

*Administration*, vol. 67, no. 2 (2019), pp. 25–45

doi: 10.2478/admin-2019-0012

# **Give credit to the market: The decision not to prohibit 100 per cent loan-to-value mortgages**

**Cathal FitzGerald**

*National Economic and Social Council, Dublin, Ireland*

## **Abstract**

A decision not to prohibit or limit high-risk mortgage products in Ireland in 2005 reveals the extent to which three important factors – interests, institutions, ideology – impact on information processing by decision-makers, and reveals irrationality or otherwise in the process. This article summarises the events leading up to the bad decision on 100 per cent loan-to-value (LTV) mortgages in November 2005. This case reveals the nature of the interaction between government departments, regulators and banks at a critical time before the crash, and shows how a department's interests can interact with institutional factors, and the ideological context, to prompt poor rational and irrational information processing, and lead to a bad decision. In particular, the dominance of a market ideology which raised the threshold for what information was necessary before intervention would be made, combined with the low institutional standing of the department seeking intervention, produced a suboptimal outcome. Finally, the case provides evidence of irrationality (e.g. groupthink, herding) within institutional actors, rather than between them.

*Keywords:* Decision-making, irrationality, mortgages, economic crash

## Introduction

If there had been an effective LTV cap in place in the early 2000s it is likely that the costs of the crisis would have been very greatly reduced. (Central Bank of Ireland, 2014, p. 9)

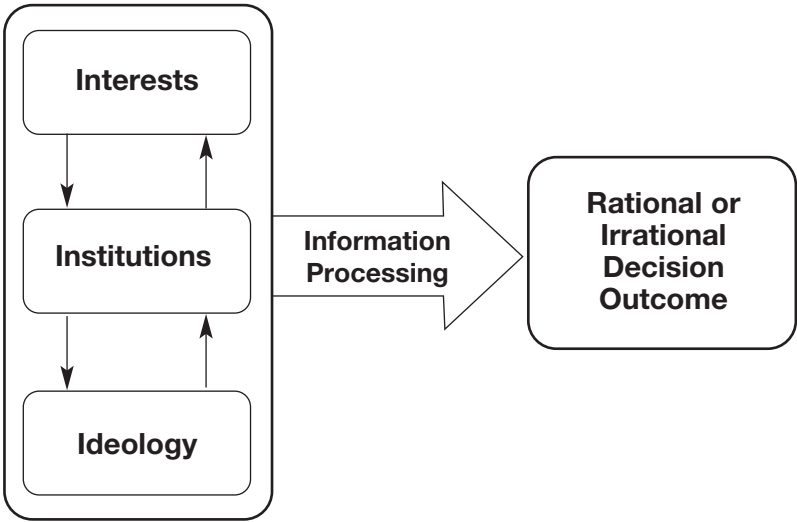
Looking back at the financial crisis in Ireland to inform policies and prevent a recurrence is a wise and laudable pursuit. When it did so in 2014, the Central Bank of Ireland honed in on a very specific policy area: mortgages, or more specifically the rules surrounding how much a person had to have saved as a deposit before securing a mortgage to buy a home. This key mortgage rule is known as the loan-to-value (LTV) ratio. The higher the LTV ratio, the lower the deposit a borrower needs to secure a mortgage. An LTV of 80 per cent means having to save 20 per cent of the purchase price, while an LTV of 100 per cent means no deposit at all is required. LTV ratios are linked to the price and demand for housing, the rate of house-building and, ultimately, the cost of a property crash.

In 2005 policymakers in Ireland had a chance to place an effective cap on the LTV ratio but failed to do so. Banks had begun to make 100 per cent LTV mortgages widely available and the department responsible for housing policy expressed concern and called for action. The Department of Finance decided against intervention. One official review of policy and decision-making in Ireland in the run-up to the crash described this as ‘an opportunity lost’ in terms of mitigating economic risk (Wright, 2010, p. 31). In 2015 the Central Bank introduced a 90 per cent LTV cap to help decision-makers resist the forces of interests, institutions, ideology and irrationality which contributed to that bad decision taken a decade earlier.

## Analytical framework

This 2005 case is analysed to reveal the extent to which the forces of interests, institutions, ideology and irrationality contributed to a poor decision on mortgage policy. The framework is set out in detail in FitzGerald (2016) and by FitzGerald et al. in this issue, but is summarised here – see Figure 1.

Based on the work of a number of scholars, most notably Baumgartner & Jones (2009), Grossman (2013), Kahneman & Tversky (1984), Lunn (2013), McCarty et al. (2013) and Nyberg (2011), the framework is applied to documentary and interview

**Figure 1 : Analytical framework of decision-making**

material using a process-tracing method (Bennett & Elman, 2006; George & Bennett, 2005; Gerring, 2007; Hall, 2003).<sup>1</sup>

The framework is employed to analyse the role and interaction of the three factors on a decision outcome, which may be rational or irrational, or optimal or suboptimal. For example, the policymaker may choose an option because it is the preference of a powerful external interest group. The policymaker may also choose an option because of the institutional framework, which may be resistant to alternatives, or in which power and knowledge is distributed in such a way as to militate against alternative options. Alternatively, a policymaker may select an option as a consequence of a rigid ideological belief held by them or their group/party, or which dominates political thinking. Finally, policymakers may deliver a poor-decision outcome as a result of irrationality, e.g. groupthink: incomplete analysis of alternatives and objectives, poor information search, failure to examine risks of preferred choice, failure to reappraise initially rejected alternatives, selective bias in processing information at hand and a failure to work out contingency plans (Janis, 1982).

<sup>1</sup> See FitzGerald (2016) for the full research design, analysis framework, material analysed, interview details and complete case study.

These forces may well interact with each other. For example, the institutional rules of the cabinet system of government may put the same types of people in a collective decision-making role, usually with the same electoral interests and ideologies, which could encourage suboptimal decisions. Research has found that a 'silo' organisational structure strengthened the effect of lack of critical discussion, groupthink, and modest or absent serious consideration of alternatives among Irish public authorities (Nyberg, 2011, p. iv).

### **Context of the decision**

By 2005 Ireland was almost ten years into a period of remarkable economic performance, had no problems with high LTV mortgage ratios, but did have housing problems. Negative wholesale bank interest rates combined with the growing population, growing incomes and lower actual and prospective mortgage interest rates together 'triggered the housing price surge' (Honohan, 2010, p. 22). Ireland's membership of the euro, the arrival of foreign banks to the Irish market and access to cheap international credit by domestic banks spurred robust competition between banks in the mortgage market.

House price inflation and affordability issues, particularly for first-time buyers, were moving ever higher on the political agenda. The debate at that time focused to a large extent on young people who wished to buy their own home but who could not do so because, while their income could sustain a mortgage, they could not provide the necessary deposit, a problem for which higher LTV mortgage ratios were seen as a solution. The increased ability to pay for housing and fierce competition in the mortgage market saw banks introduce new products, including high LTV ratio mortgages.

Mortgage products with high LTV ratios (>90 per cent) were not unheard of in Ireland in 2005, but they were marketed and issued with important conditions. In July 2005 one bank – First Active, part of the Royal Bank of Scotland group – launched the first mortgage in Ireland that 'covers the full price of a property' widely available beyond certain stable professions (Slattery, 2005). Within one month, four other mortgage lenders had begun providing the product (Permanent TSB, Ulster Bank, Bank of Ireland and its subsidiary, ICS Building Society). A headline in *The Irish Times* on 5 August 2005 declared: 'Lenders queue up to offer 100 per cent first-time buyers' mortgages'.

Within weeks, the Department of the Environment, which had responsibility for housing, having contacted the banks, contacted the

Department of Finance outlining its concerns at developments. It is at this point that the forces of interests, institutions, ideology and irrationality combine to shape the bad decision outcome which materialised via a formal response from the Department of Finance to the Department of the Environment in November 2005. In that letter Finance indicated that, despite Environment's concerns, no action would be taken to prohibit or limit the marketing or issuing of 100 per cent LTV mortgages.

### **A policy failure**

That decision in 2005 had disastrous consequences and is an example of policy failure. Much research demonstrates how insisting on lower LTV ratios can mitigate economic risk by dampening the property market as they tighten the liquidity constraints of targeted borrowers, and hence limit demand for housing (Friedman, 2009; Igan & Kang, 2011; Jácome & Mitra, 2015; Lydon & McCarthy, 2011).

Polymakers in Ireland in 2005 had contemporary research and advice from close to home to aid them. In October 2004 the Irish Central Bank published a technical paper which found that greater levels of credit meant mortgage-holders had outstanding loans higher than what they otherwise would have been if availability had been curtailed. It added that if an increasing proportion of banks' loan were to borrowers with higher LTV ratios, then they would have less of a comfort margin in the event of a decline in residential property prices (Fitzpatrick & McQuinn, 2004). The Department of Finance would in fact refer to this same research during its pre-decision deliberations. All of the negative impacts associated with high LTV mortgages – products only available because of the bad decision – were realised in Ireland. This also illustrates that the decision can be, and is, deemed to be bad, not just with the benefit of hindsight.

It is important to note that a good decision was possible and that taking a good decision in 2005 would not have been 'too late'. The official inquiries into the crisis in Ireland concluded that the government could have increased the capital requirements on banks, banned or disapproved publicly of 100 per cent LTV mortgages, attached conditions to the banking licences of certain institutions or withdrawn those licences altogether. Indeed, even a clear threat to do so if the banks did not change their lending behaviour might have had an effect.

One expert claims that though it is impossible to identify when the bubble became irreversible and a collapse became inevitable, with the

benefit of hindsight, 2006 probably represented the last chance to stop the build-up in debts (FitzGerald, 2015, p. 4). Research shows that the largest number of mortgage loans (just over 70,000) was extended in 2006, when house prices were close to their peak, and that by 2011 the largest proportion of mortgages in arrears originated in the years 2006 and 2007, accounting for over half of all accounts in such distress (Lydon & McCarthy, 2011).

In addition, in terms of affordability of mortgages the European Central Bank (ECB) began to 'hike interest rates in December 2005, and within eighteen months the ECB's policy rate had doubled' (Ahearne, 2015, p. 2). In terms of the impact of an alternative, good decision, the Central Bank's loan loss forecasting models suggest that an 80 per cent LTV cap would have lowered credit losses on residential property of the banks by at least 17 per cent, even if it is assumed that the same number of loans were made and that housing prices were the same as those that actually prevailed (Central Bank of Ireland, 2014, p. 9).

Thus, a good decision on mortgage LTV in 2005 could have helped to halt the build-up of debts, minimise later mortgage distress and minimise the negative impact of the interest rate hikes that were to follow soon after.

### **The story of the decision**

The decision not to intervene to ban, or even limit, 100 per cent LTV mortgages in 2005 is an example of the forces of interests, institutions and ideology interacting and influencing information processing. Rational and irrational decisions were taken and, above all, it was ideological and institutional factors which negatively shaped the decision to the clearest extent. Ideology, manifested as belief in the efficiency of markets and principles-based or 'light-touch' regulation, meant intervention to limit these high-risk mortgage products would only happen in the context of irrefutable evidence *ex ante*. Further, such evidence would have to emanate from an institution with sufficient standing within the policy system as to make inaction inconceivable. Suboptimal decisions were made for rational reasons (e.g. out of self-interest), and the information necessary for a good decision was available.

At the same time, there is evidence of irrationality present. The decision displays symptoms of behavioural convergence, groupthink

and herding such as selective bias in processing information at hand, poor information search and an incomplete survey of alternatives (see Janis, 1982; Kahneman, 2011; Lunn, 2013). Notably, this irrationality occurred *within* institutional actors rather than *between* them, a point not regularly or strongly made in analysis of decision-making in Ireland before the economic crisis. The emphasis has been the extent to which key actors and policymakers (government, regulators, banks and consumers) suffered from groupthink and had similar views on Ireland's economy and the prospects of a soft landing. This case shows that these actors did hold quite different views externally (e.g. the view of the Department of the Environment versus the view of the Department of Finance), but reveals less evidence of a variety of views within a key institution (e.g. the Department of Finance).

### ***Chronology of a bad decision***

The critical period in the build-up to the decision began in August 2005 when the Department of the Environment contacted Finance seeking a meeting to consider developments in the mortgage market, noting its concern over 100 per cent LTV products, and asking if there were, and in fact suggesting, ways to restrict their issuance. The decision was reached following interaction between the Department of the Environment, the Department of Finance and the Financial Regulator over the following three months.

- 9 August: The Minister for Housing writes to banks outlining his concerns at the presence of 100 per cent mortgages on the Irish market, and urging caution in relation to them;
- 10 August: A meeting is held between the Department of the Environment and the Department of Finance to discuss a response to 100 per cent LTV mortgages;
- 12 August: The Head of Banking Supervision in the Financial Regulator prepares an internal memo suggesting new measures aimed at limiting high LTV residential mortgages;
- 12 August: The Department of the Environment formally writes to the Department of Finance outlining its concerns;
- 17 August: The Department of Finance prepares a series of actions internally to inform a response to the Department of the Environment, and contacts the Regulator seeking a meeting on the topic;
- 18 August: Banks reply to the Minister for Housing defending the issuing of the mortgages;

- 1 September: The Department of Finance completes and communicates internally its economic assessment of the impact of 100 per cent LTV products;
- 2 September: The Department of Finance writes to the Department of the Environment outlining the results of its preliminary analysis and inviting it to a meeting of the two departments and the Regulator;
- 1 November: The Central Bank publishes the *Financial Stability Review 2005*, which includes analysis suggesting that economic fundamentals (e.g. disposable incomes, low unemployment, interest rates, pent-up demand, demographics) can account for the vast bulk of the increase in mortgage indebtedness in Ireland;
- 1 November: A meeting is held between the Department of the Environment, the Department of Finance and the Financial Regulator to discuss 100 per cent LTV mortgages;
- 16 November: The Minister for Housing tells Dáil Éireann that financial institutions have caused problems by offering 100 per cent mortgages and that he has serious concerns, and urges banks to be more measured in their actions;
- 16 November: The Department of Finance consults with the Regulator on a draft, formal written response to the Department of the Environment; and
- 25 November: The Department of Finance sends a formal written response to the Department of the Environment indicating that no intervention to prohibit, limit or discourage the issuing of 100 per cent mortgages will be made.

While it is not possible to reproduce here the full story of interactions across this time frame, certain points are worth highlighting.

### *The role of interests in the decision process*

There was no widespread move on behalf of, or pressure from the banks on, policymakers to allow 100 per cent LTV mortgages. First Active/Ulster Bank moved because the bank's mortgage market share was coming under pressure. The documentation reveals that Bank of Ireland only introduced the high LTV mortgage because a competitor had done so, and the motivation was to protect their franchise, not because it perceived there to be a gap in the market or because it was an inherently 'good' product. Similarly, Permanent TSB were not supportive of the product and contacted the Regulator to make the case for intervention. AIB did not market 100 per cent LTV products at all.



The evidence shows that the dominant interest of – and pursued by – the Department of Finance was not to disrupt the economic model. Intervening themselves, or intervention by the Regulator, to limit or prohibit 100 per cent LTV mortgages would undermine confidence in the wider property market on which much economic activity and revenue depended. It is clear from its note of the August meeting, for example, that it saw the housing market as a domestic risk factor, that the market was delicately poised and that any government intervention could make matters worse.

Its in-house analysis deemed the most pertinent conclusion of contemporary technical work by Central Bank staff to be the elasticity co-efficient of a change in credit to price, rather than, for example, warnings about an increasing proportion of bank loans being given to borrowers with higher LTVs. The Department of Finance's analysis relied on informal consultations with economists and suggested that up to one year's worth of data may be needed to objectively establish impact. In contrast, there were data (also available to Finance, e.g. the OECD's *Economic Outlook*) which prompted an official within the Regulator to consider intervention on 100 per cent LTV mortgages in August 2005.

Institutionally, the fact that the decision was being handled by the Banking, Finance and International Division as opposed to the Budget and Economic Division was significant. The Banking, Finance and International Division was not required to make a call on any wider macroeconomic issues when working through the 100 per cent LTV mortgages case, despite these issues making up a key element of the Department of the Environment's concerns. The equivocal findings of the in-house analysis suited the Banking, Finance and International Division, who were coordinating the response within the department, and that analysis provided reasons as to why Finance could rationalise 100 per cent LTV mortgages to be a relatively benign issue. Had that analysis produced empirical evidence or validated the concerns expressed by the Department of the Environment, the Department of Finance would have had to deal with the issue.

Further, a comparison of the draft decision letter to Environment and the final version suggests a playing down of information which gave weight to the Department of the Environment's concerns and which suggested that developments in the property market should prompt concern and intervention. The Department of Finance removed text which:

- brought to the attention of the Department of the Environment impending changes which would increase the availability of credit;
- highlighted credit growth and indebtedness as key vulnerabilities;
- stated that price moderation may not have persisted to the extent previously anticipated;
- noted that accelerated house prices would have important implications for the expectations of a soft-landing;
- stated that banks' lending criteria must be watched carefully; and
- showed a recognition that the complexity of property price inflation made identification of key contributing factors difficult.

The interests of the Central Bank and the Regulator are a function of complex institutional arrangements. One of these was the 'dual mandate' clause in the 2003 legislation establishing the regulatory system, which stated that the Central Bank and Regulator had an interest in promoting Ireland's financial services industry internationally (as well as regulating it). The case reveals that it was believed by senior management within both the Regulator and the Central Bank that intervention on 100 per cent LTV mortgages, no matter how narrow the issue or targeted the measure, would draw unwanted attention to the Irish market and the nature of regulation here.

Further, in 2005 the Competition Authority had pointed to a highly concentrated banking market and a lack of competition. Whether the Regulator pursued its prudential and consumer protection interests equally is questionable. The evidence shows that it was the short-term interests of consumers of banking services and house-buyers that primarily were being served by the decision not to intervene. This issue went beyond the availability of high LTV mortgages, and was as much to do with choice and competition in the banking market generally. These mortgage products would facilitate more first-time buyers purchasing homes, which was viewed at the time as being good from both a social and economic perspective, but the issue was as much about having many players active in the banking market.

The Department of the Environment openly pursued its interests. The Minister for Housing's letters to the banks and Environment's initial email to the Department of Finance, interventions at the two meetings on the topic, formal letter to Finance and internal notes all illustrate that the Department of the Environment's interests were in maintaining a stable housing market, avoiding inflationary policies

and protecting against wider, negative economic impacts. Even Finance's meeting notes record Environment linking 100 per cent LTV mortgages to the widely accepted soft-landing scenario for the housing market. While the Department of the Environment's interests were a factor in the decision, they did not win out as no intervention was made to prohibit or limit the high LTV mortgages in 2005. It was the interests of others (the Department of Finance, Regulator, consumers) which trumped those of Environment, when these were combined with institutional and ideological factors.

Before discussing those, it is worth noting that there is no evidence in this case of property developers seeking to influence the decision in November 2005. The same is true for political interests. There was no sense in the summer of 2005 that intervening to limit 100 per cent mortgages would pay any political or electoral dividend. On the contrary, the products were viewed as socially and politically popular, suggesting that the decision not to intervene could have also served political interests. However, there was no evidence of this directly influencing the decision.

### ***Interests, information processing and irrationality***

The banks that believed 100 per cent LTV mortgages to be appropriate (First Active) and those who believed them to be dangerous (Bank of Ireland, Permanent TSB) all issued the products in order to compete for market share. In doing so, the banks contributed to the activation of wider irrationality. It contributed to extrapolation and confirmation bias, expectations of continued house price increases and the prospect of a soft landing for the property market. This was the context for the bad decision. Once the Regulator, Central Bank and Finance did not intervene soon after the introduction of the product, and banks marketed aggressively, the process cascaded (see Sunstein & Hastie, 2015). The impact of the benign response is evident in a quote from Ned O'Keeffe, TD, in July 2005, one which indicates how the decision can generate irrationality in the form of behavioural convergence, herding and groupthink:

We must consider the current confidence in the economy. One leading institution pointed out in recent days that 100% mortgages are available for house developments. I might not agree with 100% mortgages, but when a lending organisation gives out that kind of money it shows confidence in the economy. (Select Committee on Finance and the Public Service, 2005)

This is an example of the heightened irrationality in Ireland suggested by Nyberg (2011).

### ***The impact of institutional factors***

The evidence reveals institutions and the relationships within and between the Department of Finance, the Central Bank, the Regulator, the Department of the Environment and the banks to be telling factors in the bad decision in 2005. The Department of the Environment's institutional standing on housing matters had waned in the years preceding 2005. Its oversight role for building societies ended in 1989, and it had gone from having a central role in housing policy via the Bacon reports of the late 1990s to, by 2005, responsibility in narrower areas of social and affordable housing policy, urban renewal and the publication of housing statistics.

In 2005 Environment still had a stated objective to oversee and seek to maintain an efficient housing market, and this contributed to the Department of Finance perceiving Environment's contacting it that summer as a case of 'shifting responsibility' to Finance. Interviews carried out for the case reveal a general sense in the Department of Finance that Environment had abdicated its responsibilities around housing policy (e.g. on replying to parliamentary questions on housing market issues), and for Finance the 100 per cent LTV mortgages issue was one of *housing* policy, while for Environment the issue was one of *banking* policy. Thus, the concerns expressed by the Department of the Environment did not constitute a red flag for the Department of Finance, but the same concerns expressed by the banks or the Regulator to Finance would have been dealt with as a red flag and may have been handled with a different level of seriousness and urgency by Finance. However, there is no record of similar concerns being expressed by the banks or the Regulator to the Department of Finance. This issue was compounded by uncertainty within Finance as to whether the concerns about 100 per cent LTV mortgages reflected the organisational view of the Department of the Environment or were the concerns of the Minister for Housing, who was seen to be particularly active on this topic.

As already stated, for the Department of Finance, the 100 per cent LTV mortgages issue was one of housing policy, while for Environment the issue was one of banking policy. When the Department of Finance and its Banking, Finance and International Division (as opposed to the Budget and Economic Division) took on the responsibility for the Department of the Environment's concerns as a

banking policy issue, this had a profound impact on the decision-making process. It gave primacy to the views of the Regulator and reduced the importance of wider economic concerns in the decision.

The case makes apparent that, despite the Regulator and the Department of Finance being independent *de jure* under legislation, the views held by Finance were *de facto* the views of the Regulator. (This synchronisation in decision-making is most evident in the drafting and content of the formal reply to the Department of the Environment.) Far from ensuring that one institution was not influenced by another, the institutional arrangement resulted in one of them accepting entirely the views of the other.

Despite believing that 100 per cent LTV mortgages were a matter of housing policy, once the Department of Finance had accepted that it had to respond to Environment, it deferred to the Regulator from start to finish, though it performed some in-house analysis. The Department of Finance adopted the institutional view of the Regulator, whereas the Department of the Environment displayed more independence when considering the evidence and arriving at conclusions. In this case, there is no evidence of some alternative view in Finance, though it did have access to Environment's alternative view and access to identical data that had prompted a leading official in the Regulator to propose intervention in 2005.

Another institutional factor was that the Department of Finance and the Regulator had differing views as to who was the key decision-maker on the 100 per cent LTV mortgage issue in 2005. Contrary to the belief in Finance, the Regulator believed that, while the meeting between the Regulator, Finance and the Department of the Environment did not constitute a decision-making forum, the Regulator was the lesser of Finance in decision-making terms, and the Regulator answered to the department. Though the Regulator was independent of Finance and was responsible for regulation, the Department of Finance (in the Regulator's view) set the policy, and the discussion in 2005 on 100 per cent LTV mortgages was a matter of policy.

An additional institutional contributor to the poor decision was Central Bank/Regulator secrecy and corporate identity. Legislation imposed obligations of professional secrecy on officers of the Central Bank and the Regulator, and limited the extent to which Regulator staff could share information or views with the Department of Finance. As noted above, the concerns expressed by the Department of the Environment did not generate sufficient alarm in Finance, but

the same concerns expressed by the Regulator would have. Though it emerged subsequently that there were those within the Regulator who felt strongly enough in 2005 to propose intervention on 100 per cent LTV mortgages, the Department of Finance had no sense of this during their engagement in 2005.

Interviews undertaken in this case show that had Finance known that the Regulator's Head of Banking Supervision believed that the arrival of 100 per cent LTV mortgages warranted intervention, it would have been a major issue for the Department of Finance. The explanation revealed in this case is that this crucial non-exchange of information was a result of a combination of factors: a strong organisational line within the public service and the Regulator; the institutional secrecy within the Regulator; a 'wanting to believe'/confirmation bias within Finance, which was seeking reassurance; an awareness of the political reality of the pressure on home-buyers; and the impact of recent analysis – specifically the chapter on mortgage indebtedness in *Financial Stability Review 2005*.

The impact of institutional factors on this particular decision was summed up in hindsight by a feeling within the Department of Finance that not only were confidential matters within the Regulator secret, everything was secret, and a belief within the Regulator that Finance was not seeking the views of the *representatives* of the Regulator (whom we now know held concerns) but was seeking the views of the *institution* of the Regulator as an entity in its own right.

Further, the Department of Finance's own institutional standing within the policy system had been damaged. This was a result of successive years of inaccurate forecasting on the economy, the simultaneous rise in influence of the Department of the Taoiseach and the social partnership process, and the establishment of the Financial Services Clearing House in the Department of the Taoiseach. There is no record of communication between any banks and Finance on the 100 per cent LTV issue in 2005. This suggests that the banks, at least one of whom was in active engagement with the Regulator, did not believe it necessary and/or appropriate to contact the department. This is telling given the view by the Department of Finance that a statement of concern from a bank to it on 100 per cent LTV mortgages would have 'set alarm bells ringing', in a way which Environment's concerns did not.

One further institutional issue which may have negatively influenced this decision is the phenomenon of institutional memory. Institutions' memories of the past are thought to be particularly acute

when tackling economic and financial policy problems (Haldane, 2013). The Central Bank had warned in the preceding decade of a possible housing market collapse, which had not, in fact, occurred (Honohan, 2010, p. 95). When the Regulator, upon whom the Department of Finance was relying for guidance, was giving consideration to intervention on 100 per cent LTV mortgages in 2005, there is evidence that senior management were influenced by institutional memory and feared ‘crying wolf’ once more about the mortgage and property market for fear of damaging its own reputation, and this may have impacted negatively on the decision outcome.

It could be assumed that the context of this decision was a political desire to keep the boom going and not to interfere or intervene. This desire might not have been accompanied by explicit political instruction or action; rather it may have been implicit in political and cultural ‘common sense of the moment’. Notably, there is an absence of politics in this particular bad decision. There was activity by a number of key actors, including the Minister of State with Responsibility for Housing, Noel Ahern, TD, senior officials in Finance and the Department of the Environment, and senior people within the Regulator. There is no evidence of the involvement of the two senior ministers: Brian Cowen, TD, at the Department of Finance and Dick Roche, RD, in Environment, or any advisers. All three ministers were members of the Fianna Fáil Party so Ahern’s activity cannot be deemed to have been a ‘crusade’ on behalf of a junior coalition political party. In fact, had Ahern been a member of the junior coalition party there may have been more of an onus on Finance to take the objections more seriously, or at least be seen to.

The case shows civil servants acting to represent their ministers and departments in the decision-making process, and officials from the Regulator providing the institutional view. This presents the possibility that a *propensity to act* impacted on the decision, with elected politicians being more inclined than civil servants to (be seen to) take action on high-profile issues.

### ***Institutions, information processing and irrationality***

The institutional memory of the Central Bank prompted both confirmation bias and loss aversion with regard to reputation, and was another negative influence on the decision process. In addition to the ‘crying wolf’ problem in the Central Bank in the years before the crisis,

in 2005 the Central Bank and Regulator were promoting Ireland's financial services industry abroad (as well as regulating the market) as part of their dual mandate. The case shows that despite being so concerned about the property market in Ireland that they wished to intervene on 100 per cent mortgages, they simultaneously assessed their regulatory approach in the belief that it was working (placing greater weight on existing beliefs, i.e. confirmation bias), and predicted positive outcomes while overestimating the accuracy of those predictions (overconfidence bias). This irrational dissonance or adaptive preference allowed the Regulator to pursue its dual mandate, and contributed to the bad decision.

### *The impact of ideology on the decision*

The next force at play is ideology, and the economic left/right as opposed to social liberal/conservative cleavage, with the *left* referring to an abstract belief in state action, intervention in the economy, and higher levels of government spending and taxation, and the *right* referring to a contrasting abstract belief in a laissez-faire policy approach, non-intervention by the state in economic affairs, and lower levels of government expenditure and taxation.

For the Department of the Environment, market intervention should be approached with caution, and policy should be focused on stability rather than change, which may have unintended consequences. This was especially true in the housing market due to the long lead time for the full effects of policy change to emerge.

The Department of Finance believed that the government's broad policy approach was non-interventionist. This was especially true for the housing market where, interestingly, it looked at the Department of the Environment's three Bacon report processes as an example of interference, perhaps politically driven. There was some recognition of the change in political thinking nationally with the electoral success of the right-leaning Progressive Democrats and the appointment from 1997 to 2004 of a Minister for Finance who was seen as pro-market.

The Department of Finance also took on board what was happening internationally and influencing policy in Ireland (e.g. fall of the Berlin Wall, the 'victory of capitalism/brave new world' view, and market-driven integration with deep and liquid capital markets).

The overall consequence was that the Department of Finance placed great significance on the markets and the banks having confidence in product development. While a department would not be



strongly ideological, the dominance of the market ideology generally raised the threshold of what information or signals were necessary before intervention would be recommended. This is significant in light of the earlier discussion whereby the concerns of the Department of the Environment did not constitute a red flag to Finance. Similar concerns from the banks or the Regulator would have seen the necessary threshold reached for Finance to consider a more interventionist response, contrary to the dominant ideology.

The Department of Finance was aware of international research of the time which linked financial market development with productivity gains and how this was well received in Ireland in light of declining national competitiveness. The result was hubris about the market model from 2000, and a belief that it was not a civil servant's role to second-guess the market. Further, this was at a time when Finance's institutional standing, credibility and confidence had been damaged for reasons mentioned earlier.

For the Regulator, ideology was institutionalised – the choice of regulatory structure in 2003 placing an emphasis on competition and the resulting (perceived) consumer benefits, over macro-prudential action; the creation of the statutory position of consumer director on the board of the Regulator; the legislative 'dual mandate' stating that the Central Bank/Regulator had a function to promote Ireland's financial services industry; and the choice of a principles-based regulatory regime ('spirit of the law') over a rules-based one ('letter of the law'). This last point was in the context of international developments referenced above.

From the first documentary evidence of the Department of Finance's response to the Department of the Environment's concerns, there is evidence of an ideological influence: intervention could make matters worse. While this is ambiguous in terms of ideology, the statement to Environment at their meeting on 10 August that it was important to 'trust the market' is less so. This is followed up with the point that a watching brief must be kept on developments. In its note of the same meeting, the Department of the Environment states that the first point made by Finance in response to its concerns was that the government needs a strong basis to intervene in the market.

There are also sections of the Department of the Environment's note of the meeting on 1 November that point to the influence of a free market competition ideology on the Regulator's thinking. It makes the point that intervention would put Ireland in an unusual

position internationally, that there would probably need to be substantial evidence that the Irish market was unusual in some significant respect to warrant departure, and that the Regulator was conscious of a risk that any intervention in the mortgage market could affect competition.

In its November letter the Department of Finance reminded the Department of the Environment of the ‘operational and policy context’ in which the banks and the Regulator operate, the ‘impact of competition in the banking sector’ and ‘the high degree of competition in residential mortgage lending’. The Department of Finance tells Environment – in the context of a letter on 100 per cent LTV mortgages – that competition in the residential mortgage market is a good thing because it provides customers with innovative products, lower prices and better service. This echoes the Department of Finance’s suggestion to the Department of the Environment at their meeting in August that they should ‘trust the market’.

None of the key players in the 2005 decision provided an ideological counterargument. The Department of the Environment, while cautious on intervention, did believe action was warranted in the summer of 2005. For the Department of Finance, the dominant ideology created a very high threshold for intervention in the market, a threshold it did not believe had been met. For the Regulator, the entire regulatory approach, which was based on the market ideology, argued against intervention on 100 per cent LTV mortgages in 2005.

### *Ideology, information processing and irrationality*

A suboptimal, irrational outcome can emerge due to policymakers’ rigid, abstract beliefs resisting new information flow and activating empirically established behavioural biases. Nyberg (2011, p. 94) concluded that the widespread ideological belief in the efficiency of markets became widely trusted among Irish financial professionals in private and public institutions, and prompted assumptions among institutions, strengthened through groupthink.

It is clear that the dominant market ideology of the time raised the threshold to be reached for intervention to be seriously considered by Finance. Rather than the concerns of the Department of the Environment being assessed rationally and on their merits, ideological belief in the efficiency of markets framed the discussion, prompted assumptions across institutions and within institutions, and impeded information flow.

## Discussion

The examination of this case reveals that information processing was impacted by the interacting influences of interests, institutions and ideology, but it was a combination of ideological and institutional factors that had the clearest negative impact. The examination also found that it would not be accurate to say that the decision-making process was entirely irrational (e.g. as a consequence of groupthink): many errors were made for rational reasons, often in an actor's self-interests, and the information necessary for a good decision was available. Ideology, framed as principles-based or 'light-touch' regulation, has become a ready defence, explanation or excuse in the Irish economic crisis. But this case illustrates that the process was far more complex. Irrationality, framed as groupthink and herding between institutions (banks, regulators, government, the research community, academia, firms, households), is also regularly cited as a key antecedent to the crisis.

Again, this case suggests greater nuance is required. Detailed information and options were considered and discussed by decision-makers in the case, over a period of months. This argues against impactful behavioural convergence or groupthink.

Many of the symptoms of such irrationality were present, such as selective bias in processing information at hand, poor information search and an incomplete survey of alternatives – but this occurred *within* institutional actors; *between* institutions there was detailed information exchange and deliberation. This case shows how the Department of Finance's interests (seeking to avoid the need to intervene) interacted with the institutional factors (the Department of the Environment's concerns not being given the same weight as those of others) and the ideological context (belief in efficient markets, a high threshold for intervention). Interests, institutions and ideology interacted in this case to prompt the poor rational and irrational information processing which led to the bad decision, in the same policy system which presided over Ireland's economic frailty and eventual collapse.

## References

- Ahearne, A. (2015). *Transcript, evidence to the Oireachtas Joint Committee of Inquiry into the Banking Crisis*. Retrieved from <https://inquiries.oireachtas.ie/banking/hearings-evidence> [20 April 2019].

- Baumgartner, F., & Jones, B. (2009). *Agendas and instability in American politics* (2nd edn). London: University of Chicago Press.
- Bennett, A., & Elman, C. (2006). Qualitative research: Recent developments in case study methods. *Annual Review of Political Science*, 9, 455–76.
- Central Bank of Ireland. (2005). *Financial stability review 2005*. Dublin: Central Bank of Ireland.
- Central Bank of Ireland. (2014). *Macro-prudential policy for residential mortgage lending*. Dublin: Central Bank of Ireland.
- FitzGerald, J. (2015). *Transcript, evidence to the Oireachtas Joint Committee of Inquiry into the Banking Crisis*. Retrieved from <https://inquiries.oireachtas.ie/banking/hearings-evidence> [20 April 2019].
- FitzGerald, C. (2016). *Leading to crisis: Decision-making in Ireland's Celtic tiger* [PhD thesis]. Retrieved from <http://doras.dcu.ie/21340/> [20 April 2019].
- Fitzpatrick, T., & McQuinn, K. (2004). *House prices and mortgage credit: Empirical evidence from Ireland* [Research technical paper 5/RT/04]. Dublin: Central Bank of Ireland.
- Friedman, J. (2009). A crisis of politics, not economics: Complexity, ignorance, and policy failure. *Critical Review*, 21 (2–3), 127–83.
- George, A., & Bennett, A. (2005). *Case studies and theory development in the social sciences*. Massachusetts: Cambridge University Press.
- Gerring, J. (2007). *Case study research: Principles and practices*. New York: Cambridge University Press.
- Grossman, R. (2013). *Wrong: Nine economic policy disasters and what we can learn from them*. Oxford: Oxford University Press.
- Haldane, A. (2013, September 4). *Why institutions matter (more than ever)*. Speech delivered at Centre for Research on Socio-Cultural Change (CRESC) Annual Conference, School of Oriental and African Studies, London.
- Hall, P. (2003). Aligning ontology and methodology in comparative politics. In J. Mahoney & D. Rueschemeyer (Eds), *Comparative historical analysis in the social sciences*. New York: Cambridge University Press.
- Honohan, P. (2010). *The Irish banking crisis, regulatory and financial stability policy 2003–2008. A report to the Minister for Finance by the Governor of the Central Bank*. Dublin: Government Publications.
- Igan, D., & Kang, H. (2011). *Do loan-to-value and debt-to-income limits work? Evidence from Korea*. Retrieved from [www.imf.org/external/pubs/ft/wp/2011/wp11297.pdf](http://www.imf.org/external/pubs/ft/wp/2011/wp11297.pdf) [20 April 2019].
- Jácome, L., & Mitra, S. (2015). *LTV and DTI limits – Going granular*. Retrieved from [www.imf.org/external/pubs/cat/longres.aspx?sk=43084.0](http://www.imf.org/external/pubs/cat/longres.aspx?sk=43084.0) [20 April 2019].
- Janis, I. (1982). *Groupthink: Psychological studies of policy decisions and fiascoes* (2nd edn). Boston: Houghton Mifflin.
- Kahneman, D. (2011). *Thinking, fast and slow*. London: Allen Lane.
- Kahneman, D., & Tversky, A. (1984). Choices, values and frames. *American Psychologist*, 39 (4), 341–50.

- Lunn, P. (2013). The role of decision-making biases in Ireland's banking crisis. *Irish Political Studies*, 28 (4), 563–90.
- Lydon, R., & McCarthy, Y. (2011). *What lies beneath? Understanding recent trends in Irish mortgage arrears* [Research technical paper, No 14/RT/11]. Dublin: Central Bank of Ireland.
- McCarty, N., Poole, K., & Rosenthal, H. (2013). *Political bubbles: Financial crises and the failure of American democracy*. Princeton, N.J.: Princeton University Press.
- Nyberg, P. (2011). *Misjudging risk: Causes of the systemic banking crisis in Ireland*. Retrieved from [www.bankinginquiry.gov.ie](http://www.bankinginquiry.gov.ie) [20 April 2019].
- Select Committee on Finance and the Public Service. (2005, July 20). *National Economic and Social Development Bill 2002: Committee stage*. Retrieved from [https://www.oireachtas.ie/en/debates/debate/select\\_committee\\_on\\_finance\\_and\\_the\\_public\\_service/2005-07-20/2/](https://www.oireachtas.ie/en/debates/debate/select_committee_on_finance_and_the_public_service/2005-07-20/2/) [22 April 2019].
- Slaterry, L. (2005, July 14). Property surge expected as bank offers 100% mortgages. *The Irish Times*.
- Sunstein, C., & Hastie, R. (2015). *Wiser: Getting beyond groupthink to make groups smarter*. Boston: Harvard Business School.
- Wright, R. (2010). *Strengthening the capacity of the Department of Finance*. Retrieved from <https://www.finance.gov.ie/updates/strengthening-the-capacity-of-the-department-of-finance-wright-report/> [20 April 2019].