Patrick Honohan: Financial regulation – risk and reward

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the International Financial Services Summit 2010, Dublin, 10 November 2010.

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The topic of this morning's session fits nicely with what I want to say about the way forward for the Irish banks.

To the extent that the global banking and wider financial market collapse of late 2008 reflected both a sharp upward revision in market estimates of risk, combined with a sharp downward movement in risk appetite, it is not surprising that the global regulatory response has been in the direction of seeking to shift risk to where such reassessments and changing appetites can do less damage. That entails de-risking the banking sector (as well as widening the scope of prudential regulation at least to some extent).

I like to list the main sources of social risk from banking as credit, liquidity and complexity risk, as well as the constant tension of misalignment of private incentives with social welfare. The policy responses that have been adopted and proposed, both in international fora and in national regulatory policies here in Ireland and in most other jurisdictions have sought to deal with these four risk sources. For each there is a classical regulatory tool – some dating back to the Great Depression or before – and these tools have been intensified or ramped up where they were still in operation, dusted down and modernized where they had fallen into disuse during the long period of deregulation which accompanied the macroeconomic lull from the late 1980s known as the Great Moderation.

Thus, to meet heightened *credit risk*, there have for years been capital requirements; to meet *liquidity risk* there were liquidity ratio requirements; to meet *complexity risk* there have been restrictions on scope of activity; and to meet *incentive risk* there is prudential supervision.

The Basel 3 and Financial Stability Board discussions have focused on the first two of these. The greater reliance on going concern capital instruments, the higher overall risk-ratios, the counter-cyclical mechanisms and the more restrictive definitions of capital all move in the direction of better absorption of *credit risk* and other risks relating to asset values.

The two liquidity ratios, one to lengthen the time over which short-term outflows can be reliably met and the other to reduce the scale of maturity transformation on a medium-term basis, clearly roll-back the egregious liquidity risks that were being taken four and five years ago.

Complexity risk has also been addressed in discussions that range from the "Volcker Rule", seeking to prohibit own-account or proprietary trading by regulated banks, to the suggestions from the Bank of England that narrow-banking should form the heart of the protected and regulated banking sector. (Complexity has not really been a major issue for the Irish banks and we have not had to address many issues of this type outside of the export-oriented IFSC).

Finally, intensified, intrusive supervision is on the daily agenda of every regulator I have spoken to.

Ireland – the problem

All of this discussion is of much more than theoretical interest in Ireland, where it can be said that the banks as a group went into the downturn more exposed than most other systems, and have correspondingly had to cope with worse loan-losses than most.

The regulatory response over the past few quarters in Ireland has been fully in line with the need to de-risk the banks and make them less vulnerable to confidence shocks or adverse sentiment. The scale on which capital has been replenished is very large, though the favorable impact on investor confidence has not yet been as strong as might be hoped for. Much of the reason for the slow return in confidence lies in the parallel weakness of the fiscal situation – a weakness which also has its roots in the credit-driven property bubble which lulled the managers of the public finances into a false sense of security ending up with a tax and spending structure highly vulnerable to the downturn.

With the government finances so stretched, the additional burden of recapitalizing the banks has reduced fiscal headroom and contributed to the concern of the financial markets. Still, I would like to remind you that this recapitalization burden is often over-stated as a contributor to the required fiscal adjustment. Indeed, the interest cost of servicing the notes injected to recapitalize the banks only accounts for about one-tenth of the fiscal adjustment now in prospect over the next four years.[1]

The plan

Since it became evident last year that heavy loan-losses were inevitable at the banks, and that the Government was going to meet the losses arising from the bursting of the construction and property bubble, the plan has been to divide and conquer the risks by putting the banks – as institutions – firmly back on their feet without being dependent on either future assistance or threats from government; thereby freeing the government finances from the apparent threat of bank-imposed costs.

Achieving this separation requires actions to reduce and shift risk, so that, for example, the banks are seen to be well-capitalized and sufficiently de-risked in terms of their loan portfolios. It also requires market participants to be convinced that this action has been effective and sufficient. So far, not least because of the rest of the fiscal burden remaining such a challenging problem, investors are not yet fully convinced.

Important steps in the process are still under way but nearing completion, namely (i) the purchases by NAMA of the big property-backed loans and (ii) the achievement – despite the very sizable loan losses crystallized by these purchases – of much higher capital ratios. These capital ratios are calibrated to ensure that core tier 1 capital remains above 8 per cent through to 2012 (7 per cent equity) for the main Irish-controlled banks, taking into account the inevitability that the non-NAMA book will incur additional losses not yet brought to book during that time. (The new capital injected would keep the banks above 4 per cent core tier 1 even in a severe stress scenario contemplated by the Central Bank and involving much higher loan losses across the loan book than are currently expected by the banks.) The higher capital ratios have been achieved partly through the sale of sizable non-core assets at prices above book as well as by the acquisition of equity stakes by the National Pension Reserve Fund and (in the case of Bank of Ireland) by the private sector.

Scale of losses dealt with by the capital injections

I'm not sure that it is widely recognized just how big the actual and prospective loan-losses taken account of in the recapitalization of retail banks in Ireland has been. In fact, if we include the losses of the 6 main foreign owned banks active in the domestic market, of which the largest have been Ulster (an RBS subsidiary) and BOSI (a subsidiary of Lloyds) as well as all six of the banks that were guaranteed at the end of September 2008, and if we include all loan losses that have been provided for in the accounts of the banks since 2007, as well

[1] And this is the steady state cost, which would be true even if there were no interest free period.

as the Central Bank's base case of the prospective losses through to 2012 (against the expectation of which the current capital requirements have been set), the total loan losses come to no less than €85 billion, or about 55 per cent of this year's GDP. In addition to the State's share in injecting funds to meet these estimated losses (which has already been announced and widely discussed), the remainder has in effect, been absorbed by the shareholders. I mention this not so much to emphasize the scale of the problem as to dispel any impression that the policy and shareholder response in restoring capital levels might have grossly low-balled loss estimates.

Yet investor confidence has been slow to recover fully. In part, this doubtless reflects the conventional observation that credit and confidence are lost quickly and recovered much more slowly. It will not have helped that the laborious process mandated for NAMA loan valuations have taken such a long time and that the first NAMA haircuts, high though they were, unexpectedly proved to be less harsh on average than the rest, leading to a sequence of bad news events. Undoubtedly, the severity of these haircuts has led some observers to read across to the non-NAMA book (and indeed the Central Bank has applied such a read-across on a bank-by-bank basis in respect of the property loans in the €5–€20 million category that are no longer NAMA-bound, and banks are being required to hold that much more capital).

A read across also from concerns in the US that American banks could experience further loan-losses given the slow recovery of the property market there may also have caused observers to question the adequacy of loan-loss provisions in the Irish residential mortgage books especially given the downward revisions in some of the medium term macro forecasts for employment and GDP growth in Ireland (even though the stress case expected loss ratio to 2012 of 5 per cent used by the Central Bank for the Irish residential loan books to determine required capital levels is well outside historic experience in Ireland). Despite recent trends in arrears and reschedulings, there is as yet no hard indication that the stress levels would be exceeded. Undoubtedly there are many stressed households with burdensome mortgage debts, not least in the buy-to-let category; the policy challenges that this presents in terms of achieving workable and fair solutions are more complex than the mere issue of the likely loan-losses that might be involved, for which (as I have mentioned) an allowance well in excess of the banks' own accounting provisions has already been made.

Winning investor confidence

In anticipation of next year's update of the PCAR exercise, the Central Bank is embarking on a more granular analysis of the this part of the portfolio in particular to track its evolving performance and determine whether the expected loss amounts remain sufficient.

This is a long-term book and its lifetime performance will not be precisely known for many years, nevertheless, it is important to have early awareness as possible of any deterioration resulting from the evolving macroeconomic conditions, and take any necessary consequential regulatory steps.

Accelerating Basel 3 agenda

As the Basel 3 programme is implemented for Ireland, both in terms of capital and liquidity, and supported by the intensified supervision process which we have been putting in place, the underpinnings of investor confidence will be strengthened. Bank boards and management will be already thinking along these lines. The faster this can be achieved, the better, and – though that is more easily said than done – it is clearly desirable to aim for a earlier restoration of confidence.

Capital: Already the 7 per cent equity requirement imposed by the Central Bank resonates with the same percentage built into Basel 3, though the Basel definition of capital is rather more stringent. Presumably over-capitalizing the banks would also help build confidence, but this is not something which the State can be lightly asked to do, given the pressures on its finances. Indeed, the market's perception of the stressed condition of the Sovereign is surely weighing also on the banks in terms of interest costs and ready access to funding; just as the banking problems have weighed on the Sovereign.

Liquidity: In order to meet the Basel liquidity ratios, the banks will, over time, have to either find new sources of long-term funding, or – more likely – dispose of some of their assets. Packaging sizable blocks of, say, residential mortgages and selling them to international investment funds (while continuing to administer the loans at the retail level) is one conceivable way of achieving the Basel long-term stable funding ratio in a way that allows the banks to de-risk further by funding a much higher proportion of their remaining asset portfolio with their own retail and corporate customer deposits, and not be so dependent as they are at present on short-term wholesale funding including central bank funding. To be sure, any such operation would certainly have to be designed in such a way that the new structures did not bring additional moral hazard with them. Achieving such sales at realistic prices in the current market climate – with market participants distrustful of all forms of Residential Mortgage Backed Security would likely require some form of credit enhancement. As such, involvement of external equity in such a transaction would likely be necessary.

Indeed, from a national point of view, the entry of foreign purchasers for some or all of the banks would help transfer both credit and liquidity risk to those in a better position to bear them. This is not as far-fetched a scenario as it might appear to some; astute bankers recognize that there is profitable banking business to be done in Ireland in the years to come, though they will differ on the optimal timing and pricing of entry.

We'll be contributing to an intensified effort to identify viable measures along these lines to select and implement the most cost-effective of them, as it is clear that all will benefit from greater market confidence in the financial situation of the banks as in the sovereign.

Towards a virtuous circle

This is a virtuous circle we are seeking to enter and exploit. Even if moving towards a stronger banking system in terms of capital and liquidity has entailed costly outlays for the State, it is a prerequisite for ensuring the credit of the State.

Likewise, healthier public finances are indispensible for keeping interest costs and ensuring that the banks have ready access to market funding. In the end, I believe it is the prospects for effective fiscal adjustment against the background of the global macroeconomic recovery that will most directly determine the degree to which investors will be fully convinced that the banks have been de-risked and strengthened in the manner envisaged by the Basel 3 process, and thus able to contribute more effectively themselves to the consolidation of that recovery. Besides, even if there is a negative initial demand effect, healthy government finances are – like healthy banks – needed for job creation and economic recovery.