Patrick Honohan: Additional capital requirements for four Irish banks

Remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the publication of capital and liquidity results for the banking sector, Dublin, 31 March 2011.

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Today the Central Bank announces additional capital requirements for four banks covered by Government guarantee, namely Bank of Ireland, Allied Irish Banks, Irish Life and Permanent and EBS Building Society.

This is part of what has been envisaged, since last year's initial effort, as an annual capital adequacy exercise for the banks to get to grips with the scale of losses and the challenge of rebuilding the Irish banking system.

But the present exercise is on an exceptionally intensive and elaborate basis, and is designed to respond to market scepticism about the banks. This scepticism means that the banks have to hold more capital than would otherwise be needed, in order to convince international lenders of their solidity under all circumstances.

This is being done as part of the EU-IMF Programme designed to restore market confidence to Ireland, and in particular to its Government finances and to its banks.

The capital requirements being announced form part of what we are calling the Financial Measures Programme, which represents the banking part of this two-pronged strategy. As you will hear, it involves not just a capital increase, but also a schedule of deleveraging and asset sales and some structural reorganization (on which the Central Bank has been closely involved in advising, and which will be announced by the Minister for Finance). All of these elements are interrelated.

The overall increase in capital required is sizable. The main underlying reason for such a large increase is the need to restore market confidence. It is a prerequisite to the banks returning to normal functioning that they should have ample capital to meet even the market's gloomy prognostications. The European Commission, ECB and IMF have endorsed the rigorous approach used.

This year's exercise has involved a detailed drilling down to the loan-by-loan level, including an intensive data integrity exercise and asset quality review. The Central Bank engaged BlackRock Solutions, an international firm with a strong reputation in the market for its capabilities in assessing losses in credit portfolios to conduct as comprehensive a review of the loan portfolios as was possible in 3 months, with an emphasis on determining the potential scale of loan losses in an adverse and unlikely macroeconomic scenario. Reality is therefore not likely to be as bad as the projections they have arrived at; nevertheless, they are what is needed to arrive at a sufficient capital requirement.

Three factors contribute in approximately equal amounts to the additional capital.

- First, there are the loan-loss calculations by BlackRock for the coming three years. BlackRock's method and approach build-in considerable conservatism and are based on an even more adverse macroeconomic scenario than used last year.
- Second, there is the cost of asset sales and deleveraging that are mandated as part of the EU-IMF programme and which reflect the impossibility of the banks' continuing to operate on the over-sized scale which they had reached by 2007.
- Third, a higher minimum capital percentage has been set and additional buffers have been included to take care of any concerns regarding any other factors not taken into account in the explicit calculations, for example, post-2013 events.

Therefore, while it would indeed be appropriate to make some upward adjustment in the central estimate of future bank losses from what was envisaged in previous announcements last year, I would emphasize that that is not the focus of today's announcement. The scenarios and modelling being used are not intended to provide forecasts of what will happen. Indeed, the thrust of the banking policy – including the other announcements of the Financial Measures Programme which will be made by the Government today – is to seek to ensure that the banks, their customers, and the nation in general get out of this situation with much less cost, distress and dislocation. The Central Bank's forecasts for the economy are much more optimistic than the stressed scenario used.

Now I will hand you over to Matthew Elderfield for more of the details.

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The Financial Measures Programme will create a sustainable Irish banking system through a process of recapitalization, deleveraging and reorganization. The additional capital requirements announced today provide for future loan losses over the coming three years on a scale that is unlikely to occur and provide for an additional buffer for subsequent events. Enough capital is also being provided to cover the unavoidable losses involved in needed asset disposals, even though there will not be fire-sales.

The assumptions that have been used, the methodology BlackRock has followed and the capital percentage targets the Central Bank has set together provide an exceptionally conservative basis for recapitalizing the Irish banks. The data assembled in this exercise has been published to enable independent analysts to see the basis on which we have determined loan loss projections, and as part of a continuing effort to create more transparency around these matters.

I'd also like to mention that the data verification exercise has provided some reassurance about data quality, while not all of the relevant data or paperwork was readily accessible, the consultants did not find data and paperwork matters of material impact on likely losses.

Smaller, but more soundly constituted, Irish banks should be in a better position to provide loan and other financial services to households and businesses and to support the economic recovery.