Patrick Honohan: Risk – banks and government

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the International Centre for Monetary and Banking Studies, Geneva, 15 March 2011.

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From the start of the global crisis, perhaps the most salient feature has been the jump in the appreciation of risk and in risk aversion. To be sure, in the previous years, the reverse was true: market appetite for risk was very high and risks were under-estimated. Indeed, I have long maintained that credulity in mechanical risk management models is likely to have been the most important of the several factors that were at the root of the imbalances and excesses that occurred in the run-up to the crisis. Believing that their risk models – and the financial engineering built on these models – worked better than they did (and lured by the high rewards for assuming risk), market participants piled into trades that were much riskier than they believed. The revulsion that set in once the shortcomings of key parts of the financial engineering edifice, and the associated failures of risk management, were revealed to its users also played a part in the speed with which the collapse occurred in the leading markets in September and October of 2008. Accordingly, some of the pricing changes that then occurred represented a normalisation, in that risk premia for many classes of assets had been too low, but for a while there was an overshoot.

Since then, normality has returned to many key markets. Indeed, some observers are fretting about the growing risk appetite that begins to be evidenced by some securities market prices in recent months. But for other asset classes, normalisation has not occurred; risk premia have not narrowed. Indeed they have widened. One conspicuous example is the pricing of peripheral euro area Government debt, including the case of Ireland, which is best known to me and which, when the dust has settled, is likely to be the country case most studied by future generations of students of this crisis.

I could dramatise this situation by listing the emerging countries which have the same sovereign debt ratings and yield spreads as the European peripherals. But that is a rather painful exercise and I will dodge it on this occasion. By the way, it is worth recalling that, before the crisis, spreads on euro sovereigns were rather insensitive to the ratings. Not so today.

Market participants obviously want to protect themselves against the risk that they perceive, and the spreads are a consequence of this. But the spreads themselves feed back onto the condition of the issuers. Borrowing countries whose debt is trading at unaffordable spreads, because of perceived risk and market uncertainty, struggle to correct imbalances and hence can face a negative spiral of worsening creditworthiness.

It is for this reason that economic and financial policy in countries like Ireland is heavily focused at present on reducing the uncertainty facing the prospects for the economy and for the public finances.

While the Irish problems were largely home-grown, Ireland is still among the world’s most globalised economies, and the solutions are therefore being worked out in a global environment with assistance not only from the rest of the Euro area and the European Union, but on a global scale from the International Monetary Fund. It is in the interests of all that the perception of risk that currently swirls around Irish assets is dissipated with better information, unquestioned adequacy of bank capital and a fiscal correction along as solid a national economic growth trajectory as can be achieved. Here too the heavy lifting will have to be done largely at home, but optimal engagement of partners remains a crucial element.

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In this context, it is worth looking back a little at Ireland’s experience with globalisation. Until quite recently, most observers would have seen this experience as significantly positive; how is it today?

Ireland’s increasing globalisation in the 1980s and 1990s both helped lift the economy from decades of under-performance and demonstrated its new ability to generate full employment and compete effectively at the production frontier. The intimate engagement with the European Union since membership in 1973 had helped enrich administrative and political capacity as well as resulting in a vital flow of development funding through the structural funds especially from the late-1980s to the end of the millennium.

By then the wider forces of globalisation had begun to act as a kind of turbo-charger for the economy, amplifying the competitive, export-led growth period and the subsequent residential construction and property price boom. This process helped achieve rapid convergence in living standards through the attainment of full employment, but it also fuelled an overshoot which could not be managed down given the debt vulnerabilities which had accumulated and which proved unsustainable through the global crisis.

International convergence of economic and regulatory policies towards liberalisation and light-touch, unfortunately embraced also by Ireland, and ridiculously easy availability of credit (eventually helped by the removal of exchange rate risk across the euro area) were key factors in the international environment that masked the vulnerabilities associated with the emergence of evident imbalances in the trend towards a construction monoculture: extreme house price inflation, a skewed revenue base for the Government accounts and a seemingly inexorable erosion of wage competitiveness.

A score-card on the role of globalisation in the Irish downturn shows an equally mixed picture. Despite the fact that international trade was badly hit worldwide in the macro-shock of late 2008, Irish exports held up well and provided a stabilising force in the evolution of aggregate demand both in that downturn and in the subsequent couple of years. The severe contraction in the numbers at work was somewhat mitigated by the continued availability of jobs abroad, both for recent immigrants who wished to return to their place of origin and others who sadly resumed the historical pattern of seeking employment opportunities abroad when few were available at home.

Crucially, the Eurosystem has also picked up the pieces on the downside: stepping-in to fund the liquidity deficit as the excessive bank borrowings from the global financial system drained out when markets lost confidence in the Irish Government’s capacity to both bring its regular deficit under control and pay for the mounting losses of the banking system.

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As seen from the rest of the world, and in particular from the financial markets, the key risks now facing the Irish economy lie in its financial balance sheet. To oversimplify, Ireland faces two main problems in this respect. First, it has too much debt, public and private. Second, there is a market perception of significant tail risk to the debt, not least that part that relates 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. The financing package of the Programme does not itself reduce the risks. For one thing; it is not a bail-out, (which would entail a lowering of the net present value of the debt). Furthermore, 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.

If I am right in saying that the market’s reluctance to finance Ireland is down to the exposure to tail risks that they fear, then restoring Ireland’s access to market funding needs to address those risks. There are three possible routes. First is to improve the quality and transparency of relevant information so that those parts of the perceived risk that are based on inadequate information will be dispelled. Second, to reduce vulnerabilities through mitigants – notably reducing the leverage of banks, reducing the fiscal deficit and thus slowing the accumulation of government debt. All means of restarting growth of output and employment on a sustainable basis fall into this category. That would include sustaining the recovery, under way since 2007, in wage competitiveness in international markets, as well as strengthening other elements of international competitiveness. Most of the key components of the years of "Celtic Tiger" success are still in place: clearly none should be neglected or dismantled at this juncture.

Since we are in an academic environment, it is interesting to reflect on whether financial engineering at an intergovernmental level could, in due course, improve on the current situation by reassigning risks in a way that is beneficial both to the borrower and to its creditors. This has indeed been suggested already for Ireland and other countries in similar circumstances by several authors. If the shortcomings of financial engineering were a main cause of the global crisis, yet contracts tailored with its elementary techniques still have the potential to transform the financial viability of stressed borrowers. After all, official creditors have now taken on the burden of holding the majority of Irish debt – at least so far as the State and the Irish-owned banks are concerned. Could there be financial instruments that are better adapted for both sides of the transaction? Among the suggestions that have been made here are GDP-linked bonds, tail risk insurance and even bank equity. To the extent that it is the fear of anaemic economic growth challenging the capacity of Irish borrowers to service debt, then for example converting some of this official debt into a form whose return is explicitly linked to economic growth, could reduce the risk of borrower stress, while offering upside potential to those lenders. Alternatively, the provision – for a fee – of guarantees or insurance to banks or their lenders by official funds with the capacity to absorb credit risk could ensure or restore bank access to funding.

Of course such solutions are not as easily taken off the shelf as plain vanilla lending. In particular any insurance contract is beset by moral hazard problems. While these could be addressed, unfortunately no pre-existing template exists for intergovernmental arrangements of this type, and most observers are sceptical that one could be put in place soon.

If so, we must work with what we have, and that is the policy strategy worked out for the IMF-EU Programme. It has two main elements, which essentially continue and deepen existing policies.

First, there is phased deficit reduction projected to bring Government debt under control and declining by 2014. After the period of political uncertainty engendered by the run-up to the General Election, the new Government has reaffirmed the fiscal objectives of the Programme and specifically to the 2011 and 2012 budgetary numbers. This is key to reducing risk and restoring confidence, but I will say no more about it here.

Second, accelerated resolution of the banking crisis for which we would have hoped to turn the corner already, but has proved to be on a scale which has challenged available policy tools. The banking strategy thus involves further recapitalisation and accelerated downsizing.

The recapitalisation of the banks will take place following the completion of the 2011 stress tests which, in line with the Programme commitments, will be much more granular, more explicitly transparent, and tougher, than those of 2010.

Last year's task was not just a question of assessing future losses under a speculative stress scenario; instead we were still trying to evaluate the losses already embedded in the existing portfolio resulting from the property price collapse that had already occurred, especially for development property.

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.

Usually the validity of stress tests is revealed only over a period of time, but in our case, within months of publication, one of the underlying assumptions of the 2010 stress tests was unluckily undermined. We had to go public on them part-way through the big programme of loan purchases by the State property company NAMA. These loan purchases crystallised those embedded bank losses immediately, but the prices at which the purchases would be made were calculated in a very elaborate and time-consuming way mandated by Competition Law. The stress-test's seemingly aggressive assumption that the seemingly severe haircuts in the first tranche of loan purchases would read through to the lower tranches also proved to be wrong. With hindsight it would have been great to have built in more insulation by providing for even tougher haircuts; but at the time it would have seemed an arbitrary and hard to justify exercise of regulatory powers.

This year, we are determined to present a stress test that will not only be more convincing to the market, by providing much more granular detail, but also be better insulated against surprises by using aggressive stress assumptions and modelling.

The emphasis is clearly on determining appropriate capital levels to meet stresses. The higher capital required will be driven by this rather than from any increase in expected losses: to be sure the somewhat weaker economic growth projections now available would imply some increase in expected losses, but it is the stress scenario that is the focus of the present exercise.

We will seek to largely free the tests of any excessive expectations from Irish exceptionalism in loan-loss recoveries (over the years very few Irish residential mortgages have been foreclosed in downturns by comparison with the experience in the UK and US, for example: with the help of external consultants we are referencing experience in those countries – though not slavishly so – in the analysis that will lead us to choose new tougher capital levels for the banks sufficient to convince the markets. And less reliance will be made on extrapolation from recent experience.

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The downsizing of the banks is already under way. Not only did they enter the crisis with sizable businesses outside Ireland, including a long-standing presence in the UK, as well as more recent ventures in Poland and the United States, among others, but their large property-backed portfolios of lending to Irish borrowers was heavily financed by wholesale international borrowing most of which has now been repaid, and replaced, for the time being by central bank funding. By simply operating at a lower scale, the risk of the banks, and their capital requirements, are being reduced.

The first and to date largest element of the downsizing was the sale during 2010 (at heavily discounted prices) of the development property-related loans to the purpose-created asset management company NAMA. The losses that crystallised in these loan sales – larger, as I have mentioned, than expected by anyone – have sometimes been blamed by critics for destabilising the system, though I am sure that had these losses not been transparently revealed, they would quite soon have been suspected by the market; losses on such a scale could not have been concealed for long, even if that had been desired.

In the aftermath of that experience it is, perhaps, not surprising that the authorities are most reluctant to force the pace of downsizing to the point of incurring fire-sale losses. To be sure, further sales have already occurred, most notably of the Polish subsidiary of Allied Irish

Bank. And steady progress is anticipated on the rest of a growing class of what are now being identified as non-core banking assets. But there cannot be fire-sale losses, as the sovereign – which would ultimately have to fund them – cannot afford them.

As soon as 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.

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. Provided they bring credible business plans, I look forward to welcoming new owners of Ireland's downsized and cleaned-up banks.

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Here I think it is worth acknowledging that the ECB and Eurosystem have stepped up to the mark and provided ample liquidity to the Irish banking system in a period of extraordinary liquidity pressure, thereby dramatically reducing risk. Of course the provision of such liquidity assistance has been a classic and impeccable exercise of long-standing central banking doctrine, but it has been on a scale for which there are few precedents in history. To an extent, the need for such liquidity is the mirror image of the scale on which the international market was previously tapped. Indeed, it has often been remarked that membership of the euro area facilitated bank access to foreign funds. But over-borrowing by European banking systems was not limited to the euro area. And euro membership has provided the safety net on the way down.

The European Central Bank has risen to this challenge and the Eurosystem has extended credit to Irish banks on an unprecedented scale. Governed by a detailed legal framework, the lending has been carried out either through normal Eurosystem operations (to the extent that the banks concerned had collateral satisfying the specific requirements, both as to assured and rated quality, and as to marketability, defined by the ECB) or directly from the Central Bank of Ireland.

The direct lending by the Central Bank of Ireland is of course carried out with the prior knowledge and approval of the ECB: the suggestion sometimes heard, that the ECB might be about to cut-off the Irish banks, is very wide of the mark.

They hope, as we all do, for faster progress towards restoring the confidence of the market in Ireland and its banks; but that is a very different matter.

All central bank lending to banks is collateralised, whether by other financial assets of the banks (with appropriate haircuts), or by Government guarantees. But inasmuch as almost all of the central bank lending has gone to repay bank liabilities that were already guaranteed, this process has not increased overall Government obligations. (It's important not to double-count here). Indeed, the quantum of Irish Government guaranteed bank liabilities has diminished substantially over the past year.

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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 crystallising the position of the banks and reducing their exposure. The EU-IMF Programme funding provides a window of time in which to help restore the fundamentals and reduce the risks.