Patrick Honohan: The importance of sound information in assessing the health of the Irish banking sector

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Chartered Accountants Ireland, Dublin, 23 November 2010.

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There is a letter in the archives of the World Bank in Washington DC on the letterhead of the Shelbourne Hotel, Dublin, dated Saturday, June 7, 1958. Benjamin King writes back to headquarters on his mission to Ireland. This was the first ever such mission sent by either of the Bretton Woods Institutions (the World Bank and the International Monetary Fund) since Ireland had joined both of them in the previous year. King was in Dublin at the invitation of the Secretary of the Department of Finance, T.K. Whitaker, who had asked the World Bank to help by carrying out a review of the Irish economy with a view to a possible borrowing programme for Ireland from the Bank.

But King found that much analysis had already been carried out by the Irish administration. Indeed, he had been perusing a draft of the document that would change the course of Irish policy towards its economic engagement with the rest of the World. "I have asked Whitaker", he writes, "to send you by airmail his report "Economic Development". It is over 200 pages and seems pretty good to me." And it's not just a document of factual analysis, but addresses challenging policy issues. He notes that "it is also quite tough (in a velvet-glove sort of way) with some old-established practices". With this document, King believes that Ireland would be already "halfway toward [having] a sensible program".

Ireland did not in fact borrow immediately from the World Bank but eventually it borrowed a total of US$ 150 million between 1969 and 1975 for a variety of projects, ranging from power generation, to agriculture, to education. The last World Bank loan to Ireland, to support the then ICC (now BOSI – alas closing at the end of this year) in promoting regional development and employment, was approved in August 1975.

The resonances from this 52-year old letter are particularly sonorous this week, as an IMF team scrutinizes another Irish plan and maps out another international programme of borrowing by Ireland (with the additional support on this occasion of European institutions).

The 1958 economic policy shift launched a move towards increasing internationalization and – to use a word not yet in use back then – globalization for Ireland. To be sure, Ireland had long been an open economy, but one whose international economic relationships were predominantly with Britain and its former empire (and, for migration, with the United States). Since independence, both domestic politics and the international economic and military environment had encouraged higher barriers to trade and investment. Now these were to be progressively dismantled as Ireland opened up to a wider and deeper engagement with the global economy.

One key dimension of this opening up is of course trade: exports as a percentage of GDP grew from 24 per cent in 1960 to an astonishing 101.5 per cent in 2011 (as forecast), placing Ireland in a very select league of countries (Malaysia and Singapore being the other ones of significance) for which exports exceed GDP. The pattern of exports also shifted. Predominantly agricultural in the 1950s, today (while agriculture and agribusiness-based exports are far from negligible) exports are dominated by manufactures and services. The shift to globalization was accompanied eventually by a rapid and more or less complete convergence in living standards to the highest levels of Western Europe. Once a laggard, whose relative position had slipped since independence, Ireland became seen as a European growth leader – even though much of the growth in the 1990s was really a catch-up to the production frontier as enough jobs were at last being generated to employ essentially all of those who wanted work and sucked in returned emigrants and new immigrants as well.

Speaking to an audience of accountants, I must naturally remind you, though, of the accounting and measurement challenges that have been presented by the extraordinarily globalized nature of the Irish economy as it evolved over the years. These include national accounting – which I know is not so much the professional concern of this audience today – and also corporate accounting and reporting. For it was not only the volume of exports that was remarkable, it was their character, largely produced by foreign owned multinational corporations and with a high profit component reflecting returns on R&D and other investments accruing to the owners and not to Irish residents. That distinctive pattern of globalization meant that the most common measure of economic performance – GDP – is quite misleading for Ireland, exceeding as it does by over 25 per cent the aggregate statistic which better measures the national component of production, GNP. Though GNP growth was certainly very strong in the period from 1994–2007, and reached a very high level in per person terms, growth rates and levels of GNP have been much lower than GDP. Indeed in the recent downturn, quarterly GNP has fallen 20 per cent peak to trough – much more than GDP. A mistaken national accounting focus on GDP thus risks exaggerating the strength of the Irish economy.

There are knock-on effects of the distinctive globalized structure of the Irish economy on other accounting measures of performance. With the structural shift towards high-productivity sectors during the 1990s and again since 2007, unit labour costs tend to fall even if wage costs for any individual firm or industry are increasing. Because of this shifting composition effect, as has been well-known for decades, but is routinely forgotten by superficial analysts, unit labour costs are a false friend in judging competitiveness developments for Ireland. Measurement and accounting are of crucial importance at times of structural change. Careful scrutiny is needed to ensure that policy choices are quantitatively well-judged. These matters will no doubt retain their importance throughout the period of the recovery programme now being discussed with the IMF, the EU Commission and the ECB.

Banking is a main focus of these discussions. This is not the time or the place to go into comprehensive detail on the elements being included in the programme to improve further the resilience of the banks and restoring greater market confidence in their long-term. Instead let me continue to weave the globalization and accounting dimensions to the Irish banking story. Actually, important aspects of the banking crisis are themselves a part of the globalization story. Probably almost enough has by now been said about poor loan appraisal practices and the consequences of the bubble mentality, but of course that would not have added up to anything of great consequence had it not been for the access, through the globalized banking system, to vast sums that could be borrowed from abroad. To be sure here too the banks had been internationally integrated for a couple of centuries. They sourced funds in times of need from the Bank of England, but more normally placed very substantial funds on deposit in the London money market, given that Irish land and professional classes were net savers and the banks unenthusiastic in the past about lending too much locally.

Well we all know what happened from 2003 when the banks wanted to keep feeding the property and construction boom. The run-up in net foreign borrowing was spectacular, and its contraction equally sharp (as foreign lenders declined to roll-over into an economy with a property bust and then also a stressed Sovereign). Deleveraging this exposed funding position through structural measures is a key goal of current banking policy as has been mentioned elsewhere.

Apart from the pressure on the Sovereign, the capital position of the banks has, as is well-known, been placed under pressure by actual and especially prospective loan losses. Naturally, long-term lenders to banks need assurance as to the adequacy of the banks' capital position and this means not only that the banks' capital has had to be increased – and this has been done on a very large scale over the past two years – but that investors need more and better information about the portfolio of the banks.

The lengthy process of determining the NAMA-related loan losses and the time taken in some cases to meet the Central Bank's capital target set out in the Prudential Capital Adequacy Review PCAR announcement of March 30, 2010, and revised at the end of September, has tended to muddy communication around the capital adequacy of the Irish banks. There is market concern about tail risk in the banks‟ portfolios. This, together with the heightened market uncertainty prevailing since the end of April, certainly argues for higher percentage capital targets. And, while the external experts have found no fault with the methodology used for this year's PCAR stress test, the next exercise, which takes place early in 2011, will both dig deeper where possible, and take account of evolving economic and loan performance developments and prospects over the year. As already indicated in the past couple of days, it is clear that addressing both the capital ratios and the PCAR exercise will be key elements of the programme being negotiated at present with the EU Commission and the IMF in liaison with the ECB.

Capital is an indispensable multi-purpose buffer against unexpected risks, though it is costly, especially for dealing with tail risks. There is another dimension along which tail risk can be lowered, thereby further increasing confidence of investors on a less costly basis. This falls into your area as accountants, because I am talking about accounting and other information disclosed to the market.

I have already railed elsewhere against the backward-looking loan-loss provisioning practices encouraged by International Financial Reporting Standards (IFRS) and still all too pervasive in the reporting by most of the Irish banks. I find it unsatisfactory that expected losses in many parts of the portfolio are clearly higher than the provisions already taken, because I fear that this evident and in some cases explicit discrepancy may awaken doubts in the minds of investors as to the relevance of other aspects of the reported accounts.

But banks could build confidence by going further, to disclose much more information to the market. Probably disclosure practices by Irish banks were formed during good times, when share prices were high and most of the market analysts following Irish banks were equity analysts.

Credit analysts are different from equity analysts. When stock prices are high, questions of loan losses and defaults are not on people's minds. The equity analyst is looking at growth potential, market share evolution, the competitive environment as it influences spreads, cost control and so on. When stock prices are low, we have moved into a different region of probabilities: the underlying source of volatility of CDS and subordinated debt spreads is what needs to be analyzed and it is the credit analyst that comes to the fore.

Different information flows are relevant to the credit analysts, and this sort of information has been provided by the Irish banks only in a limited way and not uniformly as between different banks.

There is a lot of information that could be provided. For instance, for the residential mortgage book, which has been much discussed recently, one could imagine much more extensive disclosures about the size distribution, broken down into a variety of sectoral and other classifications. Information on the aging and migration of loans between different performance buckets would also help. Bottom line: the banks might do well to call in the leading credit analysts and find out what information would be of greatest use to them in identifying and quantifying tail risks. And then provide it.

For, if there is no information, the credit analyst tends to assume the worst. They think: "if the actual situation were good, would the bank not have been at pains to disclose it?" Since it is not disclosed, it must be bad. At present, regulators have been gathering more and more information of this type, and the size and quality of the information set available to the regulators has been improving by leaps and bounds. Communicating more information to the market would not only enlist the expertise of market credit analysts in a way helpful to all, but could lower the cost of term borrowing as investors regain confidence. We plan to explore this aspect further with the banks; they have much to gain and formal regulation here may not be needed.

As the information flow to the market improves both in quantity and quality, and especially when the economy improves and the news contained in the information is getting better, we will hopefully move towards the euthanasia of the Irish bank credit analyst (though not of course of the accountants!).

More important, and more broadly, restoration of market confidence in the banks and in the finances of the Irish state will step by step be rebuilt by these and other measures to be contained in the programme on which negotiations have begun. This effort will help set the course of economic and financial policy on a more secure path leading to reduced uncertainty and a return to a sustainable path of employment growth and economic activity. We will have a slimmed down banking system that is much better placed to serve the needs of the economy into the future. While all of this will take some time to be worked through, we can be reassured by the announcements of recent days that the banking system retains the support, not only of the Central Bank of Ireland, but of the European Institutions.

The globalization unleashed by Whitaker's initiatives in the 1950s generated great benefits and lifted living standards over the following two generations. Analysing the distinctive structure of the economy that it created requires careful analysis of good accounting data, both national and private. Some distortions have undoubtedly resulted in the process of globalization, not least the excessive dependence in the last number of years on foreign borrowing and its consequences. These distortions reflect the phenomenal ability of globalization to generate a rapid amplification of changes that would occur slowly in a closed and inward-looking economy and society. The rapid leap forward of the Celtic Tiger period was a favourable amplification; the credit and construction bubble a disastrous one. This perspective suggests that, once we find our stride again, with the renewed help of the international and European partners with which we joined in 1957, 1973 and 1999, a favourable amplification will restore prosperity, albeit of a more sober variety.