The banking crisis in Ireland[1]

Executive summary

This paper covers the banking crisis in Ireland that emerged in 2008. The Irish banking sector experienced a deep crisis, which first was at its most intense when severe funding pressures affected the Irish banks in 2008. These pressures re-emerged in 2010, in the light of unresolved questions about the viability of some of the Irish banks, the fiscal implications of the sovereign backstop given to the banking sector, and protracted but eventually unsustainable central bank liquidity support.

The crisis stemmed from a combination of macroeconomic developments, risky bank practices and unsustainable fiscal policies. From the early 2000s, economic growth became domestically focused. Following the adoption of the euro, the size of the banking sector grew significantly and became increasingly reliant on property-related lending in Ireland and abroad. This expansion was increasingly funded by cheap, abundant but short-term international wholesale funding. Fiscal policy was largely procyclical, with structural deficits only closed by transient transactions taxes. The growing imbalances in the domestic economy led to an asset price bubble with ever increasing property prices, encouraged by tax incentives and accommodative prudential oversight. As banks chased market share, lending practices and loan documentation and monitoring deteriorated. The Great Financial Crisis (GFC) that started in 2007 exposed the fragilities in the Irish system and a significant collapse in the property sector ensued. This resulted in a deep financial crisis, impacting the whole banking sector and in turn the Irish sovereign.

In line with the scope of this series, the paper focuses on the policy response. Due to inadequate information and insufficient preparation, the Irish financial authorities initially misdiagnosed the nature of the banking crisis as one of liquidity, linked to global market turmoil and overreliance on wholesale funding, as opposed to one of solvency. The crisis response was also shaped by the expectation, widely shared by euro area authorities following the demise of Lehman Brothers and based on the information at the time, that no bank would be allowed to fail in a disorderly way. This was considered necessary to mitigate further market panic. As a result, the Irish authorities introduced a government guarantee covering almost all Irish banks' liabilities, for a period of two years. But as the economy deteriorated, the unsustainability of the fiscal position became apparent and non-performing loans (NPLs) started to increase. A major banking sector restructuring became necessary.

Following the stabilisation of the banking sector, its restructuring required action on three fronts: capital, asset quality and liquidity. Initial attempts to bolster the banks' capital positions were insufficient and the declines in banks' solvency made it increasingly clear that a bolder approach was needed. Several rounds of stress tests were used to determine banks' losses, capital positions and long-term viability. Key decisions were needed to determine which entities were viable, with two of the most problematic banks being singled out for wind-down. Deleveraging plans were used to reduce reliance on short-term wholesale market funding. As a result, the banking system emerged as smaller and more domestically/more retail-focused.

An Asset Management Company (AMC) was established to remove larger land and development loans from the banks' balance sheets. The AMC, known as the National Asset Management Agency (NAMA), was tasked with removing certain types of real estate development loans

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from banks' balance sheets where economies of scale would be more substantial. Relying on the information from the capital assessment, deleveraging plans and the asset transfers to NAMA, forward-looking capital needs were quantified, and banks were subsequently recapitalised, mainly by the Irish state. Only in 2011 did a comprehensive assessment allow capital needs to be fully determined.

Central bank liquidity was essential to fund the restructuring of the banking sector. This was because NAMA provided bonds, not cash, in return for the assets bought from the banks, while the recapitalisation of the weakest banks was partly achieved through long-dated, non-marketable promissory notes. In both cases, these bonds and notes were pledged to the Irish central bank by the banks to source cash, since market funding was unavailable and liquidity outflows from the banks materialised again, especially in late 2010. Central bank exposure to Irish banks increased significantly because of these outflows.

The Irish authorities eventually sought external support in late 2010. External assistance was requested from the European Union (involving the European Commission (EC) and the European Central Bank (ECB)) and the International Monetary Fund (IMF) via a financial sector programme. The financial sector measures introduced as part of the EU/IMF Programme largely extended measures that the Irish authorities had already taken. However, the approach to bank restructuring was more comprehensive and robust and the sponsoring authorities gave Ireland both credibility and additional resources, providing some EUR 67.5 billion, or over 40% of Ireland's GDP. The deleveraging process embedded in the Programme and NAMA's NPL workouts reduced the central bank's exposure. However, a rapid exit from liquidity support by the central bank for Anglo and INBS, the gone-concern banks, was not possible because of the sovereign's stressed situation. The exit from emergency liquidity assistance (ELA) became possible once the gone-concern banks were liquidated and the central bank's claim restructured through a collateral exchange transaction.

One key lesson from the crisis response is the need to identify its real drivers and the limits of ELA and fiscal support. The Irish experience demonstrates the importance of intrusive supervisory oversight, crisis contingency planning and the need to collect and use reliable bank data to inform the authorities about the bank's underlying conditions and allow them to select the appropriate response. It also highlights the importance of ELA not being used to substitute for the required resolution of banks. Accordingly, the use of ELA needs to be restricted to viable banks and to a predefined and short time frame. Upfront recognition of the fiscal implications of any support granted to the banks also helps avoid the emergence of a damaging sovereign-bank loop that may be extremely difficult to exit from, especially without external support.

Important lessons also emerge in relation to bank restructuring. Ireland had to undertake a comprehensive restructuring of the banking sector. Deciding at an early stage which banks are non-viable is beneficial, and this also helps to determine the structure of the post-crisis banking sector. The experience also shows the importance of selecting marketable recapitalisation instruments that don't introduce hidden risks, especially for the central bank, which may otherwise be the sole provider of liquidity against these instruments. An additional but important measure to support the restructuring of the Irish banking sector was the use of an AMC to offload to and manage the larger property-related exposures.

However, some legacy issues remain. While the resulting NPL stock has been significantly reduced, many NPLs remain outstanding and in deep arrears, most of these being residential mortgages and mainly retained by the banks. There are multiple factors explaining the persistence of such arrears. One of these relates to the existence of a strong consumer protection framework that obliges lenders to find sustainable repayment arrangements with borrowers and makes home repossession a tool of last resort. While all countries strike a balance between creditor and debtor rights, a strong government emphasis on consumer protection – which dissuades NPL sales and complicates NPL resolution – may dilute the prudential objective, which is to restore the banks' ability to lend to the economy.