Patrick Honohan: Banks and the budget – lessons from Europe

Address by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, to Renmin University, Beijing, 17 August 2010.

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My topic today goes to the heart of the financial crisis from which we are emerging. For it is abundantly clear that a breathtaking series of banking failures have, directly or indirectly, been at the root of the budgetary problems now being faced by so many countries, and the impact of the banking crisis on national budgets is set to colour the pace, character and geographical differentiation of the economic recovery generally over the coming years.

But there are several important channels of influence between banks and the budget, some more obvious than others. Because of the scale and pervasiveness of banks, and the speed with which liquidity conditions can change, the impact of banks on the budget can be crucial. At the same time, budgetary decisions including tax and quasi-taxes crucially impact on the banks themselves as do indirect influences through the direction of credit; when banks get into trouble, they are more likely than almost any other sector to be rescued by a government whose interventions are backed up by budgetary resources.

All of this has been dramatically illustrated in recent years, months and indeed weeks. And although the epicentre of the global financial crisis was the US investment banking market, the links between banks and the budget have arguably been recently illustrated in no region more than Europe and in few European countries more than in Ireland.

Two-way channels of influence between banks and the budget – the Irish example

The channels of influence are present on the way up and the way down, and in both directions between banks and the budget.

Let me make this concrete by giving you some flavour of the Irish situation. From 2003 to 2007 the Irish banking system imported funds equivalent to over 50 per cent of GDP to fund a runaway property and construction bubble. The tax revenue generated by the boom came in many forms: capital gains on property, stamp duty on property transactions, value added tax on construction materials and income tax from the extra workers – immigrants from the rest of Europe, from Africa, from China, flooded in as the construction sector alone swelled up to account for about 13 per cent of the numbers at work (about twice the current level, which is closer to what would be normal).

For over a decade the budget was in surplus (averaging over 1½ per cent of GDP) almost every year. No need, it seemed, for restraint in spending, and so, after years of relatively disciplined government budgeting, there was a relaxation of spending controls – one I will say which was broadly welcomed across most of the political spectrum. Alas, that the apparent solidity of the public finances was all a mirage was brutally exposed when global financial confidence collapsed. Already the Irish boom was well over: house prices were falling and the government deficit widening from early 2007. The global recession did its damage to the budget also through the direct effect on world trade and accordingly on economic activity, given the very open nature of the Irish economy. But a more direct effect on the budget was yet to become manifest. The progressive tightening of short-term financial markets during the second half of 2007 and through 2008, peaking in those dramatic weeks after the bankruptcy of Lehman Brothers, eventually exposed the fact that, not only had the banks fuelled an unsustainable property bubble, but they had not safeguarded their own solvency through adequate collateral and guarantees. The Government had little alternative to announcing an extensive guarantee of bank liabilities. This has proved not to be costless, and is imposing a net cost which will place a heavy burden on taxpayers and the users of public services in Ireland for several years – though it is manageable and much less than some alarmist commentary had suggested.

To be specific, every one of the top eight retail lenders – three of them subsidiaries or branches of well-known international banking groups – are recording loan losses which would eventually eat substantially into their capital were it not for the fact that this is in the process of being replenished. Thus the entire banking sector got caught up in an unreal scenario. Each firm was looking over its shoulder at the others and reluctant both to miss out on a seemingly profitable growth business and fearful of the shareholders' reaction to declining market share. In an ideal world, the prudential regulator would have called a halt, but – as I have recently documented in my detailed report to the Minister for Finance on the matter – despite some misgivings about the growing exposure, the regulatory apparatus did not fully appreciate the scale and imminence of the risks whether at the systemic or individual bank level and acted only timidly and ineffectually to restrain the lending boom.

Rather than see the banks limp on, crippled by non-performing loans that would both inhibit their ability to retain depositor funding and discourage any new lending, the government already stepped in at the beginning of 2009 to begin the portfolio restructuring of the system.

The approach being adopted is comprehensive and transparent. It is designed to remove the overhang of large hard-to-recover property loans from the books of the banks, freeing their management to concentrate on providing the credit and other services needed for the economic recovery. The banks are being recapitalized – by parents in the case of the foreign-owned banks, through market-sources, backed-up by injections of capital by government where necessary for the rest.

An asset management agency – called NAMA – has been established to purchase the largest property related loans from the banks on an ambitious scale – indeed, relative to the economy NAMA will be among the largest agencies of its type. There are close parallels with the four asset management companies (AMCs) established here in China over a decade ago for the four main banks. One difference, though, relative to the first tranches of purchases by the Chinese AMCs is that NAMA's purchase prices are being set at a market-related discount to book value with the objective of allowing NAMA to break-even over time. Despite the haircuts that this inevitably entails, all five of the main locally-controlled banks have agreed to participate in NAMA. The process of valuing and transferring the loans is a painstaking one which is taking longer than everyone hoped, but it is well under way, and the discounts on the initial tranches have been large – of the order of 50 per cent on average – more in some cases. Of course this crystallization of losses erodes the capital of the banks, and gives rise to a very visible and transparent recapitalization need.

For the main locally-owned banks, the required recapitalisation has been fixed by the Central Bank as financial regulator based on a rather tough stress-test exercise completed in March of this year. (I will speak about the more recent Europe-wide stress test a little later). In most cases the losses are not much more than initial capital, but one bank – the specialist property financier Anglo Irish, which had grown very aggressively over the past decade to become the third largest bank in Ireland – seems set to experience loan-losses in excess of an astonishing 40 per cent of its portfolio. This hole is in the process of being filled by the Irish Government, which seized control of the bank in early 2009, and which has already injected sums equivalent to about 10 per cent of GDP, and will inject more in the coming months – most of which it does not expect to recover. A far-reaching restructuring and downsizing of Anglo Irish is planned and will, subject to the approval of the European Commission, and the final decision of the Irish Government, be detailed soon.

There has been a great focus on the budgetary cost of bank recapitalisation. Exact precision cannot be expected in such matters but, although each new asset purchase by NAMA adds some information here, the overall net figure that is in prospect has not changed by much since the initial calculations made in March last. Thus, Anglo may impose a net cost to the Government of about €22–€25 billion, to which can be added about €4 billion mainly to cover one small building society. (While the two main banks are of course experiencing loan losses, these are in effect being absorbed by the initial equity capital, and will not impose a net cost on the Government). (The funds injected are a bit higher in gross terms, to the extent that government is participating in the provision of regulatory capital which can be recovered when the State's stakes in the relevant firms are sold back into the market in due course).

Much of this exceptional financial support for bank restructuring arises this year, and followers of budgetary statistics will see a sizable step jump in Irish government debt, and a sharp transient spike in government borrowing in 2010. Actually, though, these exceptional financial injections into banks are smaller than the rest of the government deficit in 2009–10. Just as expansive credit conditions filled the coffers in the good years, so the unwinding of an unsustainable domestic boom is draining the coffers in much the same way and to a similar magnitude.

As many of you will know, the Government has already taken prompt and painful steps to readjust its spending and tax profile, most conspicuously by effectively cutting public sector pay rates. It remains on target for the underlying budgetary aggregates (that is, abstracting from once-off payments to the banking sector) and, if economic growth is consistent with its projections, the announced profile will get the deficit back to 3 per cent of GDP by 2014 as promised to our European partners.

Other recent European examples of banks imposing costs on the budget

There have been several other high profile cases in Europe – Iceland and Latvia most conspicuously – where we have seen the public finances (and the economy generally) crippled by local banking excesses that coincided with, but were not in any close way related to, the contemporary excesses related to the US mortgage market.

These two cases provide a contrast to the Irish one in regard to the impact of bank recapitalisation on the national budget. As Mervyn King has remarked, the current crisis has shown the extent to which, no matter how global banks are in life, in death – or near death experiences – they are local; in this context imposing on the national budget.

As has been thoroughly documented by the report of the inquiry there, Iceland's banks had made a leap for scale which was not simply based on importing funds that pumped up the local economy. Indeed they greatly outgrew the local economy (which after all is very small, with a national population of less than half a million persons) and were heavily involved in the financing of international investment ventures of some of their Iceland-based customers. When these banks – middle sized in an international comparison – failed, the national authorities regarded the burden of meeting all of their liabilities as being too great to be assumed, and their rescue and restructuring of these entities was partial only, with much of the foreign liabilities not covered, a matter which led to a fraught international negotiation, especially with the authorities in the UK and Netherlands.

The Iceland case probes the limits of the impact that banking system rescues can have on the budget. Indeed the general issue of limiting the scope of bailouts has come under increasing international scrutiny with academics and policymakers trying to design viable ways of reducing the number of banks that can be considered too big, too complex, or too interrelated with the rest of the system, to be allowed to fail with losses to uninsured creditors. Policies designed to limit the size, remove the complexity, and pre-design an orderly liquidation scheme (living will) are all being considered as solutions in this direction. There is much to be said for this line of policy exploration; especially when it seems that some of the institutions that got into trouble globally have become too complex to be reliably managed. But I have to say that I am not altogether optimistic that there will quickly be a full solution that both preserves the effectiveness and cost efficiencies of modern finance and genuinely removes the need for rescues in all conditions.

Latvia's reliance on foreign-owned banks points to the opposite end of the budgetary impact of financial globalization. Although there was a significant local bank failure, much of the actual and prospective loan losses in the Latvian downturn are being borne by the foreign-owned banks that made the loans (the bulk of them denominated in foreign currency, a factor which certainly complicates the assessment of risks and narrows the range of policy options).

These contrasts show the uneven degree of financial globalisation in the European Union (and the European Economic Area, which embraces Iceland). The banking system in some countries, mostly smaller countries in Central and Eastern Europe, is dominated by foreign-owned banks with headquarters elsewhere in the EEA. The direct recapitalisation costs of banking failures in those countries are exported back to the home countries, providing a kind of automatic insurance to the host country. (The primary supervisory responsibility also generally lies with the home country, though the geographical match of risk and regulation is certainly not perfect.) Most EEA countries rely principally, though, on locally-owned and controlled banks. Indeed, banks that have got into trouble and required rescuing have been shrinking back into their home countries, partly in order to help them meet regulatory capital requirements and partly because the European Commission has been taking a jaundiced view of state-aid being used to bolster geographically over-extended business models. The old vision of a seamless European banking market where, regardless of their home country within the EEA, the most cost-effective providers would deliver the financial services needed by firms and households may never have been wholly realistic, at least when it comes to retail services. But this vision has certainly suffered a setback from the Iceland case, to the extent that the regional ambitions of any bank may in practice be limited by the perceived fiscal capacity of its home government.

I have so far dwelt on the problems posed for government budgets by failing banks. The country examples I have chosen are not, of course, the only ones affected. Belgium, Germany, the Netherlands, Spain, Switzerland and the United Kingdom are other European countries which have seen the need for public injections of funds in one form or another. In some cases (such as Switzerland) the main source of the problem was the participation of banks in the tainted securitisations coming from the US; in other cases national bubbles were also present.

From budget to banks

But there are also pressures in the opposite direction, i.e. from budget to banks, which have only now come to the fore for the first time in advanced economies (though this was long an important dimension of the banking crises suffered by many developing countries in the 70s, 80s and 90s).

Two aspects have so far been central here, one of which relates to the pressure that a fiscally weak sovereign places on the funding costs of its home banks; the other to pressures that can be placed on banks in other jurisdictions who have or are thought to have, exposures to those sovereigns.

The first problem has been affecting bank lending rates across much of Europe, and is most evident in the euro area, where these effects are unrelated to currency differentials. The sharp jump in sovereign spreads in the first half of May, 2010 is only the most dramatic illustration of the degree to which these pressures matter. The tensions were transmitted immediately and fully to bank funding conditions affecting both cost and availability of wholesale funds in the relevant countries. With the European Council acting to put in place a huge commitment of public funds – some €750 billion, which is huge in relation, for example, to the outstanding stock of debt in the countries affected – as a financial back-stop mechanism to ensure access of governments to funding needs (conditional on compliance with adequate budgetary discipline – requiring quite sharp fiscal adjustment measures), the ECB stepped in promptly to purchase securities outright, with the aim of unblocking money market conditions, thereby restoring a more normal functioning of debt markets and ensuring a more effective transmission of the monetary policy stance, which has been geared for many months now to providing adequate liquidity at a low interest rate consistent with the overriding goal of low inflation.

Although markets stabilised following these actions, it remains evident that spreads on the debt of several sovereigns is exceptionally high by historical standards and this is still passing through to bank interest rates in the relevant countries. Markets still evidently need to be convinced about the determination and ability of national governments to deliver on their fiscal consolidation programmes. The sooner the markets are convinced, the sooner the interest spreads will shrink to the benefit of all – including those foreign investors now holding debt which will then appreciate in the market. The Irish Government took prompt early steps in this direction not least with the two-step effective reduction in nominal public sector pay rates, implemented in mid-2009 and early 2010 respectively. Further details of the measures being implemented to ensure budgetary consolidation are in preparation. Other countries have followed with their own plans. There is, for these stressed sovereigns, no question as to whether national growth is best served by bringing the public finances back promptly to a convergent path: the impact on funding costs and confidence surely more than offsets any short-term adverse impact on domestic demand from lower net public spending.

The second problem has been the emergence of a market perception that significant European banks faced a serious problem with regard to cross-border holdings of sovereign debt. I believe that this issue was greatly overplayed by market participants and the recent EU-wide stress test exercise has, I think, gone a long way to putting it into a more realistic perspective, especially through the extensive disclosure of the relevant exposures.

Heightened awareness of the interaction between the budget and banks is stiffening a third form of pressure from budgetary policy to the banks. This relates to the new wave of proposals to tax banks one way or another. Given what has happened, it’s a natural impulse to see if some revenue can be clawed back from the banking system, especially in countries where most or all of the banks have now weathered the storm and are reporting healthy results. For my part, having seen and analyzed in the past some of the damaging economic distortions around the world caused by poorly designed bank taxation, explicit and implicit, I am relieved that an international consensus seems to be building around forms of taxation that are less likely to add to damaging economic distortions. Not only can many types of bank tax fall disproportionately in practice on the smaller customers of the banks rather than on the shareholders or senior managers of the banks (who are sometimes the political target of such taxes), but the potential for disintermediation to undermine the revenue can mean both a disappointing revenue and sometimes an increase in prudential risks. Fortunately, these dangers are being recognised, thus, for example, imposing a levy on uninsured liabilities of banks, or on a surrogate for the value-added of the banking system, seems more likely to have an acceptable ratio of deadweight cost to revenue, than other forms such as a tax on interest rates, or than a general tax on bank transactions as has been proposed by some, but which would in my view not generate as much revenue as is often supposed, and would not be effective in discouraging the forms of financial excess that caused the crisis. It may be that well-targeted corrective Pigouvian taxes can do even better, for example if they are targeted at excessive reliance by banks and other financial firms on short-term borrowing.

Taxation is of course only one aspect of the heightened policy attention now being given to banks given their role in the crisis generally and not least in the damage they have, directly and indirectly, done to national budgets. Never more, I think, will banks be given the leeway to expand their intermediation activities with only a light regulatory touch to verify soundness. Banks must reconcile themselves to a heightened and more sceptical regulatory scrutiny, such as that which is being put in place in Ireland as in several other countries. The new capital and liquidity requirements being hammered out at present by the Basel Committee, and the heightened international surveillance of banking systems, exemplified by the proposed European Systemic Risk Board, represent an inevitable recognition of the interdependence of public and private finance, and the proposition that a banking license is a privilege, not a right, and one which needs to be exercised with greater regard to the public good.