## Patrick Honohan: Restoring Ireland's credit by reducing uncertainty

Remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the Institute of International and European Affairs, Dublin, 7 January 2011.

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There is a temptation to quantify economic and financial prospects with greater certainty than is warranted. But, especially in the aftermath of events as dramatic as we have seen, this can be a big mistake. All too often in recent months, projections about the economic recovery, about the budget and about the likely evolution of banking loan losses have been provided and received without sufficient acknowledgment of the uncertainty surrounding those forecasts. But uncertainty is itself central, not only in our own assessments of future prospects, but in influencing Ireland's overall creditworthiness and thereby feeding back on the recovery process itself. Doing what can be done to reduce the uncertainty facing the Irish economy is a large part of what current economic and financial policy is about at present.

Today I want to focus mainly on uncertainty around the banks, but I'll also touch on some other key dimensions of short-term macroeconomic prospects: employment and output growth, the budget and cost competitiveness. I want to illustrate the points with some charts which should at this stage be thought of as schematic rather than representing thoroughly precise representations of our current level of uncertainty. One great visual device for speaking about uncertainty is the fan-chart. Here (Figs 1, 2) are two fan-charts, one for growth and one for the budget deficit. This is a better representation of what we know about what is likely to happen than a point estimate.

The central paths shown in the fan-chart for growth and the deficit also correspond broadly to those presented by the institutions of the European Union and the IMF – and they have committed their institutional funds on the basis of their forecast that Ireland is well able to service even if the full amount of €67½ billion debt is drawn. To use a word whose relevance and appositeness is more evident now than it was six months ago, they do not consider the debt position to be other than manageable.

A glance at bond market yields suggests, however, that market participants are not yet fully convinced that the relatively benign central scenario is the only outcome imaginable. Instead, it seems that investors in government bonds are still factoring in the possibility of what are called in the jargon "tail events."

Take tail risk in the banks.

In normal times, a well-run bank with good loan appraisal procedures will be able to forecast its likely loan losses fairly accurately, especially if the likely macroeconomic prospects can be pinned-down.

But when it becomes clear that banks have made substantial underwriting errors across a wide range of their portfolio to the extent that began to become evident in late 2008 and early 2009, the range of uncertainty balloons out. Standard valuation practices that work for properly underwritten loans in normal times are ineffective in such an environment in predicting the enormous systemic losses that can occur. Thus over the past couple of years, a point estimate – a single number – has been more misleading than helpful in terms of understanding the range of loss possibilities. (That is why we at the Central Bank have been determining bank capital requirements on the basis of two scenarios, a base case and a stress case. But of course there are more than two possible cases.)

Called in from Trinity College by an Oireachtas Committee in June 2009, I expressed the opinion that the plausible range was as wide as €50 billion. Information that could narrow this range was not readily available, but the Central Bank began to assemble the necessary information through the PCAR process and from NAMA. Gradually the range of uncertainty narrowed, especially with the last of the haircuts on the lumpy NAMA purchases. The important point is not just that the best estimate of the losses increased, but that the range of uncertainty increased at first and has narrowed, but has more narrowing to do.

(Let me quickly show a sequence of slides – Annex 2 – which illustrate *schematically* how the level of uncertainty regarding future loan losses evolved over the past few years.)

To oversimplify, Ireland faces two main problems in its current financial balance sheet. First, it has too much debt, public and private. Second, there is a market perception of significant tail risk to the debt, especially related to the banks. It is these two problems, which are obviously interlinked, and which have both been growing in the course of the past year, that have led to the market's reluctance to provide continuing funding at reasonable rates of interest.

By making an alternative line of funding available, the provision of financial support from EU partners and the IMF under the Programme buys time for Ireland to reduce these two problems. It does not itself reduce them. In particular, the financing provided is not structured to itself reduce the tail risks – that would have been beyond the current scope of the funds from which the financial support has been sourced.

Let me digress a little on this point: an ideal financial package for reducing tail risk would have offered insurance against the tail risk. Of course there would have to be a premium payable, and probably a retained proportion of co-insurance to avoid moral hazard. But an insurance scheme would be even more effective under present circumstances than additional capital in restoring market confidence in both the banks, enabling them to access wholesale term funding at reasonable cost, and it would also lower the risks perceived by lenders to the State.

Unfortunately neither the IMF nor the EU facilities are able to offer insurance of this type: they are simply lenders. This is a pity, because the wider EU and the global community has a better capacity to bear tail risks than does a single State. Offering such insurance even at a premium in excess of the fair value expected claims on such insurance would evidently be very attractive to a country in Ireland's position for the reasons mentioned above. Of course offering such insurance could expose the providers to adverse selection and moral hazard behaviour, ever the enemies of insurance markets. But these challenges have been overcome in tougher insurance situations by innovation in risk mitigation and control, and I am sure that they could be overcome in the context of the EU's institutions for financial support operations.

Absent such insurance, it is not surprising that financial markets have adopted a largely wait and see attitude in relation to Ireland, as is evident from spreads (Fig 3).

The coming couple of years are thus largely an opportunity for Ireland to

(i) deal with the level of debt and

(ii) demonstrate that the tail risk is lower than has been believed

in ways that are under domestic control.

On (i) Ireland can work to demonstrate convincingly that it has brought the fiscal deficit under control, thereby removing the largest actual and potential source of continued debt increase. On (ii) we can further analyze and document the remaining risk exposures of the banks in such a way as to reduce the perceived tail risk and we can also downsize the banks, thereby reducing a myriad of risks, especially if some of the riskiest parts of the portfolio can be divested at reasonable prices.

Ironically then, far from removing discretion from Ireland as a Sovereign entity, the success of the EU-IMF programme hinges on actions that need to be implemented at home, and which, in large part, the public authorities were already planning. Thus the budgetary measures to meet the fiscal targets both for 2011 and through the following years are all drawn from the nationally prepared 4 year plan. (That's also why we can be confident that, if a new government were to want to substitute alternative measures which were both economically efficient and of equal fiscal effect, it would receive a sympathetic hearing from the funders. Besides, the agreed measures for out years tend to be much less specific and detailed than those for 2011.)

On the banks, the EU-IMF team have, in effect, endorsed the approach already being adopted, albeit calling for quicker action. What is that strategy?

(i) Improve in a convincing way information on the quality of the banks' loan books and hence on the adequacy of their capital. This year's prudential capital assessment review (PCAR2011) will be more detailed and more intense than what we were able to accomplish last year, will be published with much fuller detail and will be validated by external consultants.

(ii) Shrink bank balance sheets by selling their most distressed and other non-core assets; replenish their risk capital to a demanding standard, seeking new private equity but where necessary taking state ownership. The funders have pressed for firm deadlines on downsizing the banks, packaging and selling non-core and other saleable assets to reduce credit risk and exposure to funding risk, though not at the cost of incurring fire-sale costs. This includes some expansion in the role and streamlining of NAMA, and streamlining of the procedures required for its price determination, as well as employing some borrowed funds to enhance the credit rating and saleability of portfolio assets. To the extent that assets can be sold outright (as distinct from being placed in a „bad bank" vehicle), then some of the banks' excessive borrowings from the central bank – a legacy of the years of extravagant bank reliance on footloose foreign funding – can be reduced.

(iii) Remove terminally damaged institutions from the market while seeking to retain enough participants to ensure competitive provision of services. This too will be accelerated.

As I have often remarked, an effective bank restructuring requires that the fortunes of the banks and the budget be convincingly disentangled. Uncertainty about each damages the other. Despite a promising start in March/April, we have not so far been able to achieve this separation, partly because the initial round of loss measurement – which has depended heavily on NAMA valuations – was completed only at the very end of the initial guarantee period in September (and we were, as mentioned, unlucky in that the sequence in which the valuations came out left the bad news until late). In addition, the announced losses have been very large, and came as a bit of a shock to the market at a time when the State's finances were already under pressure and with heightened market sensitivity to Sovereign debt issues in the euro area.

A faster and deeper implementation of the existing approach, as agreed under the EU-IMF Programme, is clearly the way to go. The funders' single-mindedness on this point will help overcome hesitation and accelerate the making of hard choices. For example, given the stressed funding position of the Government, I would myself have hesitated to call for an additional €10 billion to be applied right away to further strengthening the banks' capital, as is now agreed. It will be important to ensure that the State gets good value for this investment and that over-capitalization is not dissipated in cost inefficiencies.

Reducing the banking uncertainty will not be fully accomplished overnight. Extracting progressively more detailed and comprehensive information from the banks will help to assess the quality of their remaining non-NAMA book. The evolution of loan performance as the economy recovers will provide further precision.

Still, even though I would be disappointed and surprised if all of the €35 billion earmarked for the banks in the package were needed in the end, the weaker and uncertain economic conditions now forecast by most observers into the years ahead do underline the need for a strong capital buffer. We will get a better fix on this with the work going into PCAR2011, which, as I mentioned, is intended to determine any additional capital needs that might have emerged since we last stressed the main banks' non-NAMA portfolio in March 2010.

Keeping options open while seeking to reduce the exposure of the State to further risks has been a touchstone of the bank restructuring policy adopted over the past year. This may indeed have contributed to prolonging the process.

Increasingly it seems evident that placing the continuing parts of the system on a firm footing can best be done through the involvement of new foreign owners who can bring capital, risk control and other management skills. This would effectively short-circuit the risk-reduction process now under way. With their due diligence complementing the tail-risk reduction envisaged from PCAR2011, it is not unreasonable to suppose that such investors will see sufficient franchise value in the continuing banks to convince them that attractive investment opportunities exist. I look forward to welcoming new owners of Ireland's downsized and cleaned-up banks.

Reducing the risks of an underperforming economy also calls for sustained energy and commitment on a number of other dimensions.

I have already alluded to the adjustments that have been needed in the other two fundamental pillars of the recovery, fiscal balance and cost competitiveness. Both got badly out of kilter in, or as a result of, the boom years, in ways that I don't need to rehearse today.

As a professional deformation, I tend to talk a lot about banking, but I don't want to fall into the trap of having you believe that the fiscal crisis is all about meeting the banks' losses. To be sure, the fiscal crisis has been brought on by the bank-driven boom and bust. But I hope it is some comfort to be reminded that only something of the order of one-eighth of the fiscal adjustment over the coming years is attributable to the additional debt servicing costs resulting from the additional borrowing to fill the banking hole; the remainder is to claw the budget back to where it would have been if the structure of tax and the level of spending had not veered out of what could be sustained during the bank-driven property boom.

The current impact of the banking losses on the economy is not so much via the net long-term taxpayer cost, but comes mainly as a result of the accumulation of debt. The jump in debt associated with these losses is of the same order of magnitude as the rest of the borrowing 2009–10 (Fig. 4). Either of these components would have been unproblematic, together they make the markets and the rating agencies nervous. The fiscal adjustment could possibly have been delayed by a year or two had it not been for the banking losses; now it cannot wait.

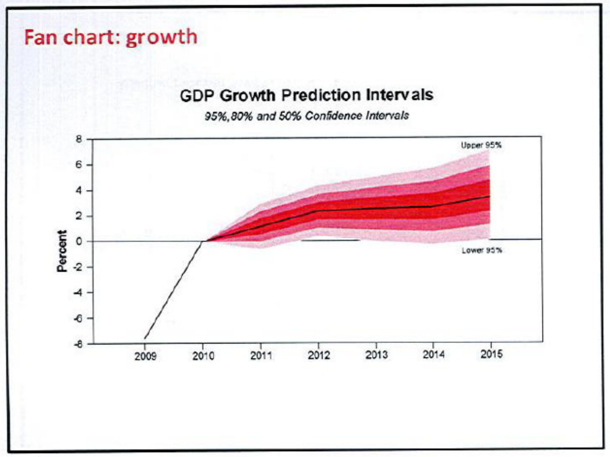
There have been misgivings about the scale of the fiscal adjustment and the withdrawal of aggregate demand that it will entail. Before the EU-IMF Programme was agreed, it was clear that a less rapid adjustment was infeasible given the rapidly diminishing appetite of the market for additional Irish government bonds. Now that the Programme is in place, the bond market can be left for a while to digest its previous meals; but that does not remove the necessity to stay on the agreed fiscal path: the new lenders – partners though they are – also need to be convinced of Ireland's societal capacity for the fiscal adjustment essential to bring the debt dynamics under control. Besides, a slower adjustment would add to the stock of debt, and worsen the long-term prospects of the economy.

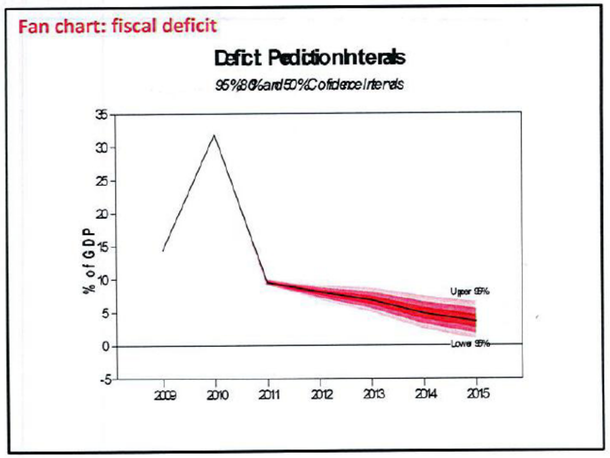
The EU-IMF programme adds external credibility to the fiscal programme and should provide assurance that the adjustment is feasible regardless of any differences of opinion on the likely macroeconomic growth rates.

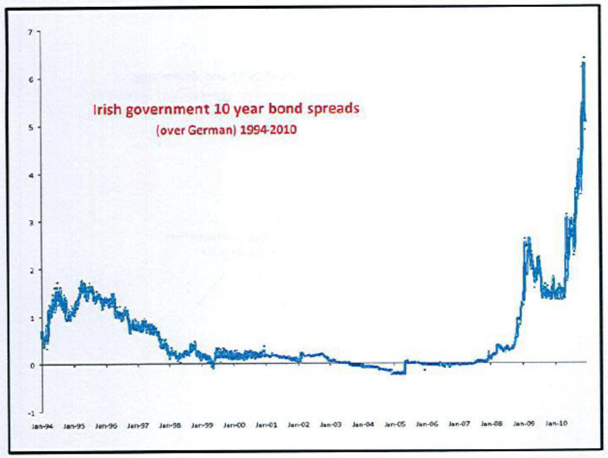
I don't have time to elaborate today on the importance of restoring cost competitiveness if Ireland is to resume exploiting its traditional potential in international markets and more generally in reducing the risks to jobs. Remember that the sustainable job growth of the nineties was predicated on wage restraint delivered by the social partnership process. There has already been a deal of adjustment, especially in the public sector. But it's not easy to see how rapid job growth can be assured if wage costs are not rolled back on a broader basis from their unsustainable run-up in the early 2000s.

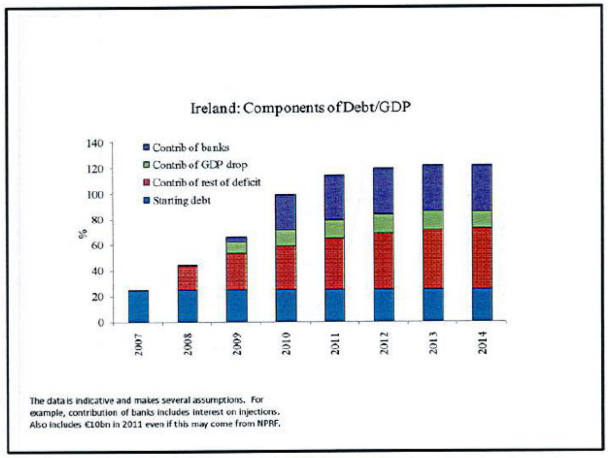
The process of rolling back the excesses that have marred the great advances made by the Irish economy over the past two decades has heightened uncertainty. In order to underpin a vigorous economic recovery, risk must be reduced, not least by ensuring the conventional elements of fiscal discipline and cost competitiveness, but also through an intensified process of clarifying and crystallizing the position of the banks and reducing their exposure. The EU-IMF Programme funding provides the window of time in which to restore the fundamentals and reduce the risks.

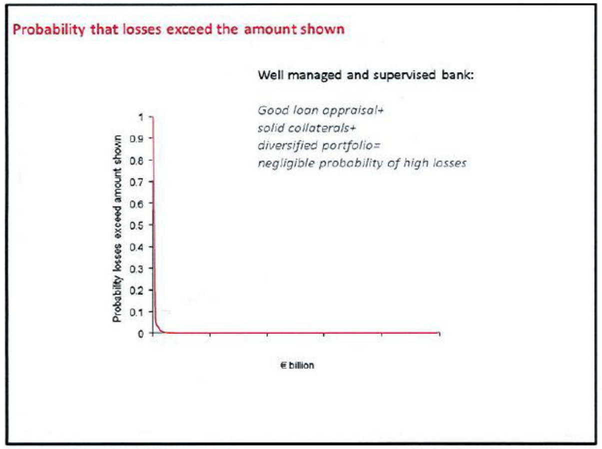
Let me end on a more philosophical note. If the previous decade had emphasized individual endeavour in a globalized economy, the last couple of years has revealed the degree of interdependence which still exists both in the domestic economy – where the excesses and failures of some have influenced all – and between different national governments – as when fiscal pressures spill over from one country to the rest of the euro area, for example. Despite the scale of the official financial support provided by EU partners and the IMF, in the end it is evidently going to be for Ireland to bear and sort out the consequences of these failures. Accordingly the national response must be one that achieves a broad buy-in which requires among other things not only fairness, but a consciousness of the unsettling effect of uncertainty on individuals throughout society, and a clearer understanding of what is possible and what is not possible to be done in managing these uncertainties.

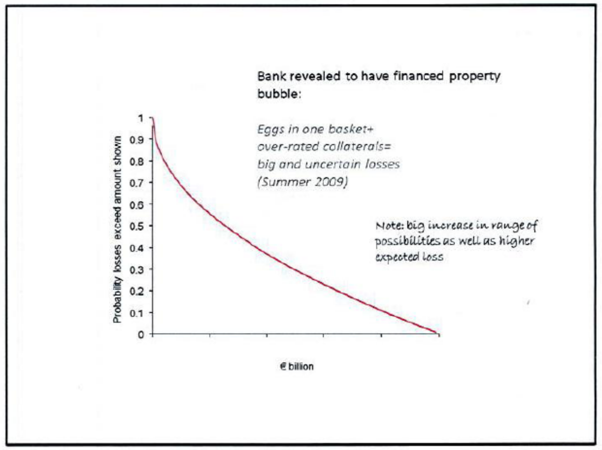

Fan chart: growth
GDP Growth Prediction Intervals
95%, 80% and 50% Confidence Intervals
Percent
Upper 95%
Lower 95%
2009 2010 2011 2012 2013 2014 2015

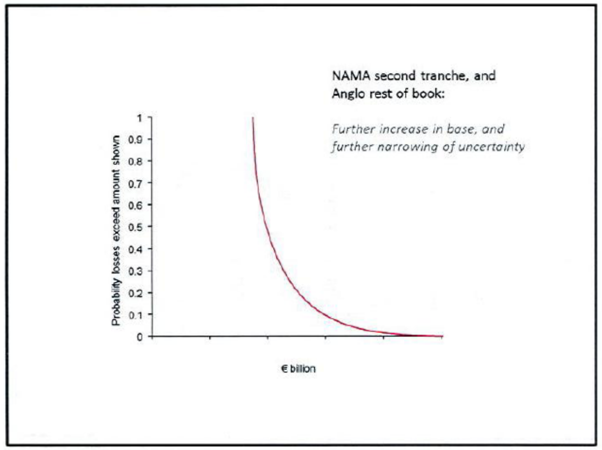

Fan chart: fiscal deficit
% of GDP
Upper 95%
Lower 95%

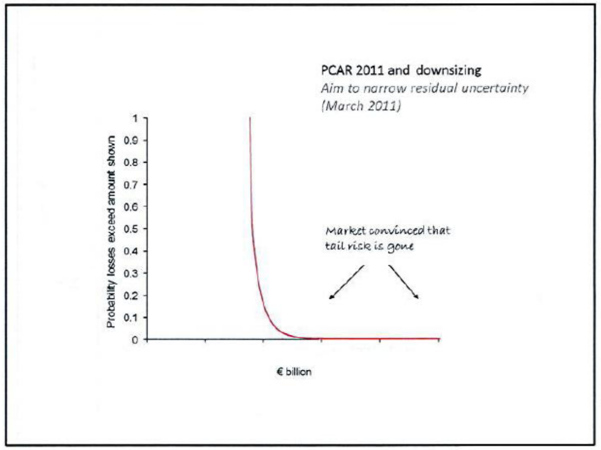

Irish government 10 year bond spreads
(over German) 1994-2010


Ireland: Components of Debt/GDP
Contrib of banks
Contrib of GDP drop
Contrib of rest of deficit
Starting debt
%
2007 2008 2009 2010 2011 2012 2013 2014
The data is indicative and makes several assumptions. For
example, contribution of banks includes interest on injections.
Also includes €10bn in 2011 even if this may come from NPRF.


Probability that losses exceed the amount shown
Well managed and supervised bank:
Good loan appraisal+
solid collaterals+
diversified portfolio=
negligible probability of high losses
Probability losses exceed amount shown
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
€ billion


Bank revealed to have financed property bubble:
Eggs in one basket+
over-rated collaterals=
big and uncertain losses
(Summer 2009)
Note: big increase in range of possibilities as well as higher expected loss
Probability losses exceed amount shown
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
€ billion


NAMA second tranche, and Anglo rest of book:
Further increase in base, and further narrowing of uncertainty
Probability losses exceed amount shown
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
€ billion


PCAR 2011 and downsizing
Aim to narrow residual uncertainty
(March 2011)
Market convinced that tail risk is gone
Probability losses exceed amount shown
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
€ billion