systemic risks. Among other things, the underlying models were not reliable when basic market parameters changed context; and in addition, scenario construction, which is at the heart of successful risk analysis, was insufficiently imaginative in exploring macrofinancial vulnerabilities and linkages.

Financial stability analysis by the Bank for International Settlements was an exception in these regards. From early in the decade, BIS authors emphasized that deep domestic financial vulnerabilities were building up in the prevailing interest rate and risk premium setting, posing risks to the system. Correspondingly, BIS authors urged that monetary and prudential policies should display more peripheral vision concerning such macrofinancial risks, rather than sticking to a narrow interpretation of prevailing mandates. But as among bank supervisors, such contrarian views, maintained courageously against the mainstream, were a minority phenomenon.

In sum, it is clear that most central banks, like most supervisors, did not recognise how powerfully the policy and market influences affecting the global financial system were interacting. Their warnings were in many cases too soft, not just in national financial stability reports but also in IMF Financial System Stability Assessments (FSSAs): almost all were analytically weak in identifying macrofinancial linkages that would later interact in the face of negative shocks. For example, there was a striking lack of scenarios that explored an interaction of asset market and funding shocks. IMF analyses in the FSSAs of the period seem notably weak in some advanced economies; and in the United States there was no such assessment, because the programme was voluntary and the United States did not volunteer.

### **III. The Crisis in Ireland**

#### **1. Macroeconomic developments and policies**

This section looks at the role that macroeconomic conditions played in triggering the banking crisis in Ireland. First, however, it seems important to recall briefly the remarkable economic success story of the 1990s, including the dramatic rise in the standard-of-living of the Irish population, which preceded and accompanied the run-up to the crisis.

##### **a. Economic developments**

When Ireland joined the European Economic Community (EEC) in 1973, it was the poorest country in that grouping, and it continued to underperform the economic growth of the other members until the late 1980s. From then on, however, Ireland's economy experienced a rapid catching-up with the rest of Europe and became, next to Luxembourg, the member state with the highest per-capita income in the EU.

The turnaround in the late 1980s was triggered and underpinned by a range of successful government policies. Significant fiscal consolidation measures in the late 1980s were one important factor in creating stable economic conditions, against the background of earlier structural reforms. “Trilateral” wage agreements between unions, employers and the government ensured wage moderation, competitiveness and industrial peace which was instrumental in attracting large amounts of foreign direct investment. In this environment, Ireland benefited greatly from the launch of the EU Single Market which meant increased openness in the EU and better access to key markets. EU funds (up to 3 percent of GDP) were put to good use by financing public investment. Deregulation and low corporate taxes made the economy more flexible. The run-up to monetary union and membership in the euro area implied a shift to a permanently lower interest rate level. A long period of high growth attracted a large number of immigrants for the first time in Irish history and resulted in the highest population growth - by far - of all EU member states with positive demand and supply effects.

This highly successful phase of economic catching-up, while preserving macroeconomic stability, came to an end early in the past decade. Even though GDP-per-capita growth in Ireland continued to outperform per-capita growth in other EU member states until 2007, underlying developments were much less robust than in the 90s. The sources of growth shifted significantly and growth became demand-driven. Financial vulnerabilities increased.

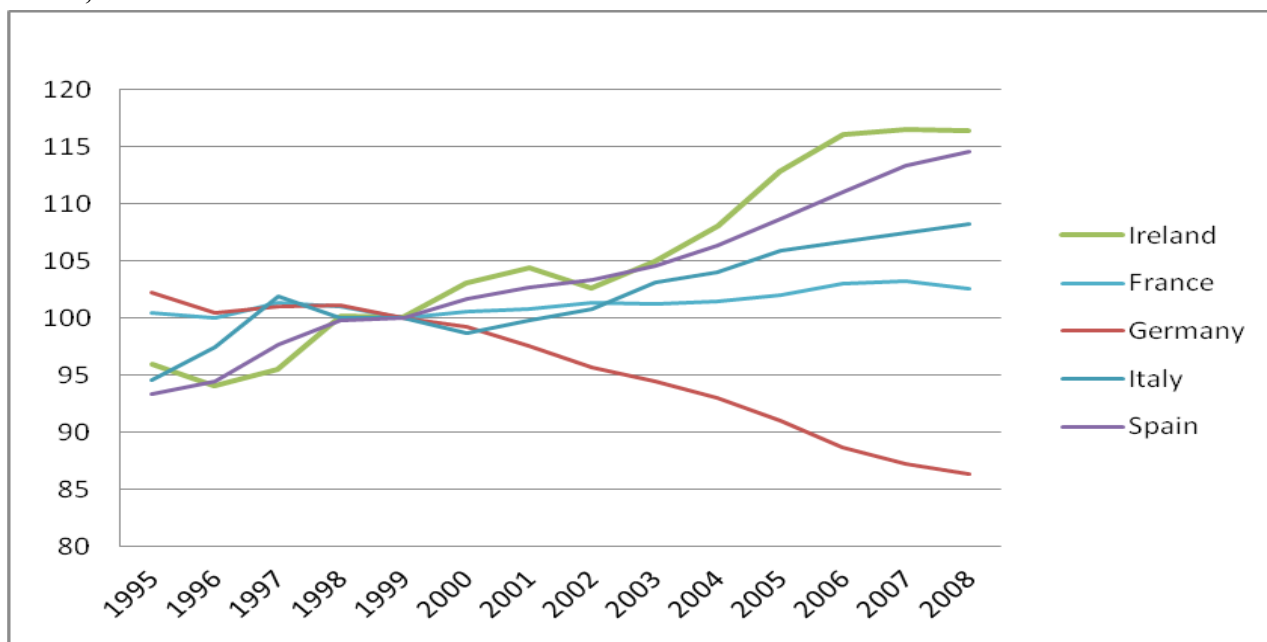
##### **b. Wages and competitiveness**

Wage settlements accelerated markedly from the late 90s, in absolute and in relative terms. The “trilateral” wage agreements continued but became less relevant as workers negotiated supplementary wage increases against the background of full employment and an overheating economy. Compensation per employee, which had grown more or less in line with the euro area

average until 1996, increased at two to three times the euro area average from 1997 to 2008. In nominal terms, annual gross wages in Ireland in 2007 were the highest in the euro area except Luxembourg. Ireland had also the highest price level in the euro area according to Eurostat statistics. Competitiveness deteriorated significantly. From 1999 to 2008, Ireland's real effective exchange rate increased more than that of any other country in the euro area.

Of course, some loss of competitiveness is the natural mechanism through which growth is slowed in a euro area economy that is overheating. In Ireland, however, an imprudent expansion of bank lending, accompanied by an unwise policy on tax exemptions, resulted in this natural economic cycle becoming much more extreme than should have ever have been the case. The loss of competitiveness went much too far; and then the pro-cyclical swings in fiscal policy and the banking system, once the cycle turned, were bound to cause a sharp slowdown. This process was already underway when it was exacerbated by the savageness of the Lehman Bros shock.

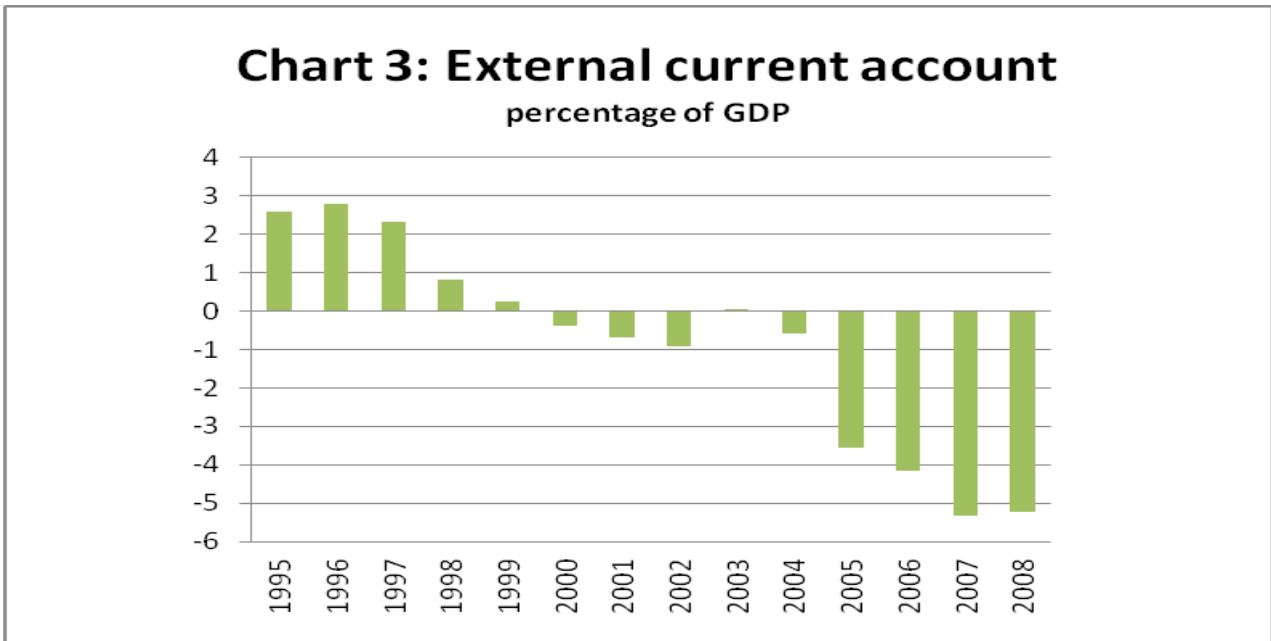
**Chart 2: Relative unit labour costs\***  
**Index, 1999 = 100**



Source: OECD

\* Unit labour costs compared to Euro Area, total economy, double export weights.

Growth rates of public expenditures also accelerated to the highest pace among OECD countries (see below). The share of the construction sector in the economy became excessive; residential investment as a percentage of national output reached nearly 13 per cent in 2006, double its long-term average, and the share of employment in construction as percent of total employment also doubled from the 1990s to 2007. Analysis by the OECD indicates that Ireland was the most overheated of all advanced economies. Consequently, Ireland lost market shares in international trade (even compared to other advanced economies), the current account surpluses of the balance of payments shrank and turned negative from 2000 onward.



Source: OECD and European Commission

Why did all this happen after a decade and a half of very successful economic developments? What went wrong in Ireland?

To a certain extent, it may be human nature and hubris that lead to excesses after a long period of success. It is understandable that wages go up more when full employment is reached, for example. However, this increases the need for “good” policies which try to compensate and set incentives in such a way that vulnerabilities in the economy do not get out of control. In a monetary union, the challenge for policies becomes even greater as monetary conditions cannot be influenced directly and the (nominal) exchange is no longer a policy instrument.

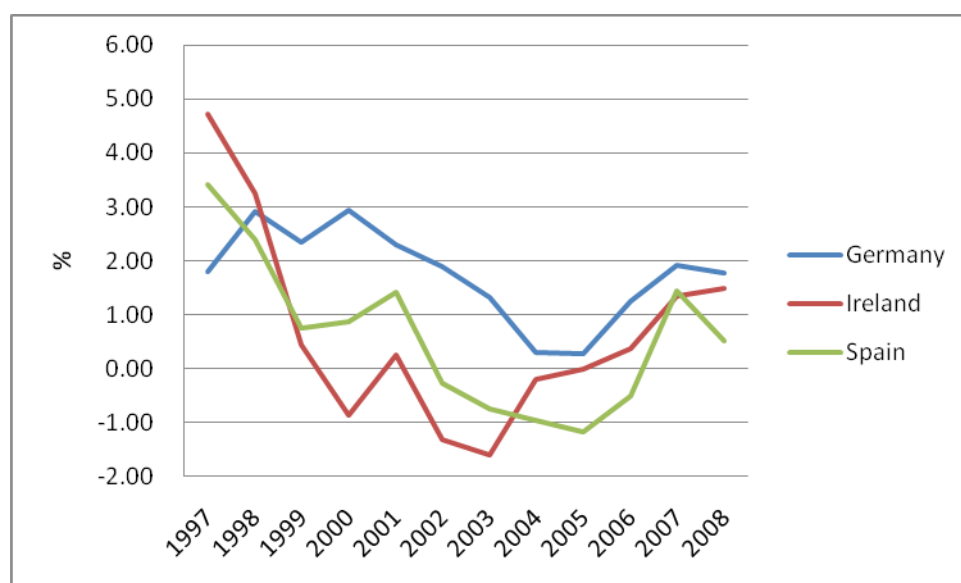
This section looks at macroeconomic aspects of the situation while Section III.2. analyses what went wrong in the financial sector.

### c. Monetary conditions and the role of EMU membership

Was it a coincidence that Ireland's economic fundamentals began to deteriorate when Ireland joined the euro area?

Certain aspects of EMU membership certainly reinforced vulnerabilities in the economy. Short-term interest rates fell by two thirds from the early- and mid-90s to the period 2002-07. Long-term interest rates halved. Real interest rates were negative from 1999 to 2005 after having been strongly positive earlier.

**Chart 4: Real short-term interest rates\***



Source: OECD

\*3-month interbank interest rates deflated by the harmonised index of consumer prices.

This contributed to the credit boom, the strong increase in household debt, the property bubble and the general overheating of the economy. The removal of exchange rate risk facilitated foreign funding, including for the growing current account deficits. This financing ease meant that Ireland's boom could continue for longer than without EMU membership, and the asset bubble could become bigger.

However, it was clear in the second half of the 1990s that entering EMU would imply a permanent shift to a lower interest rate level which – naturally – was seen as advantageous. A final appreciation of the central rate of the Irish currency in the exchange rate mechanism in March 1998 was designed to cool down the economy somewhat as interest rates were dropping. This was the last chance to use the exchange rate instrument. Other available policy instruments – such as fiscal policy, bank regulation, income policy – were not used to offset the well-known expansionary



effects of EMU membership on the macroeconomic environment or even fueled the fire, in particular tax policies (see below).

At the same time, being a member of a large monetary union helped Ireland to survive better the global financial crisis. Without EMU, European currency markets would have been in turmoil in 2008-09. Funding problems for the banking sector would have become much bigger. Firms and households would have borrowed more in foreign currency, and would have been exposed to balance sheet risks. Coordination problems for national central banks would have been significant. None of the interlocutors in Ireland and abroad, with whom the authors of this report talked, questioned that EMU membership for Ireland has been, on balance, highly beneficial.

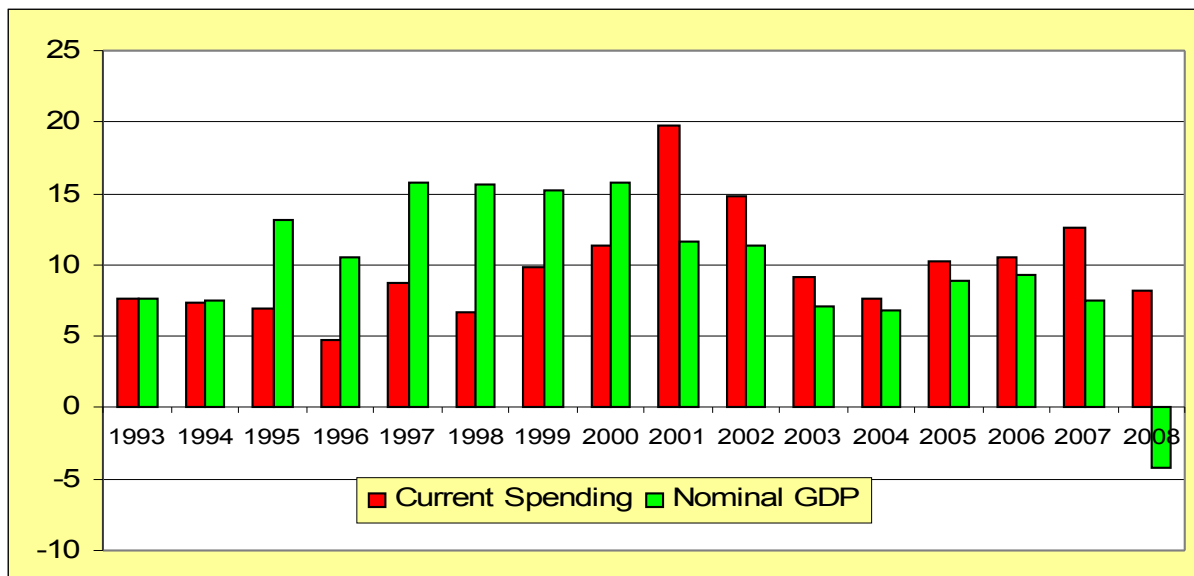
#### **d. The fiscal stance**

For a long time, Ireland's overall fiscal policy was considered to be exemplary because the country achieved fiscal surpluses every year from the mid-1990s to 2006, including the creation of a Pension Reserve Fund to make budget surpluses politically more acceptable.

However, the nominal budget figures mask an underlying deterioration in the fiscal situation after 1999. The cyclically-adjusted fiscal surplus was rather small during much of the last decade according to the data available at the time. As already mentioned, statistical tools to capture the full impact of asset bubbles on tax revenue are not well developed, otherwise it would have become clearer much earlier that the structural, underlying fiscal balance was much less favourable than assumed at the time. The IMF estimates now that in 2007, when the headline budget was approximately in balance, the underlying, structural deficit (taking into account the large positive output gap and the effects of the asset price bubble) had deteriorated to 8 ¾ percent of potential GDP and amounted to 4 to 6 percent in the run-up to the crisis. The conclusion is that overall fiscal policies were pro-cyclical during most years up to, and including particularly, 2007 thus adding markedly to the overheating of the economy.

This was the result of both public expenditure and revenue developments. The Irish public expenditure-to-GDP ratio increased during the years preceding the crisis although it remained low compared to the majority of EU countries. Expenditure increases were particularly marked in 2006 and 2007. Current expenditures, which had not kept pace with nominal GDP growth in the 1990s, grew faster than nominal GDP every year from 2001 to the crisis. In addition, from 2001 to 2007, ex-post growth in current expenditure was always higher than budgeted every year except one.

**Chart 5: Government Current Expenditure and Nominal GDP: Annual Changes (%)**



Source: O’Leary, Jim (2010), “External Surveillance of Irish Fiscal Policy during the Boom”, NUIM Department of Economics, Finance and Accounting Working Paper.

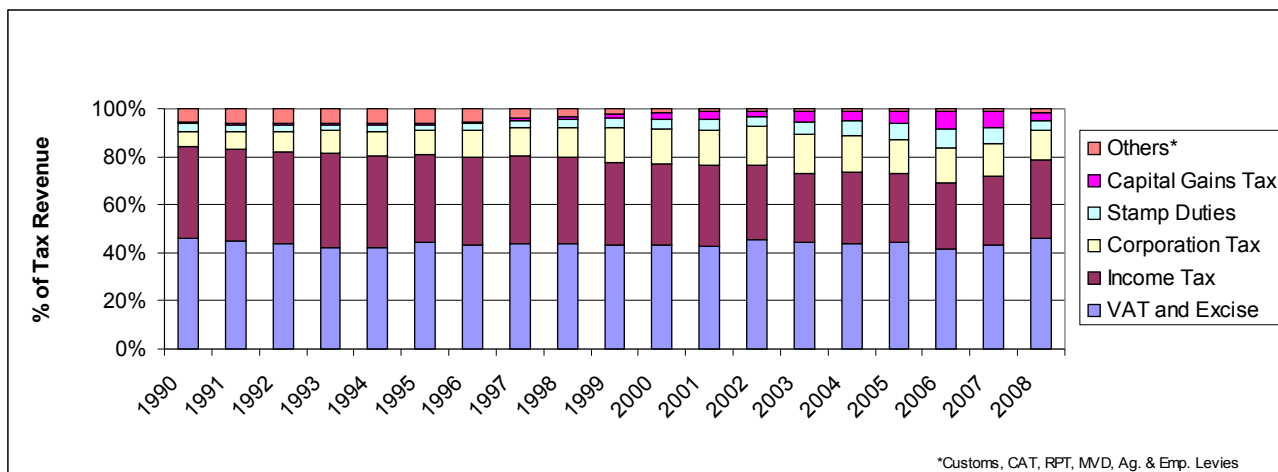
Public sector pay and the growing size of the civil service contributed particularly strongly to the growth in current expenditure. The number of staff in the Irish public sector grew by 15.5 percent from 2001 to 2008 according to OECD statistics.

Overall, developments on the expenditure side of public budgets added to the overheating and vulnerability of the economy. But developments on the revenue side were even more worrying.

#### **e. Tax policy**

The main reason for the sharp increase in the fiscal deficit in 2008-09 was the collapse in tax revenue. This was possible because the structure of tax revenue had changed dramatically from the 1990s to 2006-07. The composition of tax revenue had shifted gradually from stable sources of taxation, like personal income tax and VAT/excise taxes, to cyclical taxes, such as corporation tax, stamp duty and capital gains tax. The share of these cyclical taxes reached 30 percent of tax revenue in 2006; in the late 1980s it had amounted to only 8 per cent. The overall revenue-to-GDP ratio was more or less unchanged at around 35-37 percent from the 90s until 2007.

**Chart 6: Composition of Tax Revenue**



This shift in the composition of the tax base created two problems: (i) it made it more difficult to assess the underlying, structural situation of the budget and the fiscal stance because the cyclical taxes grew rapidly in the run-up to the crisis with implied tax elasticities of up to 5 in the years before the crisis; and (ii) it made the budget more vulnerable to a recession, beyond the normal working of automatic stabilisers, because tax elasticities of the cyclical taxes reversed rapidly in the downturn.

Why was the structure of taxation changed so massively?

First, and most importantly, the government repeatedly offered income tax cuts to achieve wage restraint in the context of the trilateral wage agreements. This seemed sensible at the time as revenue was booming. However, over time, this approach narrowed the tax base and made it more fragile because the “booming” part of tax revenue turned out to be a transitional phenomenon.

Second, the Irish taxation system favours systematically, and more than in other EU countries, property and particularly home ownership. Ireland is one of very few countries where interest payments on mortgages can be deducted from income tax yet there is no property tax (which would provide a stable source of revenue for the public sector). While this approach narrowed – again – the tax base, it also interacted in a negative way with the emerging real estate bubble by giving additional incentives to households to invest in real estate.

Third, the Irish tax system includes a large number of “tax expenditures” (tax allowances, reliefs and exemptions from income tax which – to some extent – reflect the income tax cuts mentioned above). According to the OECD, by 2005 the cost of “tax expenditures” had become larger than the remaining income tax receipts. As a percent of total tax revenue, tax expenditures in Ireland are more than three times larger than on average in the EU. Again, this excessive reliance on tax relief narrowed the tax base. In addition, it contributed – again – to the property bubble, as some of the tax relief was directed to the property sector, often in particular regions of the country. And it contributed to a more general misallocation of resources as some of the tax concessions seem to have been granted on an ad-hoc basis in a not fully transparent way. After a review by the

Department of Finance in 2006, a number of tax expenditures were eliminated and some restrictions on the use of certain tax reliefs were imposed. Nevertheless, the system remained distorted.

The significant shift in the structure of tax revenue made the budget more vulnerable. More generally, the projection of tax receipts and their relationship to developments in the economy has proved to be an Achilles Heel of policy analysis in many advanced and emerging economies during the recent cycle; and the related challenge of estimating the degree of slack in the economy in real time is also much harder than previously acknowledged. The economic analysis resources of the Department of Finance deserve to be strengthened for these reasons.

## **2. Financial sector developments and policies**

This section discusses the role that financial sector developments and policies played in triggering the banking crisis in Ireland. It focuses on four sets of issues: the impact of financial integration; the role of bank management and governance; the influence of regulation and supervision; and the contribution of financial stability reporting. These topics correspond to the frame of reference used above for the global and European financial market environment.

### **a. Financial integration**

During the years preceding the crisis, an important influence on banking developments was the continued increase in Ireland's integration with other European financial markets. Two changes in this area affected bank behaviour in Ireland particularly strongly. First, and more importantly, following euro adoption, there was a quantum change in the availability of cross-border bank funding without foreign exchange exposure. This clearly facilitated the lending boom in Ireland, while also meaning (on the very positive side) that large foreign exchange risks did not build up among end-borrowers of funds. Second, there was also an impact of foreign (especially UK-based) banks on competition for lending to the real estate sector.

These two developments were mutually-reinforcing in their impact on incentives for bank management. From a policy perspective, both were recognised to be beneficial. However, they also implied risks and challenges for policy. By mid-decade, some of these risks and challenges were identified by the regulators in Ireland, and modest steps were taken to address the vulnerabilities that they entailed. Nonetheless, the compound impact of these changes, in conjunction with other risks, was underestimated, and (particularly with the benefit of hindsight) the steps taken were too modest to make a major impact in compensating for these risk factors.

It is important to understand why this was the case.

First, concerning competitive conditions, a key preoccupation of policy-makers in Ireland early in the decade (following vocal criticism from consumer groups) was that there might be too little competition in the domestic banking market, resulting in practices such as the overcharging of customers. In the mortgage market specifically, loan approval processes were seen as long-drawn out and cumbersome.

As foreign subsidiaries became more active - offering mortgages set at a small premium over money market rates, and also 100 percent LTV loans - and as some domestic institutions also sought to gain market share through more streamlined mortgage approval processes, these developments were viewed by the authorities overwhelmingly in terms of a benign shift to a modernised and competitive market – one that was in tune with developments in the UK and US. Following a period when there had been major concerns about low competition and the overcharging of consumers, these trends were thus seen as benign winds of change blowing through the Irish financial sector. And certainly there was scope to serve consumers more efficiently.

Second, with the deeper integration of euro-based wholesale funding markets (including euro denominated borrowing in the London market), it became much easier for banks in Ireland to raise wholesale market finance across borders, and thus to finance the deficits of firms and households. One can think of this deeper financing capacity as amplifying the impact of both good and bad decisions about resource allocation in Ireland. In other words, it is clear (at least with the benefit of hindsight) that there were countervailing macroprudential risks in this new environment.

## **b. Bank management and governance**

In this setting of macroeconomic ease and growing financial integration, bank managements in Ireland faced major new opportunities. However, this environment also entailed challenges for bank governance – governance notably in areas such as internal priority setting; risk assessment systems; the enforcement of due processes for loan evaluation; disclosure standards; and checks and balances on the day-to-day operations of management.

These challenges were not met. Errors of judgement in bank management and governance contributed centrally to Ireland’s financial crisis. It seems that there were key weaknesses in some banks’ internal risk management in areas such as stress-testing; the assessment of credit risks; and in some cases major lapses in the documentation of loans – and that these were factors that allowed vulnerabilities to develop.

Before coming to institutional responsibilities, it is useful firstly to survey the facts at the level of the banking system, and to put them in perspective.

The evidence of exceptional financial exuberance in Ireland lies most clearly in four sets of indicators for the national economy and for individual institutions. These concern credit growth, asset concentration, loan to value ratios, and funding exposure.

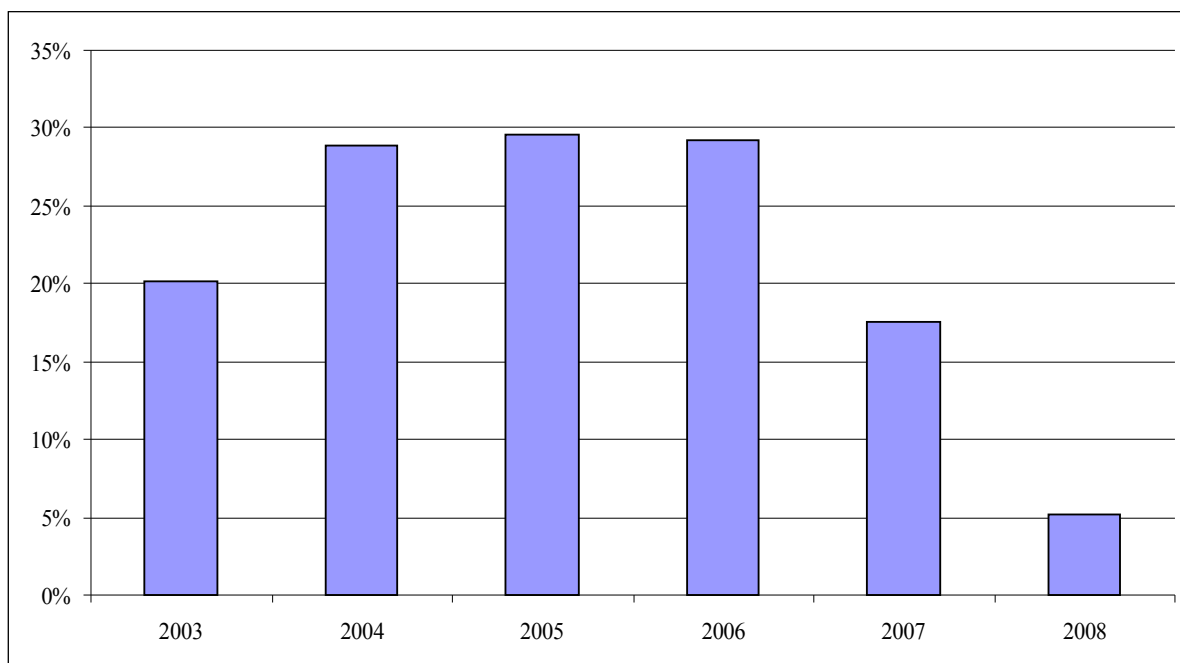
Concerning credit growth (Charts 7 and 8), what occurred in Ireland over the past decade was simply and squarely a massive financial sector and property boom. Moreover, this boom was not marked by the esoteric complexity of financial instrument design that proved the downfall of institutions elsewhere. The problems lay in plain vanilla property lending (especially to commercial real estate), facilitated by heavy non-deposit funding, and in governance weaknesses of an easily recognisable kind. Together, these factors led to acute vulnerabilities and then to deep economic and social costs.

In this regard, lending trends in the Irish banking sector – especially from 2003 onwards – feature a pace of expansion, and a rise in asset and funding risks, that should have rung alarm bells. Ireland is

a country that stands out – together with Spain, the UK and the US – in the extent to which developments in credit, asset prices, and external funding can be seen to parallel trends in economies that earlier experienced a financial crisis.

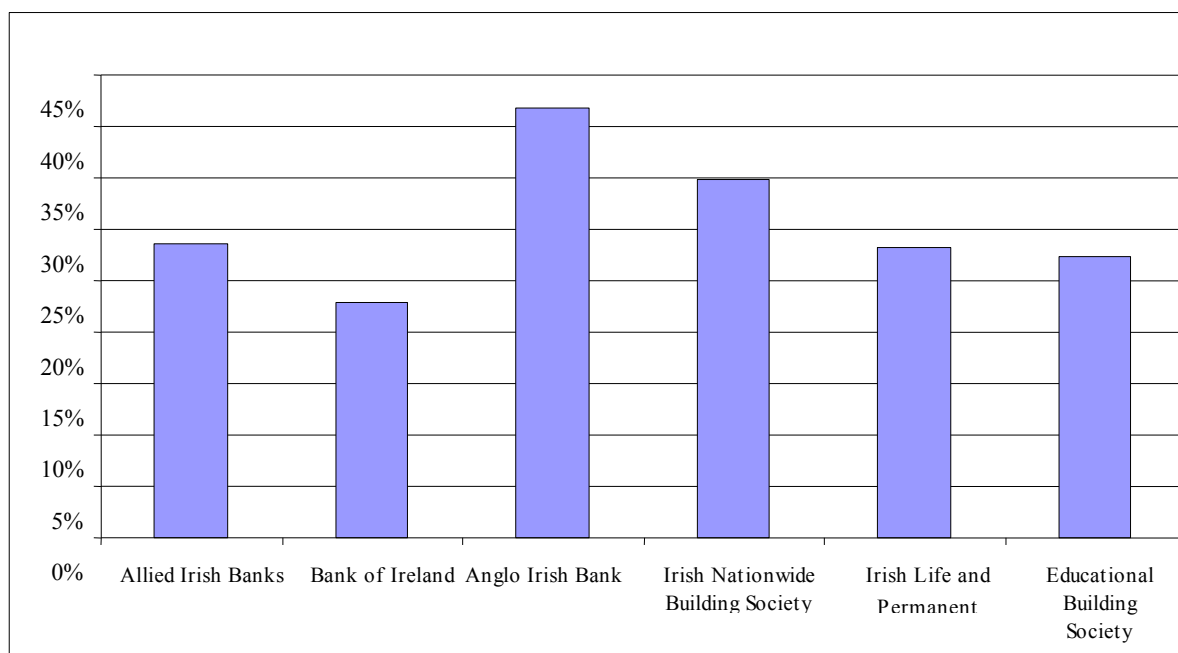
This boom was distinct from economic and financial convergence of the kind experienced in Ireland prior to 2001, and which persisted well into the 2000s in Eastern Europe. During an accelerated process of catching up, rapid financial deepening was a natural element to anticipate. But by 2001, Ireland was no longer in a stage of opening up newly to European markets, or catching up with average EU living standards. In terms of the real economy, Ireland had caught up. Indeed, the major phase of productivity growth was over.

**Chart 7: Private sector credit growth of the Irish banking system**



Source: Central Bank of Ireland  
The Irish Banking system includes subsidiaries of foreign banks  
Credit includes securitised residential mortgages

**Chart 8: Compound annual average loan growth for selected Irish financial institutions\* (2003-2006)**



\*Loans are at group level and so include foreign lending as well as domestic lending

Source: Annual Reports

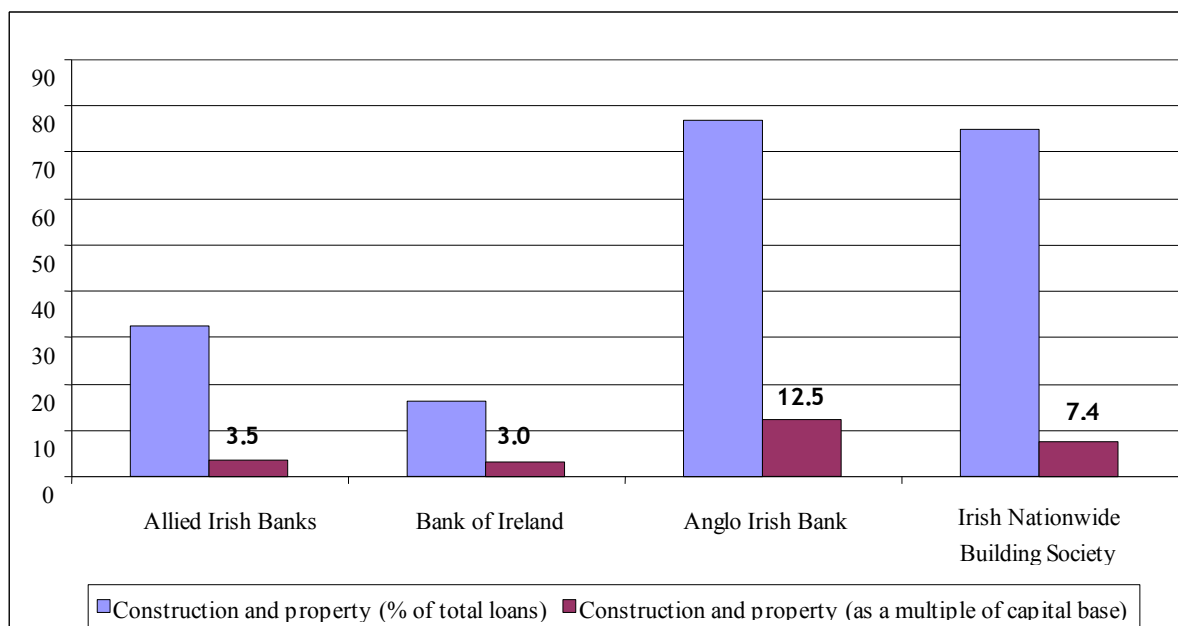
Bank of Ireland data are for the financial year ending March in the following year

Anglo Irish Bank data is for the financial year ending September

The second, and analytically even clearer, hallmark of mounting risks lay in the asset concentration of some major lending institutions (Chart 9). This was a threefold concentration. It featured loans to the property sector in general; loans to commercial property specifically; and within this latter group, development loans to interests associated with a limited number of key developers of commercial property. In this respect, Ireland stands out.

It has been widely cited that the business model of expansion through lending for commercial property was spearheaded by one or two institutions. However, partly through emulation, it became over time a feature of several leading financial institutions. Exposure levels and asset quality differed importantly across the financial sector, of course. But in this respect the asset vulnerability problem was a systemic problem, not a one-bank problem. Thus a problem emerging at one major institution risked triggering a recognition that the concern was in fact systemic. This is an important point that seems beyond reasonable doubt.

**Chart 9: Loans for construction and property excluding residential mortgages \* (2006)**



\*Data exclude residential mortgages and can thus be taken as representing the exposure of banks to commercial property in a broad sense.

Source: Annual Reports

Specifically the data are for: Allied Irish Banks and Irish Nationwide December 06; Bank of Ireland March 2007; Anglo Irish Bank September 07, estimated based on data in the 2008 annual report.

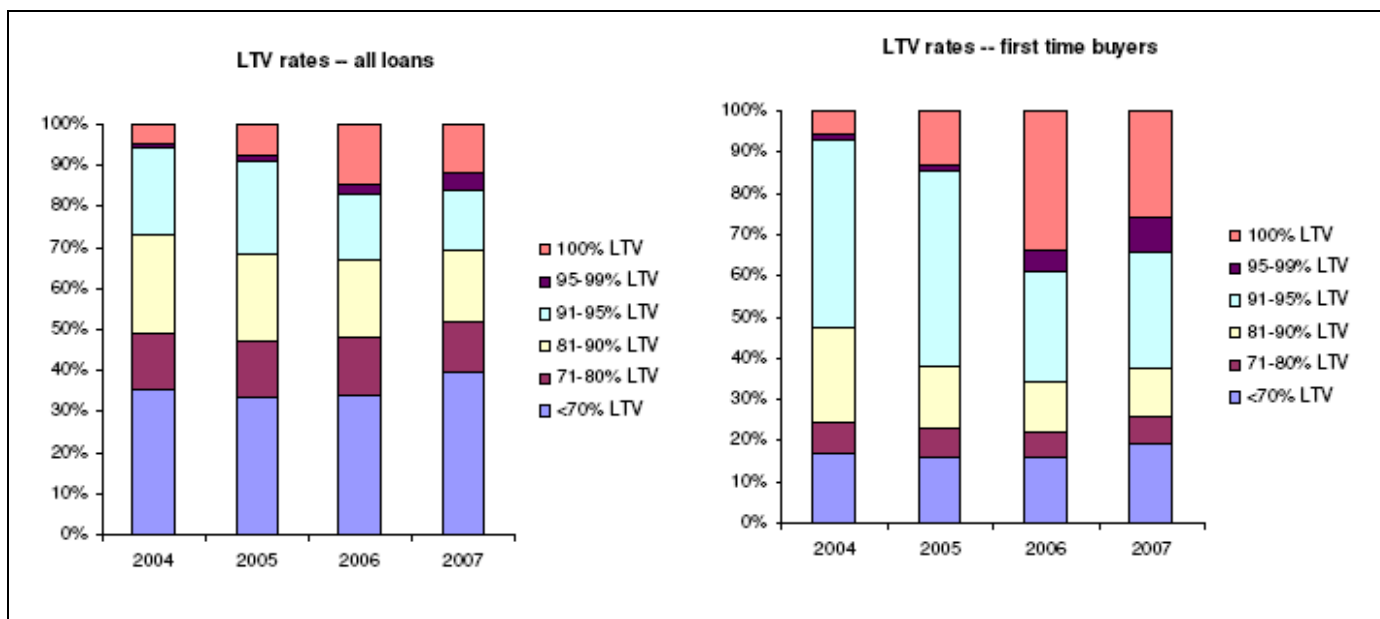
The concentration of risks in lending was a feature that made the banking system particularly vulnerable. Cycles in credit to commercial real estate are prone to particularly wide swings; and in the upswing of the cycle in Ireland, there is wide agreement that property development was well ahead of trends that fundamentals could justify. This put bank capital heavily at risk in some cases. Since this boom was bank-financed, its reversal was bound to be subject to the usual acceleration and deceleration effects that occur when collateral values rise and fall. The interaction with the procyclical policies in the budgetary domain could only amplify this effect.

In other words, a marked slowdown in the economy, and in the property sector in particular, was unlikely to end in a soft landing for significant parts of the banking system. Serious stress in the financial system was almost unavoidable – even if the Lehman Bros event had not administered a huge shock to liquidity. This is the key point that virtually all parties (including the 2006 IMF Financial System Stability Assessment) basically missed.

Against a backdrop of rapidly rising property prices, a further litmus test of overly exuberant lending practices lay in the trend of loan-to-value ratios (Chart 10). This dynamic is particularly the case if the flow of new loans is considered, not the average LTV on the stock of loans. In at least one case this trend resulted in the majority of business being put on at LTVs of 100%. These were not sound practices under any prudent assessment of the risks for future economic growth and property price developments.



**Chart 10: Loan-to-value ratios for Irish residential mortgages**

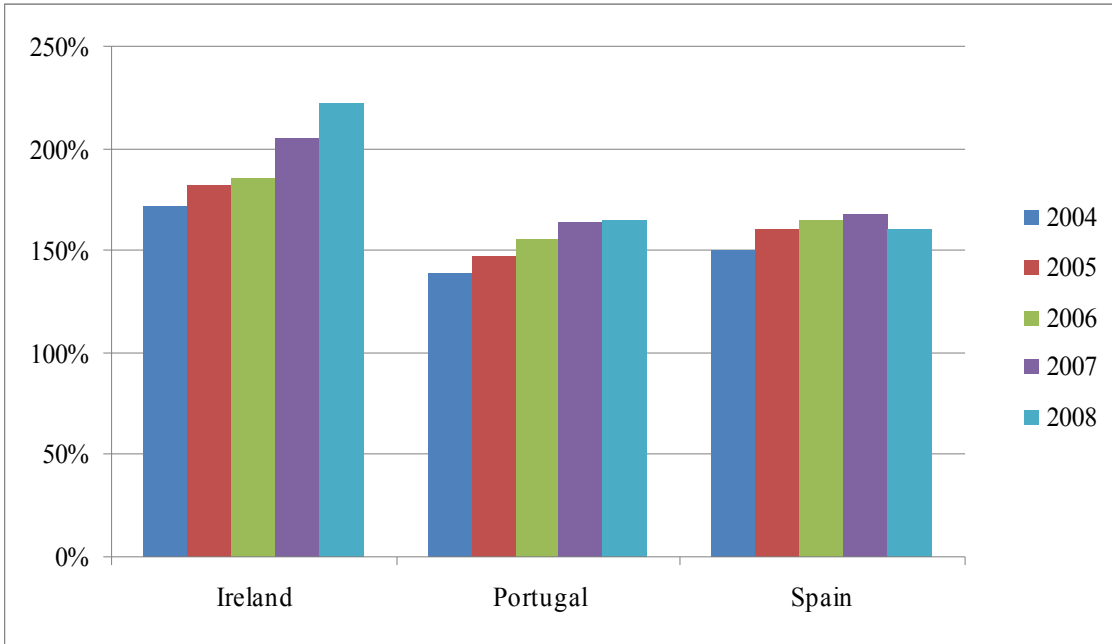


Source: Department of Environment, Heritage and Local Government. New Irish mortgages issued in the respective year, as quoted in Honohan, P., "Resolving Ireland's Banking Crisis", Economic and Social Review, Vol. 40, No 2. It seems reasonable to assume the majority of 91-95% loans were made at the 95% level.

The emergence of funding risks was also a system-wide trend. Funding exposure is perhaps best illustrated by loan to deposit ratios (Charts 11 and 12). A ratio of above 200% for the system as a whole was higher than other comparable euro area economies, leaving a large hole to be filled with debt securities and interbank borrowing.

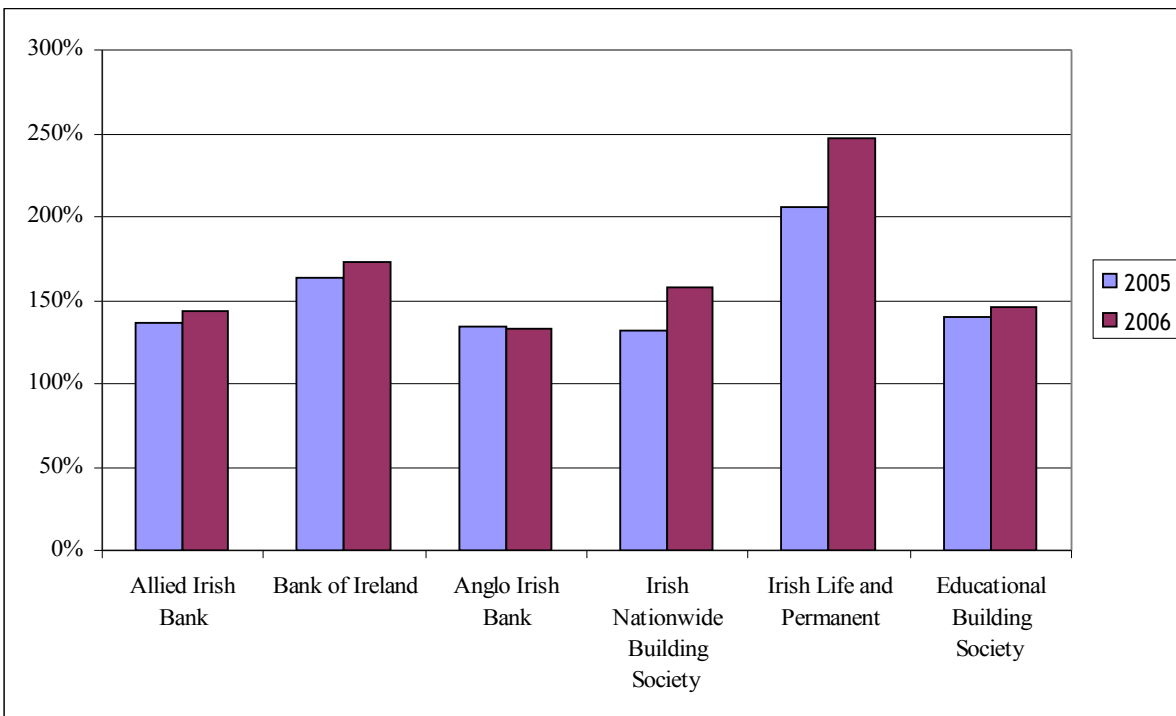
The period from 2003 to 2006 saw wholesale borrowing by Ireland in the euro area markets grow rapidly as a source of funding, reaching, in Ireland, about 39% of the combined loan books for the six financial institutions shown in chart 8 at end-2006. The growth in short term borrowing was even more rapid, with securities of one year remaining maturity or less amounting to €41bn at end 2006 for the two largest banks, up from €11.1bn at end 2003. Rolling over such borrowings was predicated on the continuation of benign wholesale markets.

**Chart 11: Loan-to-deposits ratios for the Irish, Portuguese and Spanish banking systems**



Source: IMF

**Chart 12: Loan-to-deposit ratios for selected Irish financial institutions \***



\* Loan to deposit ratio calculated at group level, incl. foreign loans and deposits.

Source. Annual Reports

All data at December 2006, except Anglo Irish Bank data September 2006 and Bank of Ireland data March 2007

The assessment above should help place in perspective the performance of individual institutions. It speaks to a collective governance failure, and in part it reflected an uncritical enthusiasm for

property acquisition that became something of a national blind-spot. It was in this sense at least a wide political and social phenomenon, and some of the underlying misjudgements about debt and property were so embedded in collective psychology that this can be imagined, perhaps, to mitigate institutional failures to some degree.

However, this report has a duty to answer the question where and how bank management and governance were to blame for their parts in the Irish banking crisis. Four key areas stand out:

- First, a critical weakness in bank risk management was the concentration of bank assets in activities related primarily to property, and more specifically commercial property. This risk concentration in a few institutions meant that they were potentially very vulnerable to an economic downturn, let alone a more severe market shock. In addition, it seems that the number of ultimate obligors in the commercial property sector, if one considers those engaged in major projects, was quite low by customary banking standards, once connections among borrowers are taken into account. All in all, property exposure gave rise to a very risky concentration of risks within certain institutions, and even more so across the banking system. In an economy which is not large, and which has one main financial centre, it would be surprising if this state of affairs was unknown to banks, even if formal data systems did not surface it.
- A second and closely related problem in the procedures of bank governance was that lending guidelines and processes seem to have been quite widely short-circuited. This occurred in a tidal wave of uncritical enthusiasm (the term “reckless” has been used by some officials in their public testimony) to participate in financing the property boom and to maintain market share. The extent and nature of such failings seems to have varied very significantly across institutions. Management inevitably would be to blame in such cases, but broader corporate governance issues would also arise. As a broad generalisation, the failings of corporate governance seem to have been much more a problem of deficient implementation than defective guidelines and processes. With strong roles of boards, credit committees, audit committees, and external auditors, common sense suggests that any *systematic* problems of this kind in an institution should have been picked up. Furthermore, liquidity management and funding policy was in some cases not prudent or conservative, even by the global and euro area standards of the past decade, but the degree of potential vulnerability here was probably much harder for management and other actors to assess at the time.
- A third issue concerns remuneration and incentives. In many popular accounts of the global financial crisis (and Ireland is no exception), this topic conjures up images of top management bonuses, or the practice of awarding stock options on a large scale. A fair degree of consensus has emerged internationally about the need for improvements concerning such practices. However, in Ireland at least, one should not neglect incentives set for middle-level bank management and indeed loan officers.
- A fourth and final set of issues is potentially much graver, and it cannot be assumed they constituted a generalised phenomena. These were very specific and serious breaches of basic governance principles concerning identifiable transactions that went far beyond any question of poor credit assessment. The Government’s notice on the nationalisation of Anglo Irish Bank, for example, refers to “unacceptable corporate governance practices” as a triggering factor in the nationalisation. The preparations for this report did not unearth additional examples beyond those that are already in the public domain. Some investigations are

already underway, and are therefore not commented on here. Relevant categories of such potential issues seem to include the disclosure of loans to directors; the window-dressing of balance sheets beyond acceptable levels; and the question whether loans by financial institutions were linked in some clear and problematic way to purchases of their own shares. One question is whether the possibility of market manipulation (in the share market) as a specific concern may deserve consideration. In some of these areas, again, there may be questions how far external auditors probed relevant draft accounts before certifying them. But, to be quite clear, there is no suggestion here that such grave breaches were a generalised feature of the Irish financial system. It seems that they were limited to, at most, specific institutions.

It is clear that these banking developments occurred against the backdrop of macroeconomic and financial conditions of a kind prone to trigger such events. This macrofinancial environment in itself should have placed bankers on the alert. However, the record of history is not encouraging as regards banks' avoidance of the herd instinct, or their insights into externalities and macrofinancial risks. This is where regulation can, and has to, play a crucial role. That role – never an easy one for public officials to play with confidence and credibility – is to be right, against the market.

### **c. Regulation and Supervision**

This was a macroeconomic and financial environment that exposed supervisors in Ireland to severe tests. Moreover, as noted earlier, it took place at a time when there was, globally, some shift away from intrusive supervision, and also a relative neglect of liquidity risks. There was, moreover, a continuing debate in the international supervisory community about the best kind of regulatory structure to adopt, and about the nature of relations between a central bank and a separate regulator. This section discusses first the overall regulatory structure in Ireland, and then the way in which supervision was implemented in practice.

The structure of regulation seems to have been less important in explaining Ireland's banking crisis than the way in which supervision was implemented in practice. However, the structure has attracted a lot of attention, and this issue deserves to be clarified.

The twin-headed bank regulatory framework in Ireland from 2003 onwards was a hybrid, by global standards. However, this structure was at times viewed as an interesting experiment (like the different, but also original, approach in the Netherlands). Indeed, the IMF's assessment of Ireland's regulatory framework, at its inception, was positive: a key question across countries was how to keep non-supervising central banks linked in to macroprudential issues, and the IMF saw Ireland's framework as offering scope to do this.

With hindsight, that evaluation proved too optimistic. Domestically, the new regulatory structure had emerged from a policy compromise, and this genesis did not help its credibility, or indeed encourage a focus on macroprudential risks. Specifically, the framework reflected in part a concern to ensure stronger competition in banking, and to make sure that households got the benefit of this (after earlier experiences with overcharging). Surprisingly, the Prudential Director was not an *ex officio* member of the board of the regulator, whereas the Consumer Director was. Even if a priority was to increase competition, an essential flanking measure should have been to ensure a parallel

strengthening of prudential supervision: these are complements not alternatives. Nonetheless a pragmatic solution was found by inviting this official to all meetings, underscoring that where there was a will, there was a way.

By contrast, the scope in this twin-headed regulatory structure to devise and implement a decisive macroprudential strategy that would dampen the property boom was exploited only to a limited degree. Supervisory analysis and implementation fell short in just the area, macroprudential risk, where the IMF had hoped that the framework might prove valuable. In this sense, design was not the issue, at the end of the day. Implemented in the right spirit, there is no question that this framework could have been made to work sufficiently well to mitigate the impact of the credit/property cycle.

There were also some questions, in this framework, about ultimate responsibility and about lines of command. These were issues that the regulator's partially interlocking relations with the central bank seem to have left open to interpretation. Again, however, such questions should not have stood in the way of firm and proactive supervision. The issue was implementation.

Another regulatory issue which cast a long shadow in recent years can again be seen in these terms. The regulatory change in the previous decade that allowed building societies to expand in commercial property (as opposed to residential mortgages) was followed by a significant rise in the riskiness of some balance sheets. However, the main point was not the permissive regulatory change. It was the supervisory approach and implementation that followed. Under all circumstances, such a regulatory change should have provoked an intensification in the supervision of these institutions to ensure that their management had the skills and judgement to avoid over-rapid expansion in new business areas. There was an extended dialogue about some governance issues; but overall the response was far too weak.

In sum, the common theme cutting across these regulatory framework issues is that they should not distract from the true problems, which were issues of supervisory implementation. Where, then, did these problems of implementation lie?

At the level of specifics, the authors of this report defer to the supervisory inquiry that is to be the core of Governor Honohan's parallel report, which is to be informed by an in-depth review of internal documents. There is no attempt here to duplicate that more forensic investigation. But from the "top down" perspective of this report, focused on diagnosing how supervisory failings fit in a composite picture of responsibility, the picture seems very clear.

There were four main failings of supervision:

- (i) The supervisory culture was insufficiently intrusive, and staff resources were seriously inadequate for the more hands-on approach that was needed

All accounts of the performance of the supervisory authority point in the same direction. Supervisors, at one level or another, were aware of most of the risks, and they did take some actions. As noted above, in the case of liquidity, they were one of the few authorities who made restrictive changes in this period. They were also more active than many supervisors in property boom economies in their decision to impose heavier capital weights on high loan-to-value

mortgages. But these changes were clear examples of too little, too late. By the time they became effective, there was little impact before market trends reversed of their own accord.

More generally, the supervisory culture was insufficiently forceful and pre-emptive. On-site inspections were infrequent. Targeted follow-up was weak, including crucially on governance issues. Supervisors were perceived as reluctant to impose severe penalties, and during the key period when major governance problems arose, they imposed no penalties on banks at all.

It is clear that there was a serious lack of skills, and to some degree of numbers of people, in the regulatory authority. This would have impeded any pursuit of a very active inspection programme, making it harder to quite literally “get inside” the management philosophy, operational practices, and governance processes of individual banks. Still, the risks inherent in the huge exposures to property (and notably commercial property) that were put on across the system should have been apparent without an army of inspectors. So should the intense concentration of lending risks to specific borrowers in the commercial property sector. This was a question of insight, not of bodies. Deeper inspections, however, could have been crucial as a follow-up in helping to identify and act on the scale of poor collateral, weak documentation, and low levels of borrower equity underlying some loans.

It can be accepted that the supervisory approach in Ireland reflected to some degree the climate of the times in the global supervisory community, with light-touch regulation and reliance on markets’ own risk assessments. And, to be clear, the supervisory approach in Ireland did not become lighter during this period. The point is rather that it remained very accommodating in a radically changed environment: a setting in which the Irish financial system had expanded hugely and was engaged in a burst of extreme lending enthusiasm. Ireland’s mounting financial vulnerabilities meant that strong action was called for to over-ride the prevalent light-touch and market-driven fashions of supervision: to call a spade a spade, in terms of mounting systemic risk, and to head off the risks of a crisis.

There are cases elsewhere, no question, of weaker responses than Ireland’s. But there are also examples in other advanced economies of supervisors standing out against the crowd on one or more key issues, thus mitigating the economic and social fallout from unwise banking decisions. When assessing policies in Ireland, in order to learn lessons for the future, these more robust cases are the appropriate counterfactual.

The argument is sometimes made that more pre-emptive action would have been impossible, or would have seriously damaged the competitive position of Irish banks. Foreign-owned banks, it is said, would have jumped in to fill the gaps left by Irish banks’ restraint. This is an important point to be clear on. It is partly, but only partly, true. To the extent it is true, it highlights a key challenge for supervisory co-ordination for Europe as a whole. Exercising “supervisory restraint in one country” is like fighting with one hand tied behind one’s back.

However, in Ireland’s specific situation, that case should not be overstated. Notably, national actions such as fiscal measures to dampen borrowing, or limits on loan-to-value ratios for borrowers located in Ireland, would have affected loans by foreign-owned subsidiaries also. Some leakage through direct cross-border loans from abroad would have occurred, and in the commercial property market these could have been significant. Experience in Eastern Europe, however, suggests that in the retail mortgage market, leakages from that source would probably have been rather low. Moreover, foreign supervisors’ cooperation could have been more actively sought. Finally, it is no small consideration that the fiscal liability on such cross-border loans, if they went bad, would have

been squarely in the court of the foreign taxpayers – not adding to Ireland’s fiscal problems. And Irish banks would have been able to re-expand later from a smaller but healthy base, softening the setback in the real economy.

The alleged incapacity of one country to act, as a black and white judgement, is an argument that should be rejected – especially as the Irish fiscal approach in this key area was in the wrong direction: it made things worse not better; and the prudential culture was clearly too mild.

(ii) Governance failures were not addressed sufficiently toughly

As discussed in the previous section of this report, the governance failures that occurred in the Irish banking system can be grouped very broadly into two categories, and these two categories (even if the edges are inevitably somewhat blurred) are important to distinguish also in assessing supervision weaknesses.

The first category of failures seem to have been quite widespread - not just limited to one or two institutions. These failings concerned weak risk management, including poor credit appraisal and the overriding of internal guidelines and processes that should have prevented the build-up of such high and risky concentrations of credit risk exposure – in property generally but especially in the field of credit related to commercial real estate. More broadly there was a failure of corporate checks and balances that should have served to restrain management’s enthusiasm for rapid and concentrated credit growth. This kind of weakness in governance was detected by supervisors, who clearly interacted with certain institutions concerning the need to improve corporate governance and indeed the need for stronger checks and balances on management in some cases. However, it is very clear that this supervisory reaction was much too weak, and this was a key problem in the run-up to the banking crisis. It is also noticeable that draft guidelines on corporate governance and on directors’ compliance statements were tabled as initiatives but never brought to fruition.

Concerning concentrations of real estate lending linked to a low number of end-borrowers, it is true that internal management reports in banks, and indeed prudential reports to supervisors, may not always show fully how dependent loans are ultimately on the health of a few borrowers, because there can be definitional latitudes in how and when to identify connected borrowers. However, such reports usually do throw up major borrower concentrations in individual institutions, and thus they also allow supervisors to make an aggregation of exposures to these borrowers across the system.

This is an area where senior management insight in the regulatory authority could have overridden systems, if needed, to prioritise the documentation of such system-wide concentrations of lending to individual or connected borrowers. A credit register would also have helped to identify and fine-focus on connected or large borrowers in this connection, of course. However, among senior officials, it would seem quite surprising if there was no common wisdom to tap that would have pointed to the fact of high concentrations in commercial real estate lending to a small number of major actors. Changes are needed to ensure that such issues are properly identified and monitored in the future, and a credit register (though not a panacea) would be a key advantage in this respect.

The second category of governance failings were more intense and localised, and they concerned what appear to have been very serious failings of governance indeed. These breaches of basic principles do not appear to have been a system-wide problem in Ireland. Some of these events are already being investigated. It is not fully clear at this point (although Governor Honohan’s report



may perhaps unearth decisive internal facts) how far supervisors were aware of these failings, or (if they were aware) whether they always identified them as failings. For example, window-dressing transactions may apparently have been viewed as benign in intent, but in fact they may have raised very serious disclosure issues indeed. What is clear is that the failure to identify, recognise the gravity of, and take tough remedial action to correct such serious governance breaches was a cardinal error of supervision during this period.

(iii) Macrofinancial vulnerabilities were underestimated

These macrofinancial vulnerabilities lay mainly in asset concentrations in property; in funding risks; and in the potential linkage between these factors. By far the most serious macrofinancial flaw was the over-exposure of institutions to commercial property, with this vulnerability being heightened by a high concentration of lending to a small number of borrowers. Supervisors were clearly aware that property exposure was risky, and they commented on this as credit to this sector continued to expand and property prices continued to rise. Indeed, as referred to briefly above, in 2006 they exploited the flexibility in the newly adopted Capital Requirements Directive to take sector-specific measures on capital cover for high loan-to-value mortgages. This was commendable. One can point to other economies where even this step was not taken. But the scale of the measures taken was very modest, and they became effective more-or-less at the end of the boom.

The fact is that supervisors, right to the end, clung on to the hope of a soft landing for the economy and the property market, as did a much wider community of opinion in Ireland (to the extent such opinion foresaw any end to the boom at all). Supervisors did not focus strongly on the extent of the possible, and really rather likely, swing in commercial property values, when the economy would slow down after a period of high consumption and overbuilding. It is hard to view the eventual impact of this on the capital of certain institutions as an exceptional or unforeseeable event. Moreover, this property lending was of a common-or-garden kind: not exotic, or complex, or hard to assess through esoteric statistical models. And it constituted a sword of Damocles hanging over the banking system.

This was a major misjudgement, since published central bank data on sectoral lending by banks would have given a reasonable clue about the scale of the problem, and the cyclical characteristics of such lending are quite well-known.

There are, however two aspects to this question. Identification of poor quality loans, and the diagnosis of an undue concentration of credit risks, in the first instance requires accounting, governance and legal skills. However, assessing the pattern of overall financial risk associated with such concentrations also requires economic insights. Resource limitations and formal understandings meant that supervisors were dependent on the central bank for such economic analysis. This interaction did not prove effective.

(iv) Key facts which should have been of central interest to supervisors (e.g., on bank governance) were not available to policy-makers in a timely manner at the point where the crisis began to unroll – the end-point of this report

This judgement rests on the way that developments unrolled, and has not been informed by the perusal of classified documents. More detailed evidence may become available from the parallel



inquiry by Governor Honohan and his team, and the judgement in this report stands to be sharpened or toned down in light of that “bottom-up” assessment. But for the time being, one illustration, falling just within the scope and time period of the present report, may serve to make the point.

The statement by the financial regulatory authority on March 9<sup>th</sup>, 2009, referring to the issue of Director’s Loans at Anglo Irish Bank, states “the issue did not surface again internally, even in Autumn 2008, when major stability and strategic issues were being addressed by the authorities, including the government.” This is a very serious concern indeed.

To summarise, the response of supervisors to the build-up of macrofinancial risks in Ireland’s banking system was the opposite of hands-on or pre-emptive. Globally, this was to some degree a product of the times. Domestically, moreover, there was a socio-political context in which it would have taken some courage to seem to prick the Irish property bubble. Even so, there are clear examples in other countries where supervisors acted to stem the tide, and this is what lacked so notably in the Irish case. Moreover, the financial regulator in Ireland was not called upon to deal with technically complex problems. Ireland’s banking exuberance was a straightforward property bubble, compounded by exceptional concentrations of lending for real estate – and notably commercial real estate – purposes. Depending in part on the results of the parallel report, this is an area for further investigation to determine what degree of censure is warranted for such clear failures of supervision. However, it would seem that any macrofinancial failings must also be laid in part at the door of the central bank, which had a near monopoly on economic expertise in the two-headed institution.

#### **d. Financial stability surveillance**

By mid-decade, the financial and property boom in Ireland presented features – both macro- and microeconomic – which should have caused financial stability analysis by the central bank to ring alarm bells. This reporting noted worrying features, but it failed to trace their interactions vividly or to warn (in public or, it seems, in private) how severe were the emerging vulnerabilities in the banking system; the risks of a hard landing; and thus the danger, ultimately, to the living standards of the ordinary citizen.

There was some valuable research in the central bank into financial institutions’ exposure to the commercial property sector in general. For example, a background paper to the 2007 Financial Stability Report does a good job at analysing aspects of this issue, while eventually expressing some agnosticism about the probabilities of a serious problem. However, in the core macroprudential analysis of the central bank, and it seems also in its private advice to government, the risks of a “hard landing” for the commercial property market, the banking system, and the economy – even without a savage external liquidity shock – were seriously underestimated.

In fairness, external surveillance fared little better. The IMF’s Financial System Stability Assessment of 2006 is not a document that warns strongly of mounting risks. It is not focused or forceful in pulling together the combined implication of mounting macroeconomic imbalances and a heavy concentration of bank assets in property (especially commercial property). The warnings are stronger than in some contemporaneous IMF reports on advanced economies. But they do not drive the point home. More generally, surveillance providers did little to buttress the case of those

internal voices that were raised to warn of the mounting risks; and this surveillance failing is particularly clear in the key area of financial stability assessment.

## IV. Policy Lessons

As Irish society begins to move on from the crisis, some issues doubtless need to be laid to rest, with suitable policy lessons being drawn for the future. By contrast, there must be other parts of the experience where closure cannot be achieved without some further investigation to clarify roles and responsibilities – including so that justice can be seen to be done. With some humility, such a triage is suggested in this and the following section of this report.

Where are there general policy lessons to be learned – lessons that should often be of potential value to other existing, and especially future, euro area members?

The over-arching lessons from the experience in Ireland fall into seven broad categories, and they are flagged here to highlight points that are explored more fully in earlier pages:

- In euro area members, fiscal and prudential policies must take into account, and seek to mitigate, a mismatch between monetary conditions and the national business cycle. This can be especially important during the period of transition to euro area membership, as the economy adjusts under the euro to a new steady state.
- The management and surveillance of euro area economies must take fully into account the imbalances and risks that can build up in both the private and the public sector of national economies, including “external” imbalances vis-a-vis other euro area members, and the way those imbalances are funded. So long as fiscal and labour market policies remain national to an important extent, the national balance of payments is a meaningful economic concept even within the euro area.
- The design of fiscal policy needs to build in sufficient allowance for temporary revenues, and the tax base should not be eroded (especially for distortive goals). The introduction of independent institutional sources for economic and fiscal projections would appear useful. It may also be helpful, after the immediate phase of crisis management, to explore the use of a domestic fiscal rule, such as a medium-term expenditure ceiling, to supplement the EU Stability and Growth Pact.
- In an adaptive financial system, there is a case for principles-based supervision, in conjunction with clear rules. But the “light-touch” approach to supervision has been discredited: it sent wrong signals to banks and left supervisors poorly informed about banks’ management and governance, potentially impairing crisis response capacity also.
- Supervision needs to be based on a deeper analysis of the links between risks in different types of asset and liability: these include the legal links between connected borrowers; the economic links between classes of assets that may deteriorate sharply at the same time; and the risk that asset problems may in turn trigger funding shortfalls. A credit register (“centrale des risques”), following the model of some other EU countries, could be one important tool in this connection.
- Financial stability analysis must be more strongly integrated into supervision. It needs to capture liquidity as well as solvency risks, and it must explore in a more contrarian way various macrofinancial scenarios for the economy, including economic correlations among assets, and between assets and liabilities, of the kind referred to above. There is need for a

more interactive, and at times a more confrontational culture, in the inter-agency discussions that explore risks during fiscal and supervisory policy design.

- Supervisory co-ordination in the EU needs to become much more intense and operational; and it needs to address cross-border risks of a macroprudential kind, not just a microprudential kind that emerge in national markets.

Reviewing these lessons from the experience in Ireland against the backdrop in Part II of this report, it is immediately apparent that the policy problems in Ireland map quite closely to issues identified in at least some other countries, including converging euro area economies. Three features stand out in Ireland, however. First, all of the above problems of policy analysis, design and implementation were present in the Irish case, not just a few; and these policy problems had a mutually-reinforcing impact. Second, policy problems in certain areas were unusually severe in Ireland: here, the weaknesses in tax policy and in the implementation of financial supervision (given the trends in the banking system) must be cited. Third, Ireland was one of those cases where there were at least some instances of extremely serious breaches of corporate governance, going well beyond poor risk assessment, and eventually having a systemic impact: the need to address these squarely is the main focus of the concluding section of this report.

## V. Areas for Investigation

This report has identified a number of more concrete factors that apparently contributed to Ireland's banking crisis. Given the design of this report, its legal status, and the fact that it has not drawn on documents protected by banking secrecy, its role is (a) to highlight such factors, without prejudice to institutions or individuals, and (b) to recommend where further investigation seems desirable to achieve greater clarity and to ensure that incentives are corrected for the future.

In order to learn lessons promptly, and to achieve closure rapidly, it would seem wise for the subsequent process of statutory investigation to focus mainly on issues that stand out as potentially highly blameworthy but also very concrete, and feasibly verifiable by a legally oriented process:

- Overwhelmingly the most important issues to investigate are those that seem to have involved very serious specific breaches of corporate governance. It is not clear that such failures were limited to one institution only, although there is no suggestion that they were in any sense system-wide. It seems important to identify how such very serious governance failures were initiated; how and why internal checks and balances failed in restraining the management of certain banks; whether there were failures of auditorial vigilance; whether supervisors knew of the events (and if not, why not); and why the response of supervisors was not more forceful. It is relatively clear also that supervisors were not in a position to warn top policy-makers of the major asset risks or of some crucial problems of governance in banks, on the eve of the crisis – a failure that had very serious implications – but the circumstances surrounding this deserve fuller investigation to confirm the picture.
- The second set of issues deserving investigation potentially relates to a wider number of institutions, though to differing degrees. These issues concern breakdowns in risk management approaches and in some cases the unwarranted or excessive overriding of internal guidelines. At the broad level of risk management and governance in the Irish financial system, it appears particularly surprising that there was not a stronger reaction within the banks themselves and among supervisors to lending trends that saw a progressive build-up of concentrated loan exposures to and within the commercial property sector. It would be valuable to establish the reasons for the absence of reaction, within banks and in the regulatory authority, since this was a critical factor that contributed to the overall level of risk exposure in the system. Again, it should be established how and why internal checks and balances failed; whether supervisors perceived the risks; and why the response of supervisors was not more forceful.

There are many other issues, of course, that should trigger important learning at the level of policy formulation and execution, and may indeed carry broader political and social lessons. A number of those were discussed in the preceding section of this report. However, those issues are in general less concrete and verifiable, and they appear less amenable to a legally-oriented process of investigation.

Both strands of the reassessment suggested above – policy review and formal investigation – now need to be pursued rapidly. This is important in order to identify lessons for policy in the future. It is also crucial in order to “clear the air,” and thus bring public debate on the Irish banking crisis to closure.



## **Appendix**

### **Letter from the Minister for Finance of Ireland, commissioning the report**

11 February 2010

Mr. Klaus Regling  
A. Adolphe Lacomblé 69,  
1030 Brussels,  
Belgium

By Fax and Email

Dear Mr Regling,

I am writing to you to thank you for agreeing to conduct a preliminary investigation into the crisis in the banking system in Ireland, and to confirm your appointment in this capacity.

As you know, the Government considers it essential to thoroughly examine how events in the banking sector, the regulatory system and the wider Government sphere of responsibility contributed to the crisis, in order to arrive at a fuller understanding of the root causes of the systemic failures that led to the need for extraordinary support from the State to the domestic banking system.

In light of this, the Government has agreed a detailed framework for such an investigation into the banking system. The investigation will have two stages. The first stage of the investigation will consist of the preparation of two separate preliminary reports; one to be prepared by you and a second report which has been commissioned from Professor Patrick Honohan, the Governor of the Central Bank and Financial Services Authority of Ireland. These reports will provide a basis for the Government and the Oireachtas (Parliament) to prepare the terms of reference for the second stage, which will involve the establishment of a statutory Commission of Investigation, pursuant to the Commissions of Investigation Act 2004. It is anticipated that the Commission will be established by 30 June 2010 and report before the end of 2010.

## Context for your report

At the broadest level, the causes of the difficulties in the banking sector in Ireland are similar to difficulties that have been experienced in the banking and wider financial sectors internationally. The Government is therefore of the view that your report should consider the international economic and financial environment, and indeed any broader social developments, which provided the context for the recent crisis in the banking sector and that it should have regard as appropriate to existing reports on the banking system, such as the de Larosière and Turner Reports. However, you will understand that a central element of the report is to identify factors specifically pertaining to the Irish banking system which exacerbated the impact of the international financial crisis for Ireland.

## Scope of your report

I would also ask that you highlight in your report the areas in relation to the conduct, management and corporate governance of individual institutions that you consider necessary for subsequent investigation by the statutory Commission of Investigation.

The Government has decided that the investigation should cover the period up to the end of September 2008, at which point the Government announced its intention to introduce a guarantee of all liabilities of certain institutions. The Government has not specified a date for the beginning of the period to be investigated. However, it is clear from existing analysis that the root causes of the systemic failures within the sector that led to the need for extraordinary support from the State in September 2008 have their origins in decisions that were taken at institutional, regulatory and Government levels over a period of time and it will be open to you to consider what is the relevant timeframe.

## Practical arrangements

The Government has decided that both preliminary reports should be submitted to me not later than the end of May this year and I understand that you are agreeable to this. My officials will discuss with you further whether they can be of assistance to you, in terms of the approach for preparation of your report, and how you might engage with key individuals. I might note that your report should be prepared with a view to its publication in full and its laying before the Oireachtas following its consideration by Government.

I should also bring to your attention that a discussion with the relevant Oireachtas Committee will be required so that you may set out to the Committee how you propose to prepare your report and that you may also be briefed on the Oireachtas' own priorities for this investigation. My officials will be in contact with you separately in relation to this. It may also be anticipated that your appearance before the relevant committee may also be required when the report is completed.

As regards the work of the statutory Commission of Investigation, you might note that the Government envisages that the terms of reference and draft Government Order to establish the Commission will be laid before the Houses of the Oireachtas in June and the report of the Commission of Investigation will, when completed, be laid before the Oireachtas for further consideration and action.

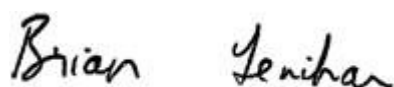
My Department has discussed with you the arrangements that will apply in respect of your fees and expenses and will provide confirmation to you separately in relation to the arrangements that will apply. My Department would also propose to make a member of its staff available to you as a point of contact for your work and to assist in the practical arrangements over the duration of your work.



It is not proposed, and I understand that you are agreeable to such an arrangement, that this official would have any role in the preparation of your report.

Finally, on behalf of the Government, I would like once again to express my appreciation for your agreement to the preparation of this report. The Government considers it a matter of the utmost national importance, in light of the importance of repairing the damage to the international reputation of Ireland's banking system, that an authoritative and substantive report is prepared at this juncture on the causes of the severe banking crisis in Ireland. Your experience, credibility and expertise will, I believe, play a very important role in providing reassurance to the Irish public and the boarder international economic and financial community that Ireland is committed to stabilising the causes of our recent serious difficulties with a view to learning the lessons required to ensure that our banking system is restored to health to underpin the recovery of the economy and its future development remains fully consistent with the maintenance of economic and financial stability.

Yours sincerely

A handwritten signature in black ink that reads "Brian Lenihan". The signature is written in a cursive style with a large initial 'B'.

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Brian Lenihan T.D.

Minister for Finance