

## Patrick Honohan: Investigating banking failures in Ireland

Introductory statement by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, to the Joint Oireachtas Committee on Finance and the Public Service, Dublin, 15 June 2010.

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Following publication of my report to the Minister for Finance I promised to come back to the Committee to discuss the report and the question of the further stages envisaged for investigating the banking failures. In preparing my report, I had the benefit of a very effective team which was rapidly assembled to make sure that the job could be adequately addressed in the limited time available. The members of the team are listed in the report and I would just like to mention here the contribution of Rafique Mottiar, who is with me here today, Donal Donovan and Paul Gorecki, who led the team, as well as Nodhlag Cadden and Suzanne Pepper (also with me today) who organised the logistics and background work.

I can remind the Committee that the context for these reports is that “the Government considers it essential to thoroughly examine the conduct of the banking sector in recent years 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.” The Government has envisaged a two stage approach to the investigation, the first stage of which involved “preliminary reports” potentially providing a basis for the Government and the Oireachtas to prepare the terms of reference for the second stage, to involve the establishment of a statutory commission of investigation.

The report I have prepared in response to the Minister for Finance’s request is on “the respective functions of the Central Bank and Financial Regulator ... in assessing and responding to risks to the stability of individual institutions as well as to the banking system as a whole”. Although the report was described as “preliminary” I believe with my team, it has been possible to establish a fairly clear and comprehensive understanding of the matters in question. I believe that clear and unambiguous conclusions have been reached on most of the issues on which I was asked to comment, and I feel that there will not be any substantial need for further factual investigations regarding the performance of the Central Bank and Financial Regulator in these matters.

In preparing the Report, an in-depth review of the powers, responsibilities, philosophy, mandate, resources, policies and actions of the Central Bank and Financial Regulator was first carried out on the basis of: (i) publicly available sources such as Annual Reports, Strategy Statements, Financial Stability Reports, proceedings of the Oireachtas, and speeches; and (ii) minutes and Board papers of the Central Bank and Financial Regulator as well as extensive internal files, principally of the Financial Regulator.

Documentary material only takes one so far. In order to obtain additional background information as well as elicit views of key officials, an extensive series of interviews were undertaken running to about 120 hours; all persons requested to attend an interview did so. All of the directors of the CBFSAI and the Regulatory Authority as well as all senior management, managers and deputy managers in relevant units of the CBFSAI during 2003–2008 were interviewed. In addition, several other officials of the CBFSAI provided invaluable assistance on a number of important issues. In addition, to obtain a fuller picture, interviews were also conducted with a number of senior officials of the Department of Finance, the NTMA, the former Financial Services Ombudsman and three former bankers.

There are legal constraints on the detail which can be published on individual credit institutions, but I have sought to disclose as much detail as possible within these constraints. That has meant concealing or scrambling the identities of individual banks in many places,

but I do not think that this has materially hampered the presentation or interfered with the possibility of explaining what went wrong.

The committee already discussed last week the work of Klaus Regling and Max Watson. Their report overlapped to some extent with mine, in that they devoted some attention to bank regulation and financial stability policy. They also discussed at some length macroeconomic and fiscal policy on which my report had relatively little to say. There was, I feel a substantial degree of concordance between the two reports.

To repeat the main conclusions of my report, it points first and foremost to prima facie evidence of a comprehensive failure of bank management and direction to maintain safe and sound banking practices.

This failure of bank management was not sufficiently countered by regulatory and financial stability policy, for three main reasons.

First, a regulatory approach which was excessively deferential and accommodating; insufficiently challenging and not persistent enough.

Second, under-resourced bank supervision that, by relying on good governance and risk-management procedures, neglected quantitative assessment and the need to ensure sufficient capital to absorb the growing property-related risks.

Third, an unwillingness by the CBFSAI to take on board sufficiently the real risk of a looming problem and act with sufficient decisiveness and force to head it off in time.

The report also points to the contributory role of macroeconomic and budgetary policies which contributed significantly to the economic overheating, relying to a clearly unsustainable extent on the construction sector and other transient sources for Government revenue (and encouraging the property boom via various incentives geared at the construction sector). A less accommodating and procyclical policy would have greatly reduced the need for preventive action from the CBFSAI.

When I appeared before another Oireachtas committee in December I said, "We understand some of what happened, but some of it is still hard to understand". I think that we now know a lot more about the dimensions of the crisis on which my report has focused, leaving relatively little to be explored at the factual level by the proposed statutory commission of investigation.

As far as other areas which deserve further study are concerned, in the same general territory, but just outside the terms of reference for my report, I feel that we still don't know enough about the risk management and decision processes in the major banks, and how they failed to avoid disaster. I believe it would be useful to commission independent reviews of risk management and governance of these matters for at least the two big banks – this can be a useful exercise on a forward looking basis anyway, but looking at the period 2003–2008 would be key for the present purposes.

The potential role of accounting and auditing professionals is another matter that deserves additional factual exploration. It may be that this particular aspect should be deferred until after more of the NAMA purchases have been completed, as (judging from the evidence provided to this committee in April by Brendan McDonagh) the due diligence for these purchases seems to have revealed some issues around loan documentation.

Finally there may also be a case for commissioning a study of the operations of the mortgage intermediaries in loan origination during the boom period.

At the Central Bank, we have learnt our lesson and are already putting in place new procedures and arrangements that take account of that, and we will be making further announcements on this in the coming weeks.

## Ric Battellino: Aspects of Australia's finances

Address by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, to Financial Executives International of Australia, Sydney, 15 June 2010.

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Given the financial orientation of this group, I thought I would focus my remarks today on some aspects of Australia's finances. In particular, I want to deal with three questions that often come up when I talk to analysts and bankers from overseas. These are:

- are Australian households over-gearred?
- does Australia have too much foreign debt? and
- do Australian banks rely too much on foreign wholesale funding?

Before I move on to these questions, I should note that, in my experience, foreigners never ask about government debt in Australia, or corporate debt for that matter. It is not hard to understand why, as both government and corporate debt in Australia are low by international standards.

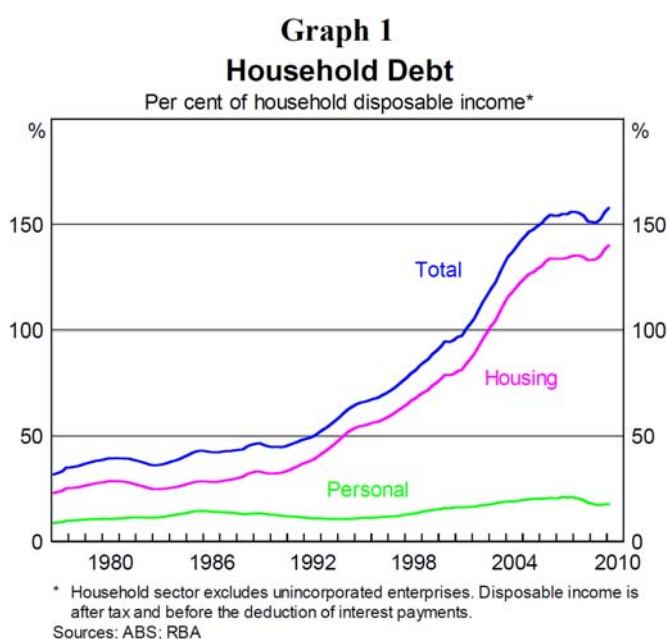
### Household debt

Let me then start with household debt.

The Reserve Bank monitors developments in household debt very closely as they have significant implications for the economy.

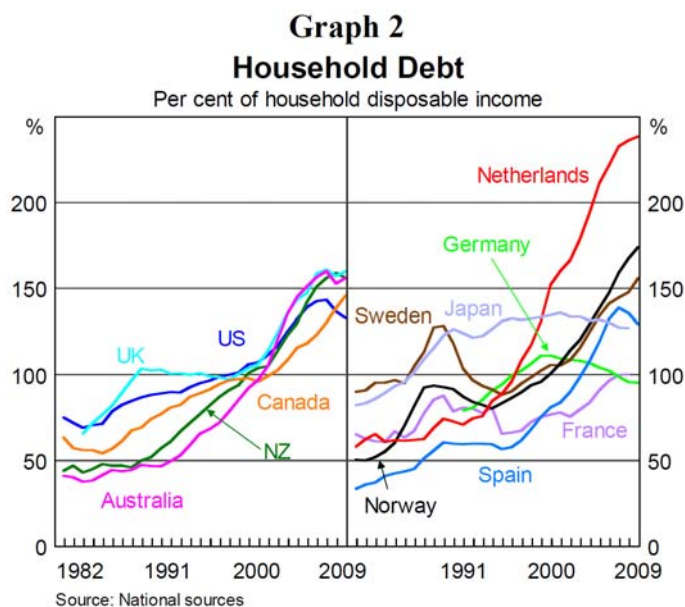
Glenn Stevens summarised the Bank's view on this last week when he noted that, while households had coped well with current levels of debt, it would not be wise for there to be further big increases in household indebtedness.

As you know, household debt has risen significantly faster than household income since the early 1990s. At that time, households on average had debt equal to half a year's disposable income; by 2006, debt had risen to around one and a half years' income. Since then, however, the ratio of debt to income has stabilised (Graph 1).



Most of the rise was due to housing debt, including debt used to fund investment properties. Other household debt, which includes credit card debt, car loans, margin loans and so on, has not changed much relative to income over the period.

The current household debt ratio in Australia is similar to that in most developed countries (Graph 2).<sup>1</sup> Significant exceptions are Germany and France, where the ratios are lower, at around one year's income, and the Netherlands, where the ratio is much higher – almost 2½ years' income – due to the tax incentives for households to stay geared up.



All countries have experienced rises in household debt ratios over recent decades. Clearly, therefore, the forces that drove the rise in household debt ratios were not unique to Australia. The two biggest contributing factors were financial deregulation and the structural decline in interest rates.

One of the consequences of financial deregulation was that the availability of credit to households greatly increased. Up to the 1980s, the various controls on the financial sector meant that the ability of households to obtain credit was constrained. Even obtaining a housing loan was relatively difficult. However, after financial regulations were eased around the globe, many new financial products were developed specifically for households, and particularly relating to housing finance. Households found it was much easier to get a loan. Most loans products have worked well, though some have caused significant problems; sub-prime loans in the United States are the clearest example.

The level of interest rates in most developed economies in the past decade has been about half that in the decade to 1995. This structural decline in interest rates has facilitated the increase in household debt ratios because it reduced debt-servicing costs (Table 1). Households have therefore found that they can now service more debt than used to be the case.

<sup>1</sup> Note that there is no particular reason why household debt ratios should be the same across countries.

	<b>1985–1995</b>	<b>2000–2010</b>
New Zealand	12.7	5.9
Australia	11.4	5.3
United Kingdom	10.1	4.2
Canada	8.7	3.1
Germany	5.9	2.9
United States	6.2	2.9

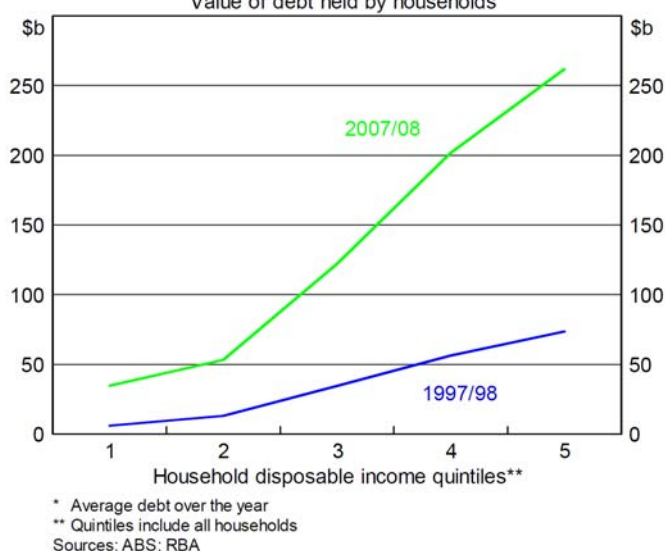
Sources: central banks; Thomson Reuters

Has the rise in household debt left households over-exposed financially? In trying to judge this, there are a few considerations to take into account.

First, at the same time as the household debt ratio has risen, so too have the assets held by households. Some commentators might dismiss this as simply reflecting the fact that the additional debt has been used to inflate asset values. There is some basis for this in relation to housing assets but, even if we exclude housing and focus only on households' financial assets, the statement is still true. Financial assets held by households have risen to the equivalent of 2.75 years of household income, up from 1.75 years' income in the early 1990s.

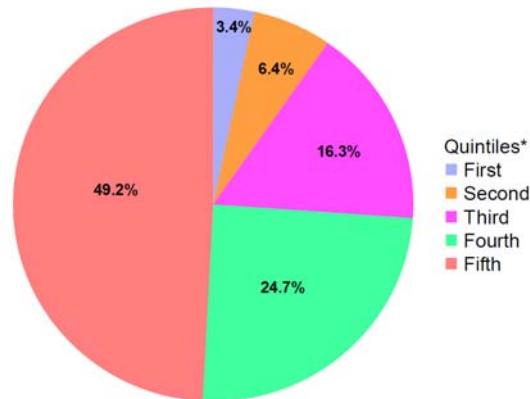
Second, the available data suggest that the increased debt has mostly been taken on by households which are in the strongest position to service it. For example, if we look at the distribution of debt by income, we can see that the big increases in household debt over the past decade have been at the high end of the income distribution (Graph 3). Households in the top two income quintiles account for 75 per cent of all outstanding household debt (Graph 4). In contrast, households in the bottom two income quintiles account for only 10 per cent of household debt.

**Graph 3**  
**Owner-Occupier Debt\***  
Value of debt held by households



### Graph 4 Indebted Households

Share of household debt held by income quintiles, 2006

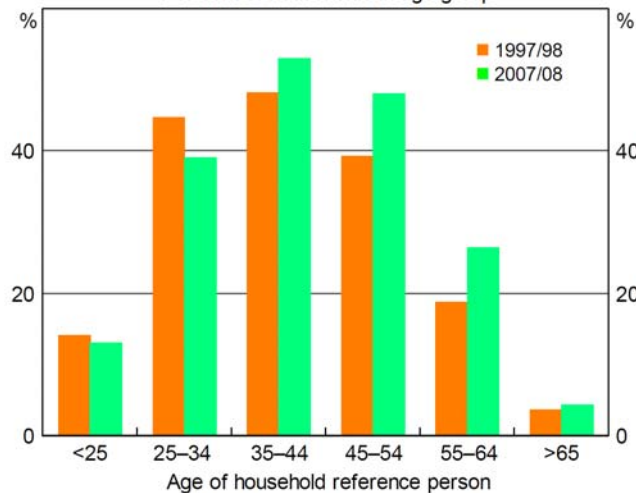


\* Income quintiles include all households  
Sources: HILDA Release 6.0; RBA

If we look at the distribution of debt by age of household, we see that the increased debt has mainly been taken on by middle-aged households. The proportion of 35–65 year olds with debt increased significantly through to 2008, as households have been more inclined to trade up to bigger or better located houses, and to buy investment properties. Households under 35 years of age (i.e. the group that would typically encompass first-home owners), in contrast, have seen a fall in the proportion with debt (Graph 5).

### Graph 5 Households with Owner-Occupier Debt

Per cent of households in age group

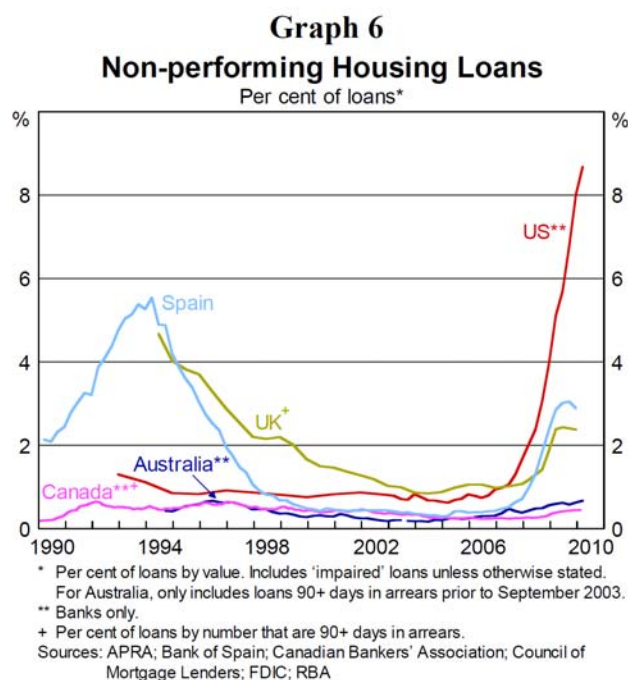


Sources: ABS; RBA

Another factor that has contributed to the resilience of household finances is that, by and large, the debt has not been used to increase consumption. Apart from some brief periods, household consumption has not been unusually elevated during this period of rising debt. Rather, the debt has mainly been used to acquire assets.

Perhaps the best, and most direct, indicator of households' capacity to support the increase in debt is the arrears rates on loans. This remains very low in Australia. The current arrears rate is around 0.7 per cent. This is one of the lowest rates among developed economies (Graph 6). Other data also suggest that households' aggregate debt-servicing capacity is

quite strong: in recent years more than half of owner-occupiers have been ahead of schedule on the repayments on the loan they took out to buy their property.



Within this relatively benign aggregate figure, pockets of stress have emerged from time to time. We saw this clearly in the south-western suburbs of Sydney following the sharp run-up in Sydney house prices over 2002 and 2003. More recently there are some signs of increased housing stress in south-east Queensland and Western Australia, again following sharp rises in house prices in these areas.

Another segment of the market that will bear close watching is first-home owners. They have accounted for an unusually high proportion of housing purchases over the past couple of years – around 40 per cent. This has reflected the incentives created by various first-home owner concessions. Most of these purchases have been funded by floating rate mortgages, and the average loan to valuation ratio is relatively high, at around 90 per cent. Clearly, this group will be very sensitive to changes in interest rates.

In summary, if we look at the way the increase in household debt has been distributed, what households have done with the money, and the arrears rates on loans, it is reasonable to conclude that the household sector has the capacity to support the current level of debt. Having said that, the higher the level of debt the more vulnerable households are to shocks that might affect the economy. We at the Reserve Bank therefore welcome the fact that the household debt ratio has flattened out in recent years and, as Glenn Stevens remarked last week, there would be benefits in that stability continuing.

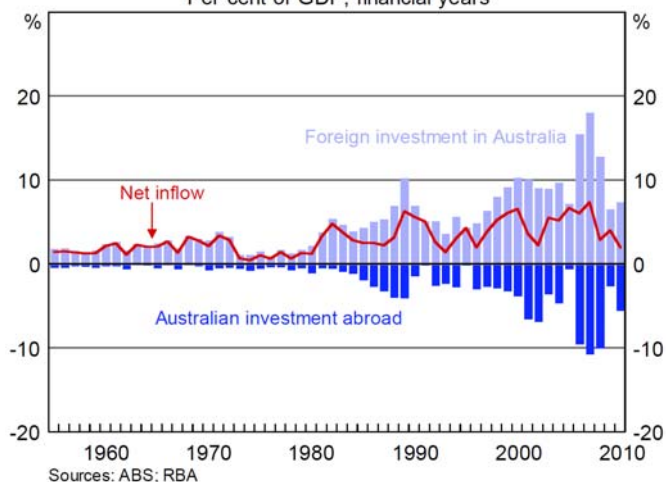
## Foreign debt

Let me now turn to the question of Australia's foreign debt.

Following the floating of the exchange rate and the removal of capital controls in the early 1980s, both foreign investment in Australia and Australian investment abroad increased sharply as the Australian economy became more integrated into the global financial system (Graph 7). In net terms, capital inflows increased from around 2 per cent of GDP to around 4 per cent, and, in the latest decade, to an average of almost 5 per cent of GDP. The current account deficit widened correspondingly, since with a floating exchange rate the current

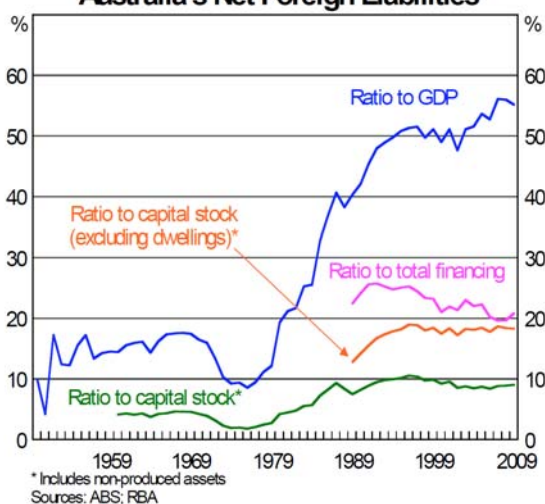
account and capital account balances must be equal and offsetting, both being determined simultaneously through the interaction of a wide range of economic and financial forces.

**Graph 7**  
**Private Capital Flows**  
Per cent of GDP, financial years



The pick-up in net capital inflow meant that the ratio of net foreign liabilities to GDP rose. From around 20 per cent in 1980, it rose to around 50 per cent by 1995. It then flattened out for a decade, but in recent years the further increase in net capital inflow has seen the foreign debt ratio rise again (Graph 8).

**Graph 8**  
**Australia's Net Foreign Liabilities**



Expressing foreign liabilities relative to GDP is, perhaps, the most common way in which people analyse them. For emerging markets, this measure has been shown to have some association with vulnerability to balance of payments crises. This is because emerging market economies often have a fixed or managed exchange rate and their foreign liabilities tend to be denominated in foreign currency, rather than domestic currency. In such instances a rise in the ratio of foreign liabilities to GDP does indicate increased vulnerability as it signals an increase in the country's foreign exchange risk and liquidity risk.



For a developed economy that can borrow overseas in its own currency, and which has a floating exchange rate, the significance of a rise in the ratio of foreign liabilities to GDP is less clear. It also needs to be kept in mind that, as economies develop, most financial variables rise relative to GDP. This seems to be a consequence of financial deepening. Expressing net foreign liabilities as a percentage of the total financing in the economy is, perhaps, more relevant, since it gives some indication of the proportion of the economy's funding that is coming from offshore. In Australia, this ratio has remained relatively steady since the late 1980s, at a little over 20 per cent.

Foreign liabilities can also be measured relative to the physical capital stock of the country, giving an indication of the proportion of the capital stock being funded by foreigners. This ratio, too, has been relatively steady in Australia since the late 1980s, at around 10 per cent.

One could argue that housing assets should be excluded from this latter measure, since foreigners' participation in the housing market is relatively limited. On that basis, the ratio rose somewhat in the early 1990s, but has been relatively steady since.

In short, these measures do not suggest the build-up of any significant disequilibrium in the economy resulting from foreign liabilities.

For developed economies with a floating exchange rate and the capacity to borrow offshore in their own currency, the risk from rising foreign liabilities is not that they will cause a traditional balance of payments crisis, but that they will undermine financial stability. The process by which this can happen typically starts with a country, for one or more reasons, becoming attractive to foreign investors. Capital floods in, overwhelming the capacity of the economy to use it productively. Credit is misallocated and eventually there is some form of a domestic financial crisis. This type of crisis can occur even in highly sophisticated economies, as illustrated by the recent sub-prime crisis in the United States.

The policy challenge for countries in this situation is to ensure that the ready availability of offshore funds does not end up distorting or weakening the financial side of the economy.

As the recipient of large amounts of offshore funds for much of the post-float period, Australia has had to remain alert to these challenges. By and large, it has been able to successfully absorb significant amounts of offshore capital over many years. There are several factors that have contributed to this:

- First, the country's foreign liabilities are virtually all either in Australian dollars or hedged back to Australian dollars.<sup>2</sup> Australia is able to do this because foreign investors are happy to hold a certain proportion of their assets denominated in Australian dollars. This means that Australian borrowers do not face foreign exchange risk on the capital sourced from overseas. Therefore, if sentiment turns and the exchange rate falls, domestic borrowers are largely unaffected. The large swings in the exchange rate of the Australian dollar that have occurred over the past couple of decades in no way threatened the corporate and financial sectors.
- Second, the offshore capital that has flowed into Australia has been used essentially to fund high levels of investment. Australia uses foreign capital not because its national saving ratio is low, but because its investment ratio is high by the standards of developed economies (Table 2). In the past decade, for example, the national savings rate in Australia has averaged 22 per cent, much the same as in Europe and well above the figure of 15 per cent in the US and UK. Over the same period, the investment ratio in Australia averaged 27 per cent, whereas in most developed economies it has averaged around 20 per cent. This high ratio of investment to GDP

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<sup>2</sup> D'Arcy P, M Shah Idil and T Davis (2009), "Foreign Currency Exposure and Hedging in Australia", *RBA Bulletin*, December, pp 1–10.

is, I believe, an indication that Australia is using foreign capital productively, and sustaining the capacity of the country to service that capital.

**Table 2: Gross National Saving and Investment**  
Per cent of nominal GDP, average for 2000–2009

	National Saving	National Investment
Australia	22	27
Canada	23	21
France	20	20
Germany	22	18
Japan	27	23
United Kingdom	15	17
United States	15	19

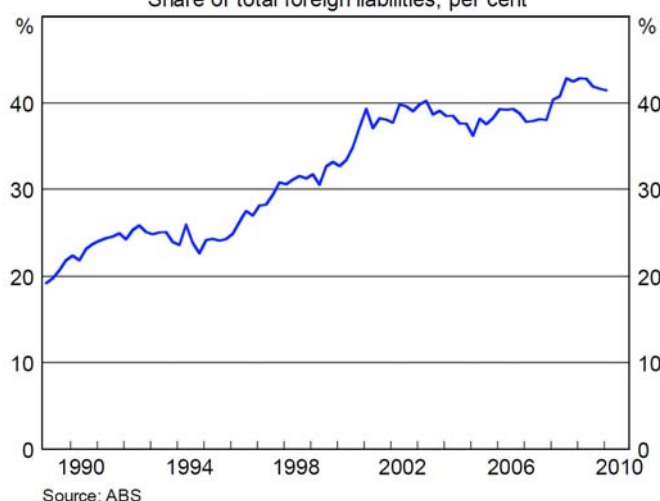
Source: ABS, IMF

- Third, credit standards, by and large, have remained robust and the amount of capital wasted through bad loans has remained limited.

### Foreign borrowing by banks

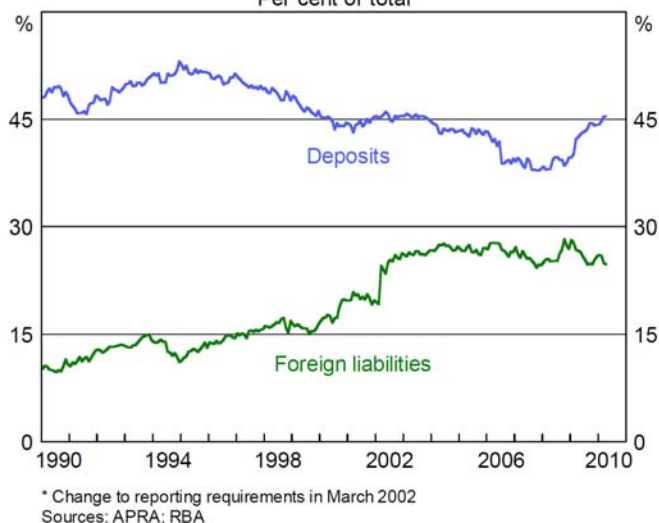
Within Australia's total foreign liabilities, the proportion accounted for by the foreign borrowing of Australian banks has increased. Virtually all this rise took place through the decade of the 1990s. Banks accounted for a little over 20 per cent of Australia's foreign liabilities in 1990 but, by 2001, this had risen to around 40 per cent. It has not changed much in the past decade (Graph 9).

**Graph 9**  
**Australian Banks' Foreign Liabilities**  
Share of total foreign liabilities, per cent



Part of this trend was the result of banks adjusting their balance sheets following financial deregulation and the growth of financial markets. These developments gave banks the opportunity to move from deposit funding to various forms of funding through markets, as a way of diversifying funding sources or reducing funding costs (Graph 10).

**Graph 10**  
**Banks' Funding Liabilities\***  
 Per cent of total



The growth of the superannuation industry, following government decisions to promote compulsory superannuation, probably contributed to this trend. Firstly, it meant households became less inclined to hold their savings as bank deposits, and second, the pool of funds created by superannuation increased demand for securities such as bank securities.

Within this trend away from deposits to funding through securities markets, there were also forces that resulted in banks increasing their use of offshore funding. As an example, a substantial proportion – about 20 per cent – of superannuation savings flow offshore, mainly into foreign equities. This reduces the pool of savings available domestically to banks and, other things equal, increases the amount of offshore funding banks need to undertake.

It is also an inescapable fact that, with Australia running a current account deficit, some funding for the economy needs to come from offshore. Households, by and large, cannot borrow offshore and the government sector has not had much need for offshore funding. That leaves the corporate and the financial sectors. Of these, the financial sector has a comparative advantage in offshore borrowing, because of the relatively high credit rating of Australian banks, both compared with Australian corporations and, in recent years, with banks in other countries.

Banks in Australia have therefore established a significant role in intermediating the flow of funds from overseas to Australia. Banks in countries where there are surplus savings, such as those in Europe, play a similar role, though in reverse; they channel funds from domestic savers to offshore.

There is a natural tendency to believe that it is riskier for banks to borrow offshore than to lend offshore. Events over the past few years, however, have shown that one activity is not intrinsically more risky than the other. It is a matter of how the risks are managed. In the lead up to the financial crisis, for example, European banks were running very significant risks through their offshore lending, not only in terms of the credit quality of the US assets they were buying, but also in terms of the short-term nature of some of the funding transactions that supported those assets. The US dollar shortages that keep recurring in global money markets are manifestation of those funding risks. These risks were largely unrecognised and, it seems, not very well managed.

The Australian banks have long recognised the risks that come from their business model, and, in my experience, are very focused on understanding those risks and managing them. This contributed to their relatively good performance through the global financial crisis.

## **Conclusion**

You may have noticed that I have not given categorical answers to the three questions I listed at the start of my talk. This is because I don't think it is possible to give simple "yes" or "no" answers to these questions.

However, looking at a broad range of financial data, and considering the fact that the Australian economy and financial system have exhibited a high degree of stability over many years, despite the many global events that have tested their resilience, is, I think, grounds for confidence that the economic and financial structure that has evolved in Australia is sustainable.