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Government Policy and the Banking Crisis: Vindicated, Misled or Flying Blind?

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Almost three years after the onset of Ireland's banking crisis, public disenchantment continues to increase, aggravated in part by the government's failure to provide a transparent explanation for the crisis and an endless stream of revelations on the increasing cost of stabilising the banking system. Although the claim that the crisis was generated by events in the international economy has since been discredited by the banking reports, the government continues to maintain that it was acting on the "best available advice" at the time.[1] As a consequence, the government has been able to largely pin the blame for the crisis on events outside its control. But these claims appear at odds not just with those of the banks, who now claim to have known about the impending crisis as early as 2006, but also with claims by the Department of Finance that it did not have sufficient information on the operation of the banking system, as well as claims by the Central Bank that it continuously warned that the economy was vulnerable to "a very serious international shock".[2] This raises a number of questions regarding just what advice was available to government in advance of the crisis. Were its officials misled? And why did it need to bring in so many external advisors to resolve a crisis that was, to all intents and purposes, internally generated and predictable? More importantly it raises wider questions regarding the credibility of government economic policy, its views on financial regulation and its justifications for imposing fiscal austerity.

Against this background, it is unsurprising that many remain disillusioned with both the expense and slow progress of banking sector reform. This disappointment can be summed up in a number of points:

- Despite extensive underwriting of liabilities in the banking system, a resumption of lending to small business has not occurred
- The two banking inquiries, though providing in-depth background to the crisis, have not revealed anything that was not already in the public domain, and their findings are

[1] Taoiseach Brian Cowen's defence of his actions while Minister for Finance has been that although some mistakes were made, government decisions were taken on the advice available at the time. See for example Cowen's defence of his time as Minster for Finance following the release of the banking inquiry reports. "Cowen Admits Mistakes were Made" Irish Times 10th June 2010.

[2] See "Banks 'did not alter behaviour' despite Central Bank warnings" Irish Times 11th March 2009

bound to appear unsatisfactory to a general public who will ultimately foot the bill for the crisis through fiscal austerity and NAMA.

- In particular, it appears unlikely that anyone will be held to account as a result of their publication.
- NAMA completed its second transfer of loans in 2010, but if anything its achievements merely reinforce the desperate conditions of the banks and their unsustainable funding models.
- There remains a perception that bankers and developers have escaped lightly, while construction workers and those in related sectors have suffered disproportionately higher levels of job losses.

It is revealing that the root of many of the current banking problems can be traced to the precarious condition of the commercial bank's balance sheets. In a companion TASC thinkpiece, it was pointed out that the banks themselves were aware of this as early as 2006.[3] But the problem was also highlighted in by the Central Bank. The reliance on non-deposit-based funding, and the excess of retail and corporate loans over deposits, were clearly highlighted in the discussion of bank balance sheet issues accompanying both the 2006 and 2007 Financial Stability Reports. The fact that these early warnings were ignored leads to the inescapable conclusion that government policy, whether in bank regulation or other areas of the economy such as wage policies, has a poor track record of using internal analysis to inform policy decisions.[4]

This thinkpiece argues that the Government appears deeply uncomfortable in relying on its own analysis and data, even that generated by its own institutions such as the Central Bank. Contrary to claims that they acted on the "best available advice", it demonstrates that the research available to the government from the Central Bank indentified a serious funding gap facing the banking sector as early as 2006. These dangers were not hidden on the banks' balance sheets. The thinkpiece argues that the inability to understand the dangers posed by the funding gap is again reflected in the Government's inability to explain to the public why NAMA and the deposit guarantee have not returned the banking sector to stability. This absence of comprehension is also reflected in the political interpretation of the banking inquiries. Although the latter raised a

[3] Damian Tobin "A Crisis of Ethics: Moral Hazard and Bank Regulation in Ireland" TASC Think Piece March 2010 http://issuu.com/tascpublications/docs/tobin_250310

[4] For example, the government appeared quite willing to justify public sector wages cuts on the grounds that they were above those in the private sector but later admitted in the 2010 Budget Outlook report that although surveys undertaken by "various institutions" indicated a downward trend – "the evolution of private sector per capita wages is a source of some uncertainty" (page 14).

number of crucial issues regarding risk management and regulation, they also place the blame for Ireland's crisis on the pro-cyclical fiscal policies. While the latter has provided an appealing justification for the Government's policy of fiscal austerity, pro-cyclical fiscal policies are ultimately an unsatisfactory explanation for poor bank governance and regulation . It is also an unhelpful distraction in moving the banking sector towards a more sustainable model of funding and regulation.

Officials Misled

Claims by the Taoiseach that the government acted on the best available advice at the time, and that they were effectively misled by reassurances from the banks, appear to vindicate the government's *laissez faire* approach to regulation prior to the crisis. They suggest that government officials had little opportunity to prevent the crisis. It is therefore curious that these claims are neither backed up by the commercial banks' own balance sheets, nor by the analysis of the funding gap by the Central Bank, nor by claims by the Department of Finance that it did not necessarily have a full picture of the workings of the commercial banks.

Although it is difficult to gain a precise picture of the Department of Finance's approach to the crisis, official records in the form of evidence given to the Committee of Public Accounts on 22nd July 2010 by Mr. Kevin Cardiff, the head of banking at the Department of Finance in 2008, provide an interesting insight into the Department's views on the banking system at the time. In his testimony, Mr Cardiff pointed to concern within the Department regarding the lack of information on the workings of the commercial banks.[5]

"...we certainly were concerned in the midst of this crisis that we did not have a sufficient understanding of the details of the workings of each bank. We certainly were reliant on the work, efforts and advice of the Financial Regulator throughout"

The accounts of the crisis by the Department of Finance appear to suggest that the collapse of the UK bank Northern Rock in 2007 served as the major warning signal. Northern Rock had a similar funding model to that of the Irish commercial banks. Yet, although the Department appears to claim that it was not completely blind to the workings of the banking system, its understanding of the severity of the problems facing the banking system does not appear to pre-date 2008.

[5] See: Committee of Public Accounts Thursday 22nd July 2010
http://debates.oireachtas.ie/DDebate.aspx?F=ACC20100722.xml&Node=H3#H3

"I would not say we were flying blind. Certainly we were taking the advice we were given as regards the solvency issues. This situation changed quite a lot in the course of a year. The solvency issues that were becoming much clearer at the end of 2008 were not nearly so clear at the beginning of 2008."

However the funding gap, and the threat it posed to bank solvency, was not hidden on the banks balance sheets. The commercial banks were clearly aware of it, and by the end of 2006 had already begun taking corrective action. Statistics from the CSO show that the number of new housing loans approved peaked in 2005. The Central Bank was also aware of the funding gap, and had highlighted it in two consecutive stability reports. The uncomfortable implication of the above is that government officials were not necessarily misled by the banks. Moreover, the inescapable conclusion from these reports and the ensuing crisis is that government was not necessarily acting on the best available advice. Instead, it chose to trust the reassurances issued by the banks themselves, the Financial Regulator, and the plethora of external advisers appointed both before and after the banking crisis.

Early Warnings Ignored

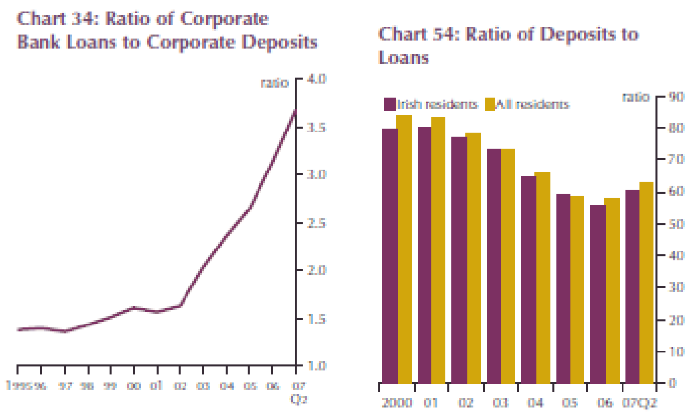
Although the Central Bank has been widely criticised for its inaction in the lead-up to the crisis, it is clear that it was aware as early as 2006 of the potential for a severe funding crisis. The Central Bank's discussion of balance sheet issues clearly identified the widening funding gap facing the commercial banks. It is revealing that the problems first highlighted in the 2005 Stability Report – including excessive credit growth, overconcentration of loan books in property, falling net interest margins, and a widening funding gap – continue to persist to this day.

While the 2006 Financial Stability Report (2006: 12-13) noted that the general health of the banking system remained robust when measured by profitability, solvency, liquidity and credit ratings, it also identified vulnerabilities arising from credit growth and rising indebtedness. But more specifically, the report pointed out that the banking sector's funding gap (as measured by the ratio of private sector deposits to private sector loans) had widened to 54 percent. This was the highest in the Euro area. These issues were further elaborated in Part 2 of the same report. Although the report notes the ease with which Irish banks were able to access wholesale funding, it pointed to two major concerns: first, that wholesale funding is more expensive than retail deposit funding, thus placing greater pressure on interest rate margins; and secondly, that an international shock could result in a withdrawal of international funding, thereby constraining the ability of Irish banks to extend further credit.

The 2007 Financial Stability Report repeated the concerns expressed a year earlier. While bank stress tests again confirmed the general health of the banking system, this time the stability report pointed to the dramatic increase in the ratio of corporate loans to deposits. The report also pointed to the persistent growth of non-financial corporate borrowings, which had continued since 2002 and stood at three times their level of the late 1990s. In terms of the widening funding gap, it noted that in 2007 (2nd Quarter) borrowings were 3.7 times the level of deposits compared with 1.4 times in the late 1990s. On page 45 of the report, Chart 34 (see Figure 1 below) clearly demonstrates the dramatic increase in the ratio of corporate loans to deposits.

Despite the clear warnings on the dangers of the widening funding gap, the report rather bizarrely goes on to quote the opinion of ratings agency Standard and Poor's that such changes merely reflected the Irish commercial banks' strategy of boarding their funding base and increasing its maturity over time. It is a source of great irony that, in the current period of fiscal austerity, the government is even more dependent on the rating outlooks of Standard and Poor's and other rating agencies to solve the desperate funding problems that these same agencies played a role in facilitating.[6]

Fig 1: The Widening Funding Gap (Source: Financial Stability Report 2007: 45)



The Funding Gap, NAMA and the Deposit Guarantee

Neither is it without irony that the two precise issues first outlined in the 2006 Financial Stability Report continue to present the greatest threats to the recovery of the banking sector. The

[6] On the 25th of August 2010 it was widely reported that Standard and Poor's had cut the Irish State's credit rating from AA to AA minus indicating an increased belief that the state would not be able to meet its liabilities. The downgrade was based on a revised estimate for bank recapitalisation. See "State Borrowing Costs rise following Credit Rating Cut", *Irish Times* 25th August 2010 http://www.irishtimes.com/newspaper/breaking/2010/0825/breaking16.html

reliance on more expensive wholesale funding continues to place great pressure on interest rate margins, while the international shock that led to the withdrawal of international funding has essentially made future lending more expensive. The former has seen banks continue to rack up losses on tracker mortgages and force them to squeeze more vulnerable variable mortgage holders. The latter has meant that, despite the best intentions of NAMA and the bank guarantee, future lending remains constrained. Yet there is little or no acknowledgement from government of the seriousness of this issue. Even if NAMA were to remove the most troubled loans from the banks' balance sheets, and even if the government were to continue with the deposit guarantee in some form or other, the desperate condition of bank balance sheets would suggest that neither squeezing mortgage holders, nor holding back on lending, will see the banking system return to stability in the short term.

Perhaps most alarming of all is that, even if NAMA achieves its targets, many of the commercial banks remain dependent on an unsustainable funding model based on access to wholesale markets. From this perspective, the purpose of the bank guarantee is not one of resuming lending, but instead one of stabilising the funding base. Using figures from the financial institutions participating in NAMA, Table 1 illustrates the effect these have had on the current condition of the balance sheets. This shows that, even after NAMA, the bank's balance sheets remain in a weak condition. Loans continue to exceed retail deposits by significant margins. More worrying is that NAMA, despite its scale, has had a very limited effect on the funding gap facing many of the participating financial institutions. It is of little surprise then that Anglo Irish Bank's chief executive has said the bank guarantee will have to be extended because the financial system has not yet stabilised.[7] It is, however, very surprising that there has been little or no discussion regarding long term regulatory policy for bank funding.

Table 1: Loan to Deposit Ratios of Financial Institutions in NAMA

Bank	Pre NAMA Loans to Deposits (%)	NAMA exp. Transfer (Billion)	Post NAMA Loans to Deposits (%)
Allied Irish Bank	146	19	123
Bank of Ireland	152	10	141
Anglo Irish Bank	265	35.6	134
EBS	175.2	1	167.6

[7] "Bank Guarantee needs Extension" http://www.rte.ie/news/2010/0806/anglo.html

Irish Nationwide	152	8.7	44

Sources: Figures are for financial year ending 2009 based on the banks' estimates for assets held for sale to NAMA from Bank of Ireland, AIB, Irish Nationwide Annual Reports (2009); Anglo Irish Bank press release 31st March 2010; and EBS press release

Conclusion: Policy Vindicated?

The view that policy makers acted on the best available advice and that mistakes were largely outside their control has provided a neat vindication for the costly approach involving NAMA and fiscal austerity. This approach has been justified using the argument that Ireland's small open economy is essentially a victim of international mistakes, a broadening of bank funding (approved by international ratings agencies), and a lack of transparency on behalf of the commercial banks. But this thinkpiece has pointed out that there were clear warnings. The question of why these were ignored has yet to be convincingly answered. Until the public receives a transparent account, the credibility of the appeal for austerity - given the nationalisation of Anglo Irish Bank and the cost of NAMA - is severely weakened.

So too is the government's reliance on external advisers and ratings agencies. In September 2008, the Department of Finance claimed that it was necessary to employ PricewaterhouseCoopers and others external agencies to perform deeper analysis, reflecting a concern that the government (via the Financial Regulator) had insufficient information on the banking sector,[8] or perhaps had insufficient confidence in the data being provided to it by the Financial Regulator. Significant sums have been spent on external advisors, many of whom ultimately failed to warn the government of the impending problems in the first place. Their silence on these issues seems curious, since many of them continue to argue that governments must impose fiscal cuts in order to satisfy international bond markets. Soon they will undoubtedly look for sources of future growth, perhaps even arguing for a stimulus! It is therefore both disappointing and surprising that the government still has not got its own independent and dedicated economic policy advice unit. Evidence presented to the Committee of Public Accounts (22nd July 2010) indicates that Rothschild has been paid €1.4 million, €2 million has been paid to KPMG, over €750,000 to PricewaterhouseCoopers, €7 million each to Merrill Lynch and Arthur Cox as well as smaller amounts to Deloitte and Ernst & Young.

A final point is worth considering. Although this thinkpiece may serve as a justification for the behaviour of banks, it should not be read that way. A companion piece highlighted some of the

[8] http://debates.oireachtas.ie/DDebate.aspx?F=ACC20100722.xml&Node=H3#H3

serious ethical and moral issues that led to the crisis. What is does seek to do is highlight many of the inconsistencies that continue to be fed to the public daily on the banking crisis. The most alarming of these is that, from a regulatory policy perspective, government in a small open economy has little choice but to rely on the best available external advice and put its faith in the markets. The experience of other small open economies which depend on financial services, such as Hong Kong, suggests that government regulation and good governance systems do matter. The costs of these inconsistencies, and of the inability of the political system to recognise its mistakes, will be borne not just by taxpayers, but also by the wider economy through cuts in public services.