Patrick Honohan: Two-way interdependence between the banking system and the State

Address by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, to the Small Firms Association, Dublin, 11 May 2010.

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I would like to take the opportunity of this occasion to speak to about the two-way interdependence between the banking system and the State, which has been illustrated in dramatic fashion in recent weeks.

Understanding and managing the elements of this interdependence is key to improving the situation with regard to the cost and availability of credit, matters that are of central interest to my hosts tonight, the Small Firms Association.

In brief, my message is twofold:

– First, continued consolidation of the public finances is key to ensuring a flow of reasonably-priced liquidity to the banks and their customers;

– Second, the recapitalization of the banks, which we announced at the end of March, is key to dispelling the cloud of ill-defined banking losses that has been hanging over the public finances for many months.

The extraordinary events in European and international financial markets over the past few days show clearly how a better flow of credit does not simply depend on the motivation and skill of bank management.

Improvements in the flow of credit can only go hand-in-hand with the creation and maintenance of firm foundations in terms of the capital reserves of the banks, the national fiscal stance and national cost competitiveness.

Credit and finance generally depend crucially on confidence. And in a country as open as Ireland – still a world champion in its degree of globalization – that confidence has to extend to the global audience, especially those who have invested in Ireland, and those who will continue to invest in Ireland. It also means confidence at home on the part of those – like my audience today – whose actions can help restart investment and boost job creation, and those whose job it is to help finance that restart.

This week and last the media focus has been on confidence in international financial markets. Ireland has not been directly under the spotlight, but the fact that it has been just off-stage is illustrated by what I would regard as wide spreads on Irish government debt, which – albeit fluctuating – have been a feature for well over a year.

We have been here before. Through the 1980s and into the 1990s Irish interest rates were kept far too high as a result of market pessimism. In effect, the Irish government was paying lenders over the odds to compensate them for currency risks on a scale which never materialized and which the government knew would not materialize. My estimate is that in those days we paid 2½ percentage points extra as a result of this unfounded pessimism over a decade.

Over the past year and more it has been a similar story. Markets have been demanding a premium for risks which the government knows are unfounded. This morning the spread of Irish government 10 year bonds above the German benchmark was still more than 1½ percentage points, despite a sharp narrowing following the measures announced over the weekend.

One way or another, commercial bank lending rates also come to embody the risk premia being paid by the national government. This is something that cannot be avoided. And that

– in broad terms – is why bank lending rates have been creeping up again in Ireland. (I won't speak today about important details such as the cross-subsidization between tracker mortgages and other lending.)

Given how intimately dependent bank lending rates are on the rates at which the government can borrow, let me say a word about the government's borrowing costs and how those have been affected by market sentiment in recent weeks.

Right across Europe, for the past several weeks, the fiscal pressures in the Greek economy have been heightening investor concerns. This resulted in Greek debt being traded in secondary markets at record yields. Despite the negotiation of a large financing package sufficient to deal with the Greek government's borrowing needs for three years, and assurances that Greek government debt would remain eligible to back commercial bank access to liquidity at the ECB, market concerns remained high. Indeed, they tended to spill over into the markets for the debt of other countries with high borrowing needs. The functioning of interbank and other short-term markets was also hampered. Irish government debt did not escape this pressure, though it was not the most affected.

The symptoms intensified during last week to the point where some financial markets seem to have become quite dysfunctional. It was clear that decisive action was needed.

The action decided upon on Monday morning had three main goals:

– First, the path of fiscal adjustment right across the European Union needed to be confirmed and for many countries reinforced.
– Second, there had to be confirmation that sufficient financial resources would be available to enable countries taking convincing and sufficient fiscal adjustment measures to accomplish this adjustment in a smooth manner.
– Third, to address the malfunctioning of securities markets and thereby to ensure the effective conduct of monetary policy throughout the euro area, wholesale markets for debt and deposits which were beginning to freeze, had to be freed up.

Progressively these actions taken over the weekend are having their intended effect. But the lesson is not that we can all sit back and relax. The experience has shown how crucial it is to stay on a disciplined course to correction of the public finances right across the euro area. This is essential if the financial markets are to work more effectively and in particular resume their key function of helping to finance the recovery including through lending to small firms.

Of course it is not just in the short-term markets that the banks and the Irish government have been closely intertwined in recent times, both in reality and, especially, in the minds of market participants. The banking losses, and recognition that the government would have to fill any eventual hole, started to weigh on markets from soon after the banking guarantee was put in place some 19 months ago.

I won't rake back in any detail today over the banking excesses that preceded the crisis of September 2008.

The whole economy was boosted well beyond its sustainable path in the middle years of the past decade. Some of the benefits of the boom were spread widely. But unfortunately an even larger part of the boom was not only unsustainable but wholly illusory and resulted in wasted resources as we see in half-finished and half-empty housing estates and office blocks all over the country.

It's much tougher to adjust expectations down, especially when one has taken on commitments on the basis of an inflated wage, unsustainably low income taxes, or – relevant for small firms – a few years of inflated profits. Above all, many of those hit by unemployment resulting from the crash – which of course has been partly due to the global downturn, but was exacerbated by domestic events – are in a difficult and debilitating position.

Money borrowed by the banks from abroad and ploughed into grandiose developments now has to be repaid by the banks.

Uncertainty about the capacity of the banks to make these repayments, and hence about the scale of the likely call on the State to step in, has represented a cloud over the public finances.

This is the other main channel of interdependence between the banks and government.

The prudential capital adequacy review whose results were announced on March 30 is going a long way towards removing this cloud.

Over the previous few months, we at the Central Bank have been making a careful assessment of the likely bank loan-losses that are in prospect over the next few years. This is over and above the valuation work being carried out by NAMA, and which gives us a good fix on the likely recoverable value of the larger property loans. We have been working on the non-NAMA loans and figuring out their likely performance as they suffer from the impact of the overall economic downturn – part of it of course attributable to the global crisis, and not just to the bursting of our own bubble. This exercise involved working with the banks, but challenging their estimates of loan-loss based on our own more realistic – some may say pessimistic – credit analysis. (I am over-simplifying the exercise, as it also looked at other elements of the profit and loss account over the coming years). The conclusions of this exercise are worth emphasizing.

To my relief, and slight surprise, it turns out that most of the banks started the boom with such a comfortable cushion of shareholders' funds that they would be able to repay their debts on the basis of their own resources. This includes the two big banks. It is because of this fact – that their shareholders' funds will remain positive through the cycle – that one of them, Bank of Ireland, has already been able to tap the private market for an additional equity injection. Of course they do need additional capital to move forward, but, as has happened in the US and elsewhere, the government's capital injections of last year into these two institutions looks like being well-remunerated.

This takes account of the low prices being paid – much lower than originally envisaged – for the loans being transferred to NAMA. The NAMA purchases replace risky property-related loans with risk-free NAMA bonds and are part of the process of putting them on a solid foundation. By the way, knowledgeable experts on the property market assure me that, at the low prices they have paid, that organization now has a good chance of breaking even over the coming years, as indeed has been its stated intention all along.

Having calculated their likely future losses, we have now required the banks to rearrange their affairs to ensure that they have ample capital reserves to ride out this period of losses. They are responding with plans that raise additional capital reserves and reduce the scale of their less central activities.

The recapitalization and restructuring of the banks will be accomplished by end year. They will be stable and secure, capable of resuming their role in providing financial services to the economy.

Just two of the banks losses go so deep as to burn through not only the whole of their capital reserves but billions of the depositors and other lenders' money. As you know, these two are Irish Nationwide Building Society (INBS) and Anglo Irish Bank. There's no point in my wasting purple prose in condemning the conduct and results of these banks. The taxpayer – and those in need of better public services – will be picking up the sizable tab for their deficiencies.

What I do want to emphasize is that – huge though it is – the net deficiency of these two banks does not impose a burden on the government's budget that could justify recent interest rate yield spreads on Irish government bonds.

INBS accounts for about €2½ billion in net budgetary costs. With the NAMA purchases not yet completed, I can't quite narrow the Anglo figure down precisely. However, rounding up recent estimates to be on the safe side, it would be a pessimist who would put the taxpayer's net cost above €25 billion. That is a huge sum, and it's unconscionable that it could have arisen. (I will have more to say about this in my report to the Minister for Finance at the end of the month).

The main point today, then, is to stress that the cost is manageable. Shocking, if you want, but manageable. I make no excuse for using that word. It is important that everyone, at home and abroad, recognizes that this is a sum that is not a game-changer in terms of the public finances. It represents about one year's borrowing requirement at current rates. It is not destabilizing.

The plan is that, when this has been accomplished later in the year, the markets will come more to realize that the banks' losses no longer represent any threat to the public finances, and that this is no longer a factor that should cause them concerns about investing in Irish government paper.

This will be good both for the banks' ability to mobilize loanable funds, and for the government's ability to fund its continuing, though steadily contracting, borrowing requirement.

After all, it is the underlying gap between tax revenue and government spending that represents the main pressure on the government's finances and that has resulted in the bulk of the recent heavy borrowing. Staying on course to reduce this underlying deficit is absolutely crucial to ensuring that confidence in the public finances can be maintained and strengthened.