TASC *Thinkpieces*

March 2010

A Crisis of Ethics: Moral Hazard and Banking Regulation in Ireland

by Dr. Damian Tobin
University of London

TASC is happy to host a space for alternative viewpoints.
The views expressed in **TASC** ***Thinkpieces*** are those of the authors.

A Crisis of Ethics: Moral Hazard and Banking Regulation in Ireland

Dr. Damian Tobin, DeFiMS, University of London

Contact: dt29@soas.ac.uk

1. Introduction

This opinion piece addresses the issues of moral hazard, ethics and behaviour in banking regulation in terms of the recent domestic banking crisis. It argues that before the crisis, the regulatory emphasis was on the integrity of the banking system as a whole and the behaviour of individual banks was largely ignored. Formal compliance with legal and regulatory standards was viewed as an adequate benchmark of good banking behaviour. Questions of banking ethics and behaviour were overlooked by regulatory authorities. Assurances by the banks that they were adequately capitalised and the benign macroeconomic environment signalled by the Central Bank's stress-testing exercise, were enough to convince policy makers and regulatory authorities that the bank's behaviour posed no risk to the economy. Regulators placed their faith in market data and ignored the potential risks of bank behaviour. The behaviour of banks was motivated more by sustaining markets, than professional ethics. The revelations of malpractices such as the non-disclosure of director loans at Anglo Irish Bank and the flawed lending practices of other leading banks, as well as the knowledge that the banks themselves knew about the impending crisis far earlier then they admitted to government, have demonstrated the severe damage the behaviour of individual banks can cause to the entire economic system. They have also discredited previous regulatory approaches. It is disappointing then that almost two years later few lessons appear to have been learned.

This paper argues that the benchmark for banking behaviour continues to be the extent of its legality and the regulatory preference continues to be macroeconomic stability. Although policy makers have recognised the reputational damage caused to the banking system, efforts at restoring this reputation have steadfastly ignored questions of ethics and behaviour. Instead the overwhelming focus of policy makers has been on ruthless cost cutting, with the implicit assumption that cuts in expenditure will improve Ireland's international reputation. Questions of ethics and reputation have almost completely been ignored. Despite the large cost involved neither nationalisation nor NAMA provide any new safeguards against repeated crisis. The belief in market integrity and that random shocks to the system are an inevitable feature of economic growth, remains largely unchallenged in policy circles.

The following argues that in many ways the recent crisis has not just been a banking crisis, but also a crisis of banking ethics and professionalism. The crisis in ethics was facilitated by a regulatory culture that for far too long was willing to accept a high degree of moral hazard in banking activities as an acceptable risk for high growth. A moral hazard is typically understood as one where a responsible party such as a bank making a loan, has an incentive to put their own interests above those of other stakeholders such as the borrower. Because the bank is "too big to fail" or of systematic importance, or if the regulatory culture is such that it does not adequately control such hazards, moral hazard is said to lead to excessive risk taking. Moral hazard is regarded as a pervasive feature of the Anglo-American regulatory culture. It is disappointing then that little has changed. While governments

around the world have put considerable efforts into economic stimulus (with the notable exception of Ireland) and banking recapitalisation, and have recognised many past mistakes there still remains a reluctance among regulatory authorities to move beyond systematic concerns.

2. A Predictable Crisis

Although much has been said about the inevitability of banking crises, such attitudes tend to reflect a willingness to tolerate risk within the system rather than ignorance of its consequences. Mainstream macro-economics is not necessarily designed to predict crisis, but rather assumes that non-stationary or random shocks not only occur, but can sometimes occur in such combinations as to lead to severe economic crisis. The view that under normal circumstances the economy under financial liberalisation enjoys faster growth, which compensates for occasional crises even when they have severe recessionary effects gained intellectual legitimacy over the past decades (Goodstadt, 2009: 6-8).[1] Although such explanations seem inadequate, they are not that different from those put forward by the banking system. In January 2010, the US Financial Crisis Inquiry Commission heard evidence indicating that senior bankers clearly understood the acceptance of risk as a price of growth. Jamie Dimon of JPMorgan Chase argued that financial crises are things that happen every five to seven years and that we shouldn't be surprised.[2] Similarly Goldman Sachs's Lloyd Blankfein compared the financial crisis to a hurricane nobody could have predicted. Recent research by Cramen Reinhart and Kenneth Rogoff (2008) tends to reinforce this view showing the dramatic rise in the proportion of countries experiencing banking crises since the mid-1970s.[3] These views – while highlighting the tolerance among bankers of moral hazard in the system – also underline the fact that such crises are ultimately the work of people in the banking system. Neither should they be allowed to obscure the view that governments have a duty to regulate economic activity.

Ireland's banking crisis was undoubtedly a predictable one not just from the available economic data, but more importantly because the banks also anticipated it. Such attitudes were clearly demonstrated at the Joint Committee on Finance and the Public Service in July 2008. At this Committee, representatives of the major banks were clear that they anticipated the coming slowdown as early as 2006.[4] Richie Boucher of Bank of Ireland noted that his bank had already anticipated a slowdown in 2006, while David Guinane of Permanent TSB believed that the slowdown began in early 2007.

> "In 2006 we anticipated the Irish property market would commence slowing. We expected this to have an impact on the broader economy," Mr Richie Boucher 2nd July 2008

> "...our belief is that demand began to slow in early 2007, and this has been well documented. The first movement was that developers held back on new developments, prices started to fall and customers lost confidence in the overall economy," David Guinane Permanent TSB

At the same committee Pat Farrell of the banker's federation presented data to show that the decline in the housing market began in the first quarter of 2006. However he appeared to believe that because this happened earlier than the global credit crunch, banks would not have had reason to adjust their lending practices:

> "Regarding mortgage finance generally, the next figures show that the decline in the housing market began in the first quarter of 2006. The chart clearly shows this from a number of indicators such as house registrations and house completions. My point is that the decline in the housing market began much earlier than the present credit crunch and much earlier than banks had reasons to adjust their lending policies." Mr. Pat Farrell Irish Banking Federation

This inevitably begs the question as to why then was the government so convinced that the banks were stable. Part of the reason is that Banks complied with minimum acceptable standards of liquidity, capital and corporate governance. At the Public Finance Committee, Donal Forde of Allied Irish Bank noted that because Irish Banks were forced to comply with the Basel II this meant that other banks could find comfort in the fact that they were robust and stable.

> "Part of our dilemma as banks is that we are trying to maintain the competence of the international system because we are relying on that system for funds and money. Part of the reassurance they take about the standing of Irish banks is that we do have a high quality regulatory regime. It forces us to apply the dimensions of Basel II and gives transparency to our business. They can then evaluate our business and can compare it with the business of other banks across the world, and find comfort that we are what we say we are — robust and stable," Donal Forde AIB

That this robustness and stability was an illusion that depended on the good faith of individual banks appears to have been poorly understood by both regulatory authorities and government. The level of this misunderstanding was not just however reflected in the willingness to accept assurances of the bankers, but also in the Central Bank's own stress-testing exercises.

3. Stress-Testing and the Tolerance of Moral Hazard

Given the willingness to tolerate moral hazard within the banking industry, it is unsurprising that as late as July 2008 the Minister of Finance was still convinced that the Irish banking system remained solid and was underpinned by good profit margins, sound liquidity and was adequately capitalised.[5] Neither was the true extent of the problems facing the banking system evident from the Central Bank's own stress-testing exercise.[6] It is therefore unsurprising that both policy makers and regulators were unaware of the terrible problems facing the banks. Their unyielding faith in market integrity and their ability of markets to clear ultimately blinded them to the reality.

Macroeconomic stress-testing has been the traditional regulatory tool for assessing the stability of the banking system. It is now clear that stress-tests consistently failed to warn of the risks undertaken by individual banks such as Northern Rock and Anglo Irish Bank. The problem was

particularly severe in Ireland where the Central Bank's own stress-testing exercises indicated very limited risks to the banking system. Because stress-testing focuses on macro indicators, it places enormous faith in the behaviour of banks. By removing the focus from individual banks it implicitly tolerates a high degree of moral hazard as regulators may incorrectly assume that the lending practices pose little threat to the stability of the banking system. The nationalisation of Anglo Irish Bank and the severe problems facing Allied Irish Banks and Bank of Ireland as well as building societies such as Irish Nationwide, indicates that stress-testing consistently underestimated the potential of individual banks to damage the system.

In the Financial Stability Report for 2007 only one signal (out of six) showed up as potential warning on the Central Bank's radar, low rates of return on assets. In terms of financial soundness indicators, the report found private sector indebtedness, the concentration in property and the household repayment burden as the major risk factors. However overall the report pointed out that there was little cause for concern. In all the stress-testing exercise appeared to signal a benign environment.

It is interesting then that the stress-testing exercise gives little or no attention to the increasing extent to which Ireland's banks relied on non-deposit-based funding, which increased from 26.7 per cent in 2003 to almost 50 per cent in the second quarter of 2007. This innovation in bank funding which became a key characteristic of the British mortgage market and ultimately led to the collapse of major banks, although different in practice to the securitisation that led to the sub-prime crisis, was no less damaging. Described by the Governor of the Bank of England, Mervyn King, as a distinctive but ultimately senseless feature of the British banking system over the past decade, it was treated with indifference in the Central Bank's 2007 stability report.[7] The report cites ratings agency Standard & Poor's as saying that this simply reflects the broadening of the funding base of Irish banks. It has nothing to say about the risks this might entail for individual banks or what it means for their lending behaviour. The point being that the stability of the system as a whole was preferred over the increasing bank-level risk as a measure of stability.

Yet at bank level the dramatic change in lending behaviour was clearly evident. The severity of the problem is clearly illustrated in the commercial banks annual reports. For example, the Bank of Ireland's loan-to-deposit ratio stood at 162 per cent for the financial year 2005/2006, increasing to over 173 per cent for the year 2006/2007.[8] Allied Irish Bank's loan-to-deposit ratio stood at approximately 157 per cent for 2007. A survey of bank balance sheets by UBS noted that apart from Nordic and Portuguese banks, Irish bank's have the highest loan-to-deposit ratios of Western markets.[9] The average for US banks is around 113 per cent, while other large banks such as HSBC maintain a ratio less than 100 per cent. However this type of bank-focused comparison does not appear to have been carried out. If it was, its findings would have been quite revealing. Instead regulators placed their faith in data on market prices.

These ratios matter for two reasons. Firstly, the government and Central Bank should have known much earlier, possibly as early as 2005, that Irish banks were overly reliant on wholesale markets for expanding domestic lending. A cursory glance at better run international banks would have illustrated this. Secondly, it is clear that the banks themselves knew of this danger much earlier than they have admitted. Statistics from the CSO show that the number of new housing loans approved

peaked in 2005 at 120,037 and had declined to 88,747 by 2007.[10] Loan-to-deposit ratios at the Bank of Ireland dropped back to 158 per cent for the year 2007/2008. Such corrections were arguably too late and appear to represent more an attempt to avert disaster while at the same time maximising their exposure to Ireland property boom. Rather astonishingly they continued to convince government, regulators and shareholders that all was well. Their story appears to have been accepted by both government and regulatory authorities without question.

The ability to convince regulatory authorities that all was OK raises interesting questions about the ethics of bank management. Surely it is not unreasonable to ask that if banks knew that lending patterns were out of kilter, they had a duty to truthfully inform regulatory authorities of the risks they faced. The suspicion that banks were willing to put the sustainability of their own markets above professional ethics is hard to avoid.

4. A Crisis of Ethics

When Sean Fitzpatrick resigned as Chairman of Anglo Irish Bank following revelations of connected loans and the window dressing of the bank's balance sheet, he claimed he did nothing wrong. He may yet be proved correct, at least in the eyes of the law. Indeed in the aftermath of Fitzpatrick's resignation, even the media were not necessarily convinced that any illegality had been committed. Reporting of Fitzpatrick's resignation centred on the fact that his behaviour though inappropriate was ultimately not illegal.[11] It was also pointed out that since bankers are not prohibited from personal property investment and since most banks have rules governing the disclosure of personal interests and the avoidance of conflicts of interest, such behaviour was not illegal.[12] In other words the benchmark for banking behaviour was its legality.

This is not surprising. For many years the major Irish banks had systematically overcharged customers, yet no one was prosecuted. Such behaviour was not thought serious enough to endanger the entire banking system. When Irish banks expanded their loan books well beyond their core deposit base, regulators assumed that this was simply a broadening of the funding base of the banking system. Since Irish banks were assumed to be adequately capitalised there was little suggestion from regulators that their activities could endanger economic stability. Irish bank executives were paid well in excess of their international peers and board of directors were staffed by bank insiders. It was also revealed that large building societies such as Irish Nationwide routinely bypassed credit committees and ignored warnings from the Central Bank. Yet because they complied with formal or minimum corporate governance standards and because such behaviour was not thought to endanger the banking system, it was considered tolerable.

This all serves to highlight a deeper problem that the benchmark for good behaviour has become the extent to which it is legal. Stephen Green, Chairman of HSBC, argues that compartmentalisation or dividing life into different realms, which are subject to different ends and different rules, provides a refuge from ambiguity in an uncertain world.[13] It can help us to avoid questions of morality and ethics. He goes on to argue that one of the most obvious manifestations of this is in our work life where "questions of value (other than shareholder) or of rightfulness (other than what is

lawful)...need not arise" (Green, 2009:18). If bank behaviour complies with minimum governance standards and does not threaten the stability of the system, questions of rightfulness or ethics simply do not arise.

5. The Policy Response

The global policy response to the crisis has demonstrated the importance of bank stability to the national and global economies. While responses have varied in magnitude across countries they have generally consisted of increases in liquidity, bank rescue and recapitalisation, expansionary fiscal policies and regulate domestic and international financial systems.[14] Bresser Pereira (2009) argues that these four responses showed that policy makers had quickly relearned what they had forgotten in an era of deregulation. However it was in the last area of regulation that the least learning had occurred. Others such as Leo Goodstadt (Hong Kong Institute of Monetary Research) argue that having realised and admitted their mistakes, Anglo-Saxon regulators have implicitly accepted the existence of moral hazard and risk in the system and moved on to systematic concerns.[15]

There is little evidence to suggest that Ireland has radically departed from the Anglo-Saxon approach. In his new role as Governor of the Central Bank, Patrick Honohan has made some interesting observations on both past regulatory difficulties and his views on the solutions to these problems.[16] Honohan notes the problems of the assessment of standards have become mere box ticking exercises. He points out that although stress-testing has not delivered on its earlier promises; he has expressed the belief that it has value in exploring the implications for balance sheets of a realistic forward-looking expected loss based on the most likely macroeconomic scenario. However he also appears to recognise that putting in place a fully adequate quantitative description of the assets and liabilities of all of the systemic financial firms, and their interactions, has proved to be a demanding exercise. Moving forward this will require a more detailed data and ingenious modelling process. Although Honohan recognises that econometric-based empirical models for forecasting banking crises have not performed well, he believes that a more promising use of macro indicators can act to defining a zone of financial stability in which the probability of a crisis is low.

Although these remarks point to regulation with continued and improved emphasis on systematic stability, his remarks also point to recognition of past mistakes. In particular they signal recognition that prices are not sufficient statistics and market data does not tell all. The recognition that the data needs of investors are different from those of regulators is interesting. The Financial Stability reports and stress-testing exercises of the Central Bank appeared to assume that these are the same. Regulators are interested in the tails of distributions or the outliers, while investors are interested in the rest of the distribution. While the latter suggest recognition of the dangers of an over-reliance on macroeconomic signals, it is perhaps disappointing that there is nothing in Honohan's remarks to suggest recognition of the damage individual banks can do to the entire system. In effect, these remarks and those of other regulators suggest that regulatory bodies are likely to continue to tolerate the existence of moral hazard as the price of macroeconomic stability and growth.

Separately, there has been a call for an in-depth inquiry to indentify the weaknesses and failures in the regulatory system.[17] While such an investigation can be justified on public interest grounds, its merits when placed alongside the prevailing regulatory culture and the acceptance of market risk are questionable. Many of those calling for an inquiry retain an implicit belief in the integrity of markets. More importantly this analysis has demonstrated that banks had significant awareness of the dangers they faced but chose not to inform regulatory authorities. The system accepted such risks. The Central Bank's own data also reflected these dangers. That they chose to ignore or misinterpret them is revealing, as it demonstrated that the bank was willing to rely on market based data over the dangers evident from the bank's balance sheets. Ultimately regulatory authorities and politicians placed their faith in market integrity and were willing to tolerate this risk.

6. Conclusions

Almost a decade ago, in the aftermath of the Asian Financial Crisis, Joseph Stiglitz (2000: 1085) posed the question as to whether financial policies were being designed on the basis of the best available economic theories or whether there another agenda that is impervious to the effects of these policies; not just on growth, but also on stability and poverty.[18] Stiglitz went on to argue that if the latter is true, then we have a more fundamental problem in the international financial architecture. Almost ten years on, and another financial crises down, much closer to home, it would appear that there are indeed some very fundamental problems in the international financial architecture. The assumption that markets clear without cost or that they are somehow based on integrity has been once again challenged. The cost to the Irish taxpayer of correcting the banking system will be substantial. But the cost is not just an economic one. The intellectual legitimacy gained by financial liberalisation is unlike to disappear and is likely to continue to dominate policy. For as long as moral hazard is tolerated, the incentive for banks to benchmark their behaviour against what is legal is likely to continue. Financial markets will remain sources of self-sustaining behaviour and questions of professional ethics will simply not arise. Perhaps most disappointingly of all, we may have lost a golden opportunity to fundamentally reform the regulatory system.

Endnotes including References

[1] Leo F. Goodstadt (2009) *The Global Crisis: Why Regulators Resist Reforms*, Hong Kong Institute of Monetary Research Working Paper No. 32/2009.

[2] See Paul Krugman "Bankers without a clue" New York Times, 15th January 2010 http://www.nytimes.com/2010/01/15/opinion/15krugman.html?src=twt&twt=NytimesKrugman&pagewanted=print

[3] Reinhart, Carmen and Kenneth Rogoff (2008) "Banking Crises: An equal opportunity menace" National Bureau of Economic Research Working Paper 14587

[4] Joint Committee on Finance and the Public Service 2nd July 2008: http://debates.oireachtas.ie/DDebate.aspx?F=FIJ20080702.XML&Ex=All&Page=2

[5] Dail Eireann – Volume 660 – 10th July 2008 Written Answers – Financial Services Regulation

[6] Financial Stability Report 2007

[7] Mervyn King (2009) "Finance: A Return from Risk" 17th March 2009

[8] Calculated based on Loans and Advances to Customers/Customer Deposits. Source: Bank of Ireland Annual Report 2008.

[9] Sunday Tribune 15th March 2009

[10] http://www.cso.ie/statistics/annual_housing_indicators.htm

[11] "Drum quits Anglo in loans fallout" RTE.ie, 19th December 2008

[12] "Most banks have rules on disclosure and avoiding conflicts of interest" Irish Times 14th December 2009

[13] Stephen Green (2009) *Good Value: Reflections on money, morality and an uncertain world*, London: Allen Lane

[14] Luis Carlos Bresser-Pereira (2009) The Global Financial Crisis and After: A New Capitalism? Escola de Economia de Sao Paulo, Textos Discussao 240

[15] Leo F. Goodstadt (2009) *The Global Crisis: Why Regulators Resist Reforms*, Hong Kong Institute of Monetary Research Working Paper No. 32/2009.

[16] The following analysis is base on remarks by Governor Patrick Honohan at the RBWC, OeNB and Austrian Ministry of Finance Conference: Tools for systemic risk assessment in Europe - The Parameters of the International Financial Architecture Post Crisis, Vienna. Available at: http://www.centralbank.ie/frame_main.asp?pg=nws_article.asp%3Fid%3D484&nv=nws_nav.asp

[17] Colm McCarthy, Sunday Business Post, 13th December 2009. http://www.sbpost.ie/commentandanalysis/we-need-to-know-the-cost-of-sorting-out-the-banks-46195.html

[18] Stiglitz, J. 2000. "Capital Market Liberalisation, Economic Growth and Instability," *World Development*, Vol. 28 (6), pp. 1075-1086.