John Hurley: Restoring stability to the banking system

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to ACI Ireland, Dublin, 10 June 2009.

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Introduction

Thank you for inviting me to speak to the Association again. When I last addressed the ACI it was the autumn of 2007. We had by that time experienced the first months of market volatility, which had started out as a problem centred on the US sub-prime market quickly followed by global problems of declining liquidity and a sharp re-pricing of risk.

As we now are aware, we were, back then, only in the foothills of what has turned out to be a financial crisis of very major proportions; one that has demanded, and continues to require, an immense response from authorities worldwide. It is also a crisis with a particular domestic resonance here, coinciding as it did with the correction in our own property and construction-related sectors. As in other countries, the authorities here have taken extraordinary and unprecedented measures to stabilise the banking system and the economy.

My address tonight will focus on events since September of last year when the turmoil became a full-blown crisis and how authorities have responded since that time. It is clear that that this crisis will drive significant changes both in terms of the structure of banking systems as well as the regulatory regime and I will share some thoughts on these issues. Restoring stability to the banking system is a necessary but, on its own, not a sufficient condition for restoring health to the economy. I will conclude by commenting on the other key policy challenges of restoring competitiveness and stabilising the public finances.

Financial market turbulence evolves into a crisis

The events of last September, centring around the failure of Lehman Brothers, were seminal, after which governments and central banks everywhere had to intervene in an unprecedented way and on a scale that was not conceivable beforehand. Beginning in September, global interbank markets increasingly seized up, even at the very shortest maturities. The severe shortage of liquidity impacted significantly on the operations of banks everywhere. In response, policy makers across the world have taken exceptional steps through direct financial sector interventions, as well as monetary and fiscal policy responses. Recapitalisations, deposit guarantee extensions, the provision of credit and liquidity, and programmes to deal with distressed assets were all undertaken to support financial institutions, while central banks cut policy rates to historically low levels and have introduced a range of non-conventional monetary policy measures.

The response of public authorities in Ireland

Notwithstanding the limited exposure to structured financial products of Irish banks, the interaction of the global shock to financial markets with the pre-existing vulnerabilities in the domestic economy triggered systemic repercussions here. A particular vulnerability here was an overheated property market that had been financed through the banking sector, in large part with funds raised on wholesale markets both at home and abroad. The immediate systemic consequences of the shortage of liquidity for the domestic banking system have been accompanied by the broader economic impact we are now experiencing.

The principal motivation behind all of the decisions that have been taken subsequently with respect to the banking system has been to limit damage to the real economy from the banking crisis. The banking sector plays a crucial role in the modern economy by acting as a financial intermediary and ensuring that funds are distributed from those who wish to save to those who wish to borrow. When this vital function is impaired, it can have severe effects on economic activity. Downturns that are preceded by episodes of financial stress tend to be longer in duration and, partly because of this, more severe than those caused by other factors. Furthermore, when the financial stress is related to the banking sector in particular, then the impact tends to be even more significant.

The approach adopted here in response to the crisis is consistent with the general approach adopted by countries across the EU; namely, the initial introduction of a state guarantee for banks' liabilities, followed by recapitalisation of banks to ensure viability and nationalisation where warranted, and most recently, measures to address banks' non-performing property-related assets through the establishment of the National Asset Management Agency (NAMA). A final necessary stage must address the optimum shape and structure of the domestic banking sector that will be required to meet the needs of the economy in the years ahead.

The State guarantee

By end-September of last year, the severe shortage of liquidity in global money markets was impacting significantly on the operations of Irish banks. Funding pressures were exacerbated by negative international investor sentiment, related to Irish banks' exposures to the property sector, at a time when property prices and transaction volumes were declining following a period of unprecedented increases. Daily liquidity reports were showing that the situation was becoming increasingly strained.

Events came to a head on Monday 29th September when it was found necessary to introduce a State guarantee for a range of domestic banks' liabilities. The objective of the guarantee was to give sufficient time for our banks to stabilise their funding situation, by providing the necessary confidence for international investors that would enable them to continue lending to Irish banks in the fraught environment at that time, thereby relieving short-term funding constraints and preventing a drain of liquidity. To maintain the confidence of international wholesale markets on which Irish banks are heavily dependent, it was essential that the guarantee be pitched at a level that ensured success. The guarantee resulted in an immediate improvement in the liquidity situation. Subsequently, a large number of countries, including at least 14 other European countries, introduced guarantee schemes in order to obviate the same risks, although the type, and maturity, of liabilities covered has differed according to different circumstances and judgements made in individual countries.

Recapitalisation

It was recognised at the time that the guarantee was not a long-term solution and that it would still be necessary to determine if additional capital would be necessary for Irish banks. On the basis of supervisory information, Irish banks met their regulatory requirements. Across Europe, however, international markets were expecting higher core Tier 1 capital ratios than before the crisis. A number of countries, including Ireland, took the decision to recapitalise banks on this basis. A further consideration in the Irish case was market participants' expectations of significant write-downs on property-related assets that would eat into existing capital. The severity of the downturn in the economy was also a factor in recapitalisation here. While Irish banks, unlike many of their international peers, were not exposed to securities based on US subprime mortgages, the exposure that attracted concern in the Irish case was our system's over-exposure to property-related loans. There was great uncertainty about the ultimate impact of the unwinding of an overheated property market on the quality of banks' assets. There was also concern that banks might attempt to improve their capital positions only by curtailing the supply of credit. Historical experience from other countries shows that this type of dynamic would potentially have had severe and lasting negative repercussions for the economy and the financial sector and needed to be avoided

After consultation between all the relevant authorities, a decision was taken to recapitalise our largest domestic banks following due diligence on these banks' exposures. The banks were also required to make a commitment to increase lending capacity to small and medium-sized firms and first-time buyers. Following the emergence of unacceptable governance issues, Anglo Irish Bank was taken into public ownership to protect the stability of our wider financial system.

Non-performing assets on banks' balance sheets

International commentators, such as the IMF in its Global Financial Stability Report, suggest that the challenge now for many countries is to address banks' balance sheets – specifically, to identify and deal with impaired assets – as a necessary step in recovering from the crisis. Our domestic banks have substantial exposures to land and development loans, which creates uncertainty about their capital positions and, ultimately, affects their ability to provide credit to the real economy.

It is in this context that the Government has decided to establish the National Asset Management Agency. The intention is to transfer the land and development books and appropriate associated exposures to NAMA in return for government bonds. It is essential that this is done; it is a critical stage in the process to renew confidence in the banking sector. The correct pricing of these assets is a most important issue and must balance value for the taxpayer with restoring the capacity of the banking sector to support the real economy.

The Eurosystem response

Alongside the various domestic initiatives outlined above, the Central Bank has continued to respond to the crisis as a member of the Eurosystem. The Governing Council of the ECB has reduced its key policy interest rate by 325 basis points cumulatively since last October. This has had a very significant effect in lowering borrowing costs for households and firms across the euro area, including in Ireland. There has been a pick-up in investor sentiment over the last number of months and this partly reflects economic indicators, which have been somewhat more positive both in Europe and globally. Nevertheless, this follows a very sharp contraction in euro area GDP in the first three months of the year and the more recent data, for the most part, point to a further – but smaller – decline in activity in the second quarter.

The recovery is likely to be gradual and extended, however, given the nature and scale of the crisis we have experienced. As a result, monetary policy will have to remain accommodative for as long as is required and will only be adjusted when there are definite signs of a significant improvement. As regards prices, euro area inflation is expected to turn temporarily negative for a period this year but to return to positive territory again thereafter. I would like to emphasise that, over the medium term, indicators of inflation expectations remain very much in line with the Governing Council's definition of price stability. This reflects the Eurosystem's credibility.

The Governing Council's response to the crisis has been exceptional and has also included innovative non-conventional measures, particularly in terms of liquidity provision. Banks are currently able to access unlimited liquidity against suitable collateral at a fixed rate for up to six months, and later this month they will be able to do so for an even longer period, up to 12 months. This has been of enormous benefit to Irish banks and to the euro area banking sector in general. At its last meeting, the Governing Council announced the details of a programme to purchase around €60 billion of euro-denominated covered bonds issued in the euro area, which will help an important market, and again will be of benefit to banks and support credit provision. The European covered bond market is currently stalled and the programme will help stimulate the market, as it increases demand for the instruments in question, making new issuance attractive for banks. Covered bonds form an important funding channel for the main Irish banks.

What does the future hold for banking systems generally?

While it remains unclear when the crisis will end and what its ultimate effects will be, recent signs of recovery remind us that we need to look at the type of financial system that we want to see emerge when the crisis is over. This holds at national, EU and global levels.

The ongoing crisis underlines the need to adopt a system-wide approach to regulation and supervision. The proposals of the de Larosière report are particularly pertinent on this point. A feature of the current crisis has been that, while the build-up of pressures at a macro, or system-wide, level was widely recognised when it was happening, the publication of these concerns, which was the internationally accepted way for central banks to convey their concerns, was not effective. This was the case both internationally and in Ireland. It is essential, therefore, that we bridge the gap between financial stability, or macro-prudential supervision, on the one hand and micro-prudential, or traditional supervision, on the other. In this context, the European Commission has proposed a new supervisory framework for the EU based on the de Larosière proposals. The proposal for new structures recognises explicitly the need for macro-prudential risk assessments in order to identify emerging vulnerabilities in the financial system and issue risk warnings but also, crucially, the necessity to follow these with policy actions when appropriate. While the details of the proposed new EU framework still need to be ironed out, I strongly support the direction proposed. I welcome also the recent announcement here providing for full integration and co-ordination within the Central Bank of responsibilities for both financial stability and micro-prudential supervision. These new domestic arrangements would fit very well with the proposed new European framework.

The current crisis has made it clear that risk management practices across all parts of the financial sector need to be improved significantly. One of the key aspects that must be addressed is ensuring that the regulatory framework does not magnify the cyclicality already inherent in the financial system, as it has during the current crisis. In this context, it is essential that we develop mechanisms and procedures to ensure that banks accumulate resources in good times to act as a cushion when the cycle turns. Clearly, accounting standards play an important part here, and I welcome initiatives being undertaken both at the IASB and the Basel Committee to improve reporting in order to reduce cyclicality. The restructuring of remuneration packages is another important issue related to risk management practices, and the re-alignment of incentives to prioritise long-term sustainability above short-term profitability is necessary.

Structure of Irish banking sector

In the light of all that has happened, we need to examine the structure of the domestic banking system. When the crisis comes to an end the structure and shape of our banking system will be different. This is likely to be an international trend. In Ireland, the very existence of NAMA will in itself be central to this. The banks that emerge from that process may well be smaller but better prepared for the new environment. This should allow for a more focused and consolidated banking sector. We need to ensure that the banking system that emerges is one that is there to serve the future needs of the economy.

The global financial services industry is going through a period of radical change as a result of the financial crisis. At this stage, it is not clear what will be the ultimate impact on the industry. The international financial sector operating in Ireland is obviously not immune to these global developments. However, there is a broad range of activities located in the IFSC, which as a whole has withstood the crisis reasonably well, and I am confident that the IFSC will continue to make a very significant contribution to the Irish economy.

Economic assessment

While huge efforts have been put in to stabilising the financial sector, we also need to act to restore stability in other areas. More generally, it is vital that we act credibly and quickly to confront the very significant challenges that we face and chart a path that will in time ensure a sustainable recovery in economic growth. Over the past two decades, Ireland has demonstrated a strong ability to exploit its advantages – in the form of flexible markets, a competitive economy and a highly-skilled and educated labour force – to generate growth. In more recent times, these strengths have come to be masked by increased costs and by the fact that economic activity had become unbalanced. We had become too dependent on largely construction-driven growth in domestic demand. Among other things, this pattern of growth entailed an overdependence on property-related transaction taxes. The inevitable downturn in construction activities then gave rise to an extremely sharp and severe deterioration in the public finances, the scale of which has exceeded even that of the downturn in economic growth. The importance of taking effective and immediate steps to improve cost competitiveness and address fiscal imbalances cannot be overstated.

Economy-wide productivity gains have been very modest and labour costs have been relatively high in recent years compared to our main trading partners. This deterioration must be addressed if we are to return to a sustainable growth path. A strategy to restore competitiveness must encompass action on a number of fronts including pay and non-pay costs, infrastructure improvements which support productivity growth, the enhancement of competition in sheltered sectors, continuing to encourage innovation and R&D activity and enhancing the skill levels of the labour force.

In particular, a flexible approach to wage developments is essential. More recently, in the face of the sharp contraction in economic activity, many firms have taken action to reduce their costs including the negotiation of reductions in wage rates, with a view to protecting employment. While this has undoubtedly been painful for those concerned, it nevertheless reflects encouraging evidence of the flexibility and realism that is needed if the economy is to maintain the maximum possible number of jobs in the short-term while placing Ireland in a favourable position to benefit from an eventual recovery in world demand. This type of flexibility must embrace all sectors of the economy.

The deterioration in the fiscal position has been a cause for serious concern. The Government has agreed with the European Commission to correct our Excessive Deficit position by 2013. The Government's introduction of a public sector pension levy and the Supplementary Budget are steps they have taken to this end. It is important that the target agreed with the European Commission be met.

Future lower medium-term growth potential means that cyclical recovery will not solve our fiscal problems. The Commission on Taxation and the Special Group on Public Service Numbers and Expenditure Programmes, which are currently underway, will have a key role to play in identifying measures that will improve the budgetary situation in coming years, These measures are necessary to restore confidence, deal with financing concerns and underpin the medium-term growth potential of the economy.

Conclusions

In summary, we remain in a very difficult and challenging environment. The very significant global downturn, as evidenced for instance by the IMF in their latest global economic forecasts, coupled with our own economic difficulties, is impacting significantly on Irish households and businesses. On a human level, the contraction in the economy is impacting directly on households' incomes and resulting in very significant levels of unemployment. Sound economic management and timely decision making to deal with the unfolding situation are therefore essential. In this context, it is critical that continuing action is taken to both improve the economy's competitiveness and address the deterioration in the fiscal position. It is also vital to ensure that stability is restored to the banking sector as quickly as possible and I have outlined the actions already taken in this regard. If we address all these challenges head-on, the economy has the potential to grow solidly again in the medium term and the process of reducing our significant levels of unemployment can begin.