Irish Economy Note No. 5

"Irish Banking Policy during and after the Crisis"

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IRISH BANKING POLICY DURING AND AFTER THE CRISIS

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At a time of crisis the character and priorities of prudential banking policy move through three distinct—albeit interrelated—phases: containment, resolution and prevention.

Containment

Containment entails preventing or stemming panic and stopping the rot in terms of loss-making activities. After several months of low-key containment efforts largely behind closed doors during the early months of 2008, Irish containment moved into top gear at the end of September with the announcement of emergency legislation for an extensive guarantee of the liabilities of the main Irish-controlled retail banks.

Triggered by the effective failure of Anglo-Irish bank in very difficult international funding conditions, the guarantee was just one of several dramatic containment steps taken by Governments in Europe and the US during September and October.[1] The first by an OECD country for some time, the blanket guarantee was quickly followed by other countries, albeit the other guarantees were less extensive and in most cases less formal. In contrast, Iceland, whose banks recklessly plunged into grandiose international adventures, was unable to backstop their failure.

Many people ask me whether a blanket guarantee was really necessary. Although one can quibble with the scope, with the inadequate consultation with partner regulatory authorities elsewhere in Europe, and with the denial of underlying solvency issues at Anglo, there is little doubt that an extensive guarantee of Irish banking liabilities was needed as an immediate containment response, given the situation that had emerged.

[1] Including nationalizations, capital injections, guarantee schemes for new borrowings and depositor guarantees of varying coverage.

The scale of the Irish banking crisis, and the fact that it occurred against the backdrop of the parallel but different collapse in international banking confidence, have made containment quite difficult. Indeed, containment might not have been possible without the help of the European Central Bank, which has now lent Irish banks a staggeringly large sum of money (Figure 1) needed to allow them to repay foreign market borrowing they had made over the previous five or six years (Figure 2).

Maintaining confidence is not the only criterion for good containment. Indeed obsessing on this aspect can lead to suboptimal decisions. But confidence aspects are central, not least because of the knock-on effects on government borrowing costs.

In the febrile atmosphere of financial markets that has prevailed during the past year, revelation of Irish banking difficulties has had a clear knock-on effect on the cost of Irish Government borrowing. While the sharp fall in tax revenues and the heightened pressure on government spending is having a larger impact on prospective government borrowing, it is the banking difficulties that have especially caught the adverse attention of international financial markets. That has complicated both the substance and the communications of ongoing containment and resolution policy. Any announcement, even one that should be applauded as likely to limit future damage, such as the nationalization in mid-January of Anglo-Irish Bank, risks reminding potential lenders of the difficulties and causing an upward ratcheting of borrowing costs.

Figure 3 shows the astonishing fluctuations in the premium charged in the CDS market to insure Irish Government bonds. (In the figure, an entry such as 200 means the premium is 2 per cent per annum of the sum insured). Although movements in the actual cost of borrowing have not been quite so pronounced (the CDS market is rather thin and illiquid), and although some of the fluctuations reflect global risk premium fluctuations rather than Irish conditions, awareness of the sensitivity of borrowing costs has, I think, been a worrying constraint on the implementation of effective crisis resolution policy. (Illustratively, an additional 2 per cent per annum for 10 years on gross borrowing of, say, 50 per cent of GDP adds up to €15 billion to budgetary costs.) All the more reason to ensure that international lenders to the State are made confident that resolution action will not involve the State assuming an excessive burden from the bank restructuring.

Resolution

Resolution of a banking crisis entails getting the banks back on to a self-sustaining financial basis, and ensuring that lenders are confident that this is so. It also requires ensuring that an effective management team is in place in each bank and that it has the capacity both to deal with inherited problem loans, and to move forward with new lending activities.

It is in this context that we should interpret the Government's injection of capital into three of the banks, the departures of some senior staff and directors, and the creation of NAMA. Evidently this whole process is still in its early stages.

Sequencing is an issue here. The textbook says that among the first things to be done in the resolution phase is to decide on the allocation of who should bear the losses. Evidently it is intended by the Irish Government that it will assume whatever of the losses are not taken by the shareholders and other providers of risk capital. But beyond that, it is not yet possible to be precise. In order to get more precision, a good estimate of the prospective losses is needed. Because of the unprecedented depth of the macro crisis here and abroad, getting a reliable estimate (not only of development property-related loans but also loans secured on residential property, loans to commercial and manufacturing firms, credit cards and so on) seems beyond reach. (The new management and board at Anglo-Irish bank seem to have gone further than the others in acknowledging the likely situation).

As losses crystallize and get taken into account in a bank's balance sheet, its cushion of capital (essentially the difference between its assets and its non-risk-bearing liabilities) shrinks. For example, their last balance sheet showed Anglo's capital to have dipped well below regulatory minima, and they had to be given temporary regulatory waivers. In order to stay in business Anglo needed to find more capital, hence the injection of Government funds. Now, any such injection has the incidental side-effect of boosting the likely value of the remaining capital, owed to risk-taking subordinated debt holders, because it makes it less likely that any further losses will be absorbed by them. Buying out those sub-debt holders (whose claims are traded below par because of the sizable risks they bear) helps reduce this unfortunate side-effect.

NAMA

NAMA can be seen as part of the resolution process: an asset purchase scheme that can (i) free the banks from being preoccupied with trying to recover from their largest delinquent borrowers, thereby allowing them to focus on identifying the borrowing needs of healthy customers; and (ii) replace problem loans of uncertain value in the banks' portfolio with sound, marketable assets that can be used to mobilize liquid resources for onlending.

Other countries have also been moving to set up some kind of asset purchase agency, notably the US and Germany. Neither has managed to get a formula that commands widespread approval among experts. A particular sticking point is pricing. If an asset management company such as NAMA mistakenly pays too much for the loans it buys, this will entail an unwarranted gift to the shareholders and other unguaranteed providers of capital to the banks. The US system is stalled for want of a solution to this problem.[2] The UK has chosen a different route, offering the banks partial (90%) insurance against further loan losses – this too exposes the UK taxpayer if the premium and deductible paid by the banks prove to be too low.

I have proposed a two-part payment mechanism whereby NAMA would pay the bank for loans of uncertain value only a small part in cash – well below the realistic best estimate of the net amount they will eventually yield – with a sweetener in the form of an equity stake for the bank shareholders in any future recoveries by NAMA. This strategy ("NAMA 2.0") ensures that the taxpayer does not pay too much. It still separates the bad loans from the bank, while sharing the pricing risk fairly between taxpayer and shareholder. (The two-part risk-sharing approach is evidently far superior to the idea of a levy to be imposed after the event if loan recoveries disappoint.)

[2] The German and US schemes, inferior to NAMA 2.0 in their risk-sharing characteristics, also differ from NAMA in key respects. The US scheme envisages privately run agencies; the German scheme is designed for banks which are already in public ownership.

Unless the loans are valued at unrealistically high prices, the NAMA process will leave the banks with insufficient capital. This is especially true considering the additional loan losses in non-property lending that are inevitable given the depth of the recession and which will have to be provided for.

As is well understood, the Government will therefore have to step in again and inject more capital funds; thus it will end up owning a large fraction of the shares unless it can find new providers of capital (which should not be impossible since the new investors would be buying a cleaned-up concern). Some have jumped the gun by calling for an outright nationalization come what may. I don't see this as a goal in itself. My reading of the international evidence is that any protracted period of outright government ownership is more likely to have adverse consequences on economic recovery, so I prefer to see the government's ownership share as something that falls out of the loan valuation calculations and the success or otherwise in finding (presumably abroad) other potential capital providers, public or private.

As we begin to see in very recent court proceedings, there are going to be huge complications in achieving effective corporate work-outs where, as is going to be the case for most of the big cases, there are multiple bank claimants. This is true with or without NAMA. The whole area of workouts and recovery is not my area of comparative advantage, so I will not dwell on it. Let me just mention one reminder: seizing collaterals; and liquidating them, are two different things. While it may very well be true that this is not the best moment to be liquidating development land and half-completed buildings, that is not in itself an argument for forbearance in dealing with a delinquent borrower.

Credit crunch

So, after massive injections of funds courtesy of NAMA, the Government, and possibly new shareholders, the banks should be ready to dish out loans to all and sundry? Not so fast! Indeed there is a risk of disappointment here. It's not simply a question of pouring money in one end and expecting it to come out in the form of loans on the other. The injections the Government is making are more about rebuilding the cushion of capital that protects the depositors and other creditors against future risks as they are about making loanable funds available. That helps the bank raise additional loanable funds, and helps reduce management's levels of anxiety and fear, thereby restoring some of their willingness to make new loans. But they will still not want to lend to poor prospects. And, given that it's going to be largely Government money that's at risk, the general public should not want them to be lending to poor prospects. Given the budgetary constraints made all the more evident and immediate by An Bord Snip Nua's report, few would be advocating budgetary grants to be given to loss-making firms that do not have much hope of survival. A bank loan given to such a firm by a largely state-owned bank is in essence a budgetary grant.

How is the crunch going? Given the degree to which banking has exacerbated the Irish economic downturn, it is tempting to believe that fixing the Irish banks will solve all of our problems. It will not. The collapse in the public finances, which has inevitable knock-on effects in compressing domestic demand, will still be a factor, as will the downturn in international demand as is reflected in the sharp fall in all employment-important components of manufacturing and service exports. None of these factors results from the undoubted tightening of bank credit standards. Figures 4 and 5 show some of the facts relevant to understanding the degree to which there has been a credit crunch.

Figure 4 summarizes the fall in nominal credit (that is, before adjusting for the fall in prices that has also been happening) that has occurred in the past year or so. Figure 5 is, perhaps, more interesting. It is based on bank responses to a Central Bank questionnaire on the demand and supply of credit. While supply (measured mainly by the credit appraisal standards and pricing of loans) has certainly tightened, this happened after—not before—the fall in demand. Broadly speaking, the Mazars Report commissioned by the Department of Finance, also presents a somewhat muted picture of a moderate tightening of credit – though it does point to a bit of a disconnect between the self-reported experience of rejection by SME loan applicants and the rejection rate reported by the banks.

Protecting the functioning of the banks was, in the short run, an imperative more because of their role in assuring normal functioning of the economy (albeit at less than 90 per cent of its peak level) and to protect internal and external confidence in that functioning. Full resolution of the banking crisis will facilitate a relaxation of credit standards which will strengthen the recovery, but a return to normal levels of credit availability may take quite some time if the past experience of other crisis countries is any indication. They can be encouraged and even required to speed up the return to larger credit flows, but efforts in this direction in the UK and France, for example, seem so far to have limited effect, and could be counterproductive if backed with unduly generous further government credit guarantees. Instead, we could be heading into what has, in other countries, been facetiously termed a "credit-less recovery". The faster and more effective the resolution, the more likely it will be that the banks will play their full part in the recovery.

Prevention

As the resolution comes to completion, regulatory emphasis will shift to preventing the next crisis. Of course the way in which the crisis is resolved will help set the scene here. If bank insiders and shareholders are seen as getting off too lightly, this will surely worsen recklessness next time around—moral hazard as it is known. In addition, though, there is much international discussion these days of ideas for better prudential regulation that would help prevent the next crisis.

Most of these reforms centre around improving the alignment of banker incentives with social welfare, and improving transparency so that regulators and other market participants can help forestall problems. More equity capital – i.e. a higher proportion of banks' lending and activities to be funded by shareholders – is a goal on which there is wide agreement. It will take time to get there, of course, since it is hard to raise even the amounts of equity capital required by current regulations. The structure of individual banker remuneration is also rightly under the microscope. Mechanical rules limiting rapid balance sheet growth and other ratios could also help. Other types of regulation, especially those relating to fancy derivatives (should be traded through organized exchanges and not over-the counter), rating agencies (downgrade reliance on them) and loan sales (obligation for originator to retain some of the risk), are all moves in the right direction, though they do not really speak to the problems we have had in Ireland.

Instead, the goal of better “macro-prudential” regulation should strike a chord for us. It was not just that one bank that went bad (although one bank’s egregiously rapid growth certainly accelerated the infection of others). Instead the error of judgment that led to the banks lending so much with so little solid security into an unprecedented property bubble reflects a systemwide failure to appreciate the scale of the risk being assumed. Technical discussion of mathematical risk models is irrelevant here. Instead what is needed is improved organizational and descisionmaking skills by the regulator, including a way of taking into account in a considered way, the warnings of dissident sceptics whose views tend at present to be dismissed as cranky. Here, institutionalizing an outside view – provided for example by international sharing of supervisory staff – would in my view be one valuable element.

Protecting the consumer and the economy

I don’t want to close without mentioning consumer protection. The worst aspects of this, such as out-of-control loan originators pushing unaffordable sub-prime mortgages, seem not to have been as widespread an issue in Ireland as it was in the UK or of course in the US (cf. Financial Ombudsman Annual Report). But, more generally, the future banking landscape in Ireland needs not only to be safe and sound, but inclusive and low cost. There had been the beginnings of work on this aspect in recent years, not only by Combat Poverty, but also by the Financial Regulator, whose public information function had indeed come to be seen as somewhat gold-plated. If we end up with a smaller handful of main players, this must not be allowed to result in monopoly pricing and neglect of small and vulnerable customers. In this regard, the apparent de facto retreat of several of the foreign banks is a regrettable development which I hope will only be transitory.

An effective financial system has been shown in numerous academic studies to have the potential to accelerate long-term growth. Even before the crash, Ireland’s banking system had not displayed conspicuous effectiveness of this type (as I discussed in my 2006 paper in the *Economic and Social Review*. As we move through the steps of containment and resolution towards rebuilding a safe and sound system, let us try to ensure that it makes a better national contribution in the future.

Figure 1: *Irish bank borrowing from central bank*
(Stock, 2006-2009)

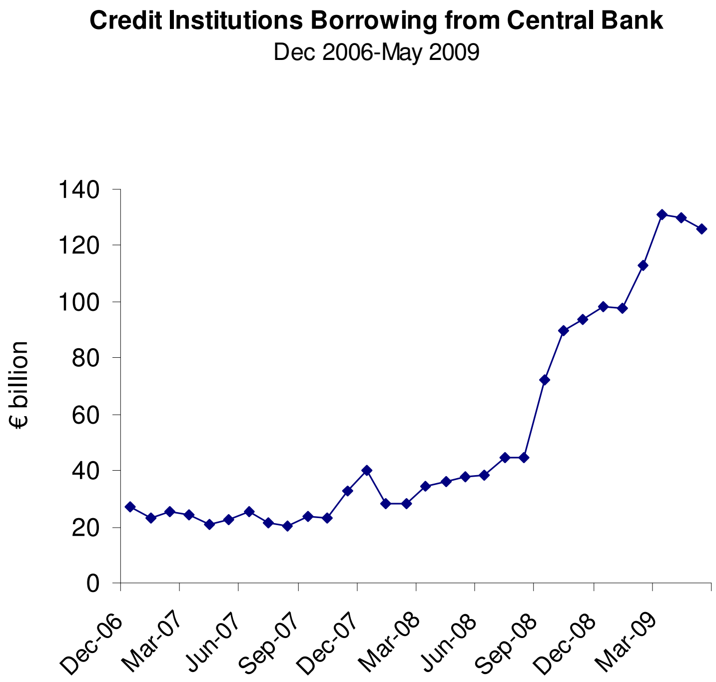

Figure 2: *Foreign borrowing by Irish banks*
(Stock, 1999-2009 – does not include borrowing from Central Bank)

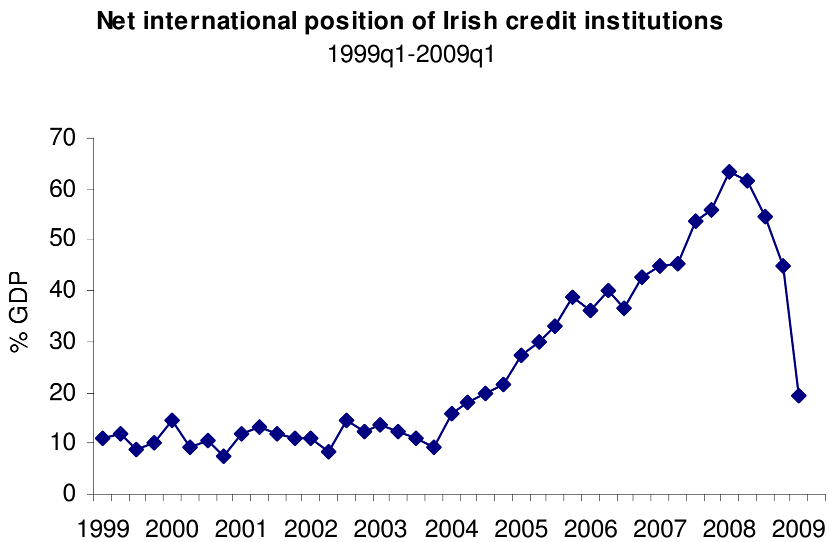

Figure 3: *CDS spreads on Irish Government bonds*
Sept 2008-July 2009

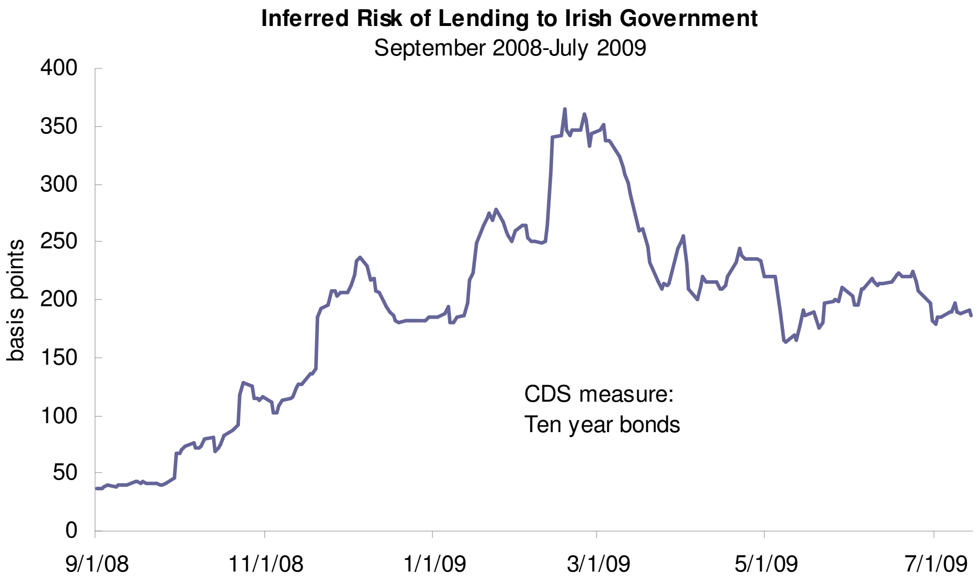

Figure 4: *Fluctuations in credit growth*
(residential mortgages and other, 1999-2010)

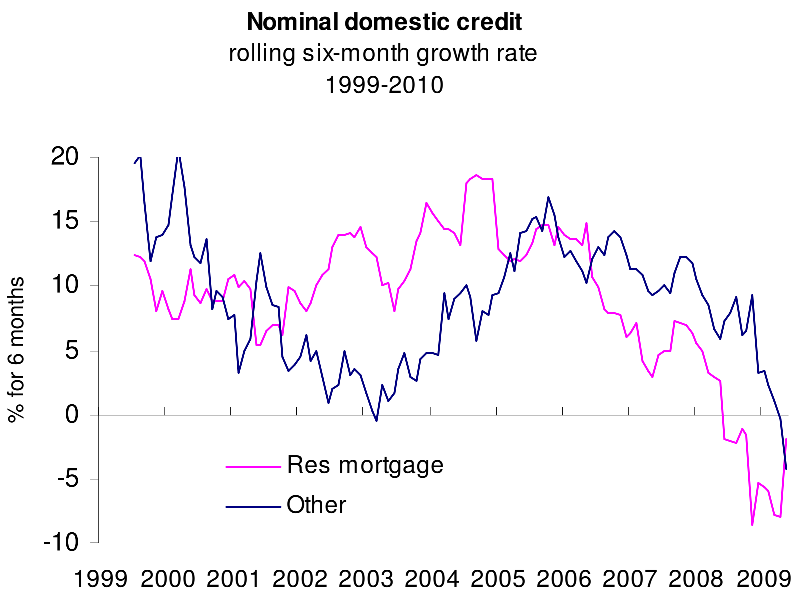

Figure 5: *Indications of credit supply and demand, 2003-2009*