Matthew Elderfield: The Irish banking sector – five challenges

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, to the Association of Compliance Officers in Ireland, University College Cork, Cork, 19 October 2012.

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Completing the task of fixing the Irish banking system is not an end in itself. A healthy functioning banking system is essential to the economic well-being of Ireland. It is essential for breaking the damaging link between a distressed banking system and weak public finances. And it is important for economic recovery that the banks are once again in a position to lend to small businesses and homeowners. But despite the considerable effort that has gone in to recapitalising, shrinking, restructuring and otherwise reforming the banking system, the process is by no means complete and significant challenges remain. How much longer will this process take and what can be done to speed it up? It may be a source of considerable frustration that this process is not yet over, but considering the severity of the banking crisis in Ireland, compounded with the on-going Eurozone debt crisis, it is perhaps not a surprise. What then are the remaining challenges that need to be tackled to speed up and complete the process of fixing the banks?

I would highlight 5 such challenges: problem portfolios, balance sheet restructuring, profitability, culture and capital. Let me take some time today to talk about each of these in turn.

Problem portfolios

While the banks have transferred their troubled commercial property loans to NAMA (and are selling down their non-core portfolios), they retain their legacy portfolio of mortgage, SME and other assets which have a high level of arrears, impairment and embedded losses. A lot of work has been undertaken to assess the quality of these assets and to ensure both that adequate capital is held against them and that adequate accounting provisions are held (following new guidance from the Central Bank). So, a much greater level of capital has been set aside against the risk of loss and higher levels of prudent provisions are now in place.

However, more work remains to be done in order to develop a more precise and clear picture of the performance and degree of embedded losses in these portfolios. This is the first challenge. Efforts to date have involved, in the first instance, a top down estimate of portfolio losses and, more recently with the assistance of Blackrock (a consultant used by the Central Bank), a bottom-up loan by loan loss forecast exercise based on conservative modelling assumptions. But there is a remaining task: a case-by-case re-underwriting, involving where possible recovery and where necessary restructuring, of troubled loans.

This is crucially important for a number of reasons. While the banks still have uncertainty about the granular performance of their loan portfolios, they will be unsure of the exact capital buffer that is in place and the extent to which they have adequate capital for extreme loss developments. To my mind, this encourages an attitude of hoarding capital and provides disincentives to lending. At the end of the summer, there was much debate around a widely reported Central Bank analysis of lending to the small business sector, where we found that loan rejection rates were significantly higher than other EU jurisdictions, excepting Greece, and which to our mind pointed to supply constraints in the banking sector (in addition to problems over credit quality). Uncertainty about the current loan book and the exact losses that will crystallise (and therefore consume capital) are likely a factor in constraining lending. Absent an exercise of even further recapitalisation, the best option is more specificity and understanding of the performance of the legacy loan portfolios – and an exercise in facing up to losses and modifying loans as necessary.

The banks' mortgage portfolios are a case in point and have involved close attention by the Central Bank. At this event last year, I explained how we were initiating a project to require mortgage arrears resolution strategies from all lenders in Ireland. We received these in November of last year and provided feedback to the banks, highlighting the need for more effort on a number of fronts. One major area of concern was the lack of operational capacity in the banks to deal with customers in arrears so we required senior management to commit to a step change improvement in that capacity. The plans we received showed significant improvement and we are continuing to monitor progress closely.

We also pressed the banks to work harder to develop specialist strategies for their buy to let portfolios. And, crucially, we insisted that the banks develop a broader range of techniques to deal with loans in arrears, drawing on the ideas of the so-called Keane group. In a slight simplification of the position, the banks were relying heavily on the provision of interest only arrangements or the capitalisation of interest arrears, even though these techniques were clearly unsuitable for a sizeable group of customers with unsustainable mortgages as a result of a severe reduction in income. The banks were required to identify a broader range of techniques, including loan modification arrangements such a split mortgages and the introduction of mortgage to rent schemes, and to pilot these during Q3 of this year. These pilots are now mostly concluded (although are dragging on in one or two cases) and the banks are now in starting the process of rolling out the new arrangements more widely.

This process offers the prospect of restructuring loans where necessary to avoid customers continually re-defaulting. The Central Bank has studiously avoided prescribing the detail of the loan modification arrangements adopted by the banks and it must necessarily be for the banks themselves to undertake the case-by-case review of customers that is required. However, I would observe that there is significant variability in the approaches that the banks are taking to loan modification. That is natural and understandable, and I would not expect a standard approach across so many different institutions, with different portfolios and different types of owners, for so many different customers. But there are some key parameters in the typical loan modification arrangements that might perhaps merit a close side-by-side comparison in due course. For example, a crucial new technique is that of the provision of a split mortgage. This involves rightsizing the performing part of the mortgage based on affordability, as determined by current income, and warehousing the non-performing part. This is to be welcome, but the treatment of the warehoused element merits close attention. For example, is there shared risk between the bank and the customer regarding this element? And is it realistic that full interest accrues on this warehoused element? As the banks move out of their pilot phase on these new techniques and adopt them in their mortgage arrears resolution strategies, our code in this area requires them to publish full details on their websites. So there will shortly be an opportunity for some comparative analysis of the different arrangements that are being promulgated and therefore some public and customer feedback on the design choices that have been made.

One important message today is that these efforts underway for mortgage arrears need to be matched for the banks' SME portfolios. Earlier in the year, the Central Bank commissioned an in-depth analysis of the leading banks operational capacity for SME loan review, recovery and resolution. The results were in many respects dismayingly similar to those regarding mortgage arrears operations. For example, the reviews found the following: limited specialist skills, limited ability to scale up to conduct restructuring and resolution activity, inconsistent quality and depth of financial analysis of borrowers, incomplete financial information collected from borrowers, lack of portfolio segmentation and limited use of KPI's.

More fundamentally, it appeared that portfolios were largely subject to rescheduling and extended forbearance rather than a determined effort to restructure loans and deploy a wide range of workout options. Given the extent to which many SMEs entangled themselves in property investment, there is clearly a difficult task facing the banks. The message from this review work is that here too we need to see a step change in operational capacity and a mindset change in terms of tackling, rather than deferring, problems.

So, while we will not be rolling out the same extensive regulatory framework as is in place for mortgages and mortgage arrears (due to the different consumer protection standards that are relevant), a key area of regulatory focus in the coming months will be to press the banks to effectively re-underwrite their SME portfolio and more decisively tackle the challenge of recovering and as necessary restructuring problem loans. The banks need to raise their game on the handling of problem SME loans and the Central Bank intends to press them to do just that.

Balance sheet restructuring

The second principle challenge facing the Irish banks is of one of balance sheet restructuring. By this, I mean the process of disposing of certain assets in order to strengthen the financial position of the bank and to shrink the size of the balance sheet so that its funding position is more sustainable. (I should note that I haven't set out funding as one of the principal five challenges, which is perhaps unexpected, but this is on the grounds that improving the banks liquidity position and capacity to fund themselves with reduced reliance on the central bank will flow from successfully addressing the other challenges. And indeed while all these are necessary conditions for improved funding, they are not sufficient, as it is clear that sustained access to wholesale markets – apart perhaps from heavily collateralised transactions such as covered bonds and the like – is only realistically likely to occur after the Irish sovereign has fully returned to the market. So: funding is an important and pressing issue, but one that will only be solved after both the foundations of a stronger banking system ***and*** sovereign market access have been re-established.)

Ireland has demonstrated strong progress with the challenge of balance sheet restructuring. The first phase of this exercise, as is well known, involved the implementation of NAMA. This allowed the transfer of hard to value and poorly performing commercial property assets out of the banking system to improve the balance sheet strength of the Irish banks. The second phase of this exercise, which is now well progressed, has involved the identification and disposal of so-called non-core portfolios. This has less to do with cleaning out poor quality assets – although there are some in this category – but rather reducing leverage in the balance sheet and reliance on central bank funding, by rightsizing the banks' balance sheets to a sensible proportion relative to their on-going ability to fund themselves.

Progress in the disposal of non-core assets has been impressive, with most banks hitting or exceeding their targets and doing so at a lower cost to capital, by achieving better prices, than had been budgeted in our stress test exercise. The environment for asset disposals has, however, been getting more difficult, as the Eurozone crisis has widened and the imperative to deleverage has touched other banks as well. The remaining challenge, then, in this space is to make sure that the asset disposal process remains on track and is concluded successfully. However, the Irish authorities have been keen to emphasise that this process should not be at the expense of fire sale prices, so the current market environment may provide a constraint on the ability to reach the endpoint to a predefined schedule.

Should that be the end of balance sheet restructuring? One area of debate is whether it is advisable to undertake a third phase of restructuring involving a select number of banks and certain portions of their core portfolios. The objective here would be to trim back the core balance sheets by identifying poor performing or hard to value mortgage assets for transfer out of the banking system. However, important technical issues remain to be solved regarding the suitable vehicle for these assets, and how that would be funded. In short, there may be an opportunity for a new phase of balance sheet restructuring to provide a further strengthening of the banking system – but this is not yet assured.

Profitability

The profitability challenge should, I hope, be obvious. It is important that the banks regain profitability in their core businesses so that they can stand on their own feet and no longer rely on taxpayer support. In post-crisis Ireland, where it often seems that regard for the banks among the general public is at an all-time low, the prospect of the institutions which have caused so much economic distress, and required so much taxpayer support, earning ever-increasing profits from their activities is understandably met with dismay by those hard pressed consumers that are being charged more. But it is surely preferable that the banking system is able to operate based on the commercial arrangements it has with its customers rather than continuing to have dependence on government and taxpayer assistance. By breaking the nexus between banks and Government, both will be able to access funds at a cheaper rate driving down costs to both bank customers and the taxpayer. The banking system needs to generate retained earnings to bolster its capital position of its own accord, and therefore needs to re-establish its profitability.

How is the profitability challenge going? Further balance sheet restructuring will help if it strips out poor performing or high risk assets. Also, crucially, recognition of impaired assets and a granular and diligent re-underwriting of problem portfolios will allow loan book losses to be put in the past. These developments will help, but more is needed to be done, especially while domestic demand remains depressed and inhibits new business growth.

At the centre of the profitability equation for the banks is a need to improve their net interest margin. On aggregate, the net interest margin for the three main Irish banks has fallen sharply, from 1.83% in 2007 to 0.82% by the first half of this year. Net interest margins remain highly compressed for the banks and will continue to do so while prevailing interest rates are low. Progress on profitability will only be possible in the interim due to gradual re-pricing of assets to reflect the cost of funds.

I should also note that in my view we are getting close to the position where the changing circumstances arising from successful implementation of the IMF/EU programme and the introduction of the banking union should permit the full removal of the government guarantee. This will favourably impact on profitability as a result of reduced fees.

Realistically, however, the prospects for significant improvement in net interest margins as a driver of profitability will be limited for the immediate future in light of the macro-economic environment. What is in the banks' own hands, however, is to rigorously tackle their operating costs. The banks need to continue their efforts in this area and the management teams should be commended for tackling tough decisions around staffing levels and branch closures, which are clearly difficult but necessary measures. As a note of caution, it is important that this process of rationalisation does not compromise the risk management infrastructure and IT/operational framework in the banking system. These would be short-term cost savings that sowed the seeds for later problems and painful expense, as we've seen in the past and indeed quite recently. So, the Central Bank will encourage bank management to stick to their cost-cutting agenda, but to do so with careful deliberation. They do need to maintain the capacity to deliver the needed services to the economy and the general public.

Culture

While most of the challenges are financial in nature, there is one that is not but is nevertheless absolutely essential: We need to see a substantial, deeply rooted and sustained change in the culture that operates within the Irish banking system. Cultural change is evidently a complicated, laborious and time-consuming process and will need to touch on the number of dimensions, but at its essence we need to see a fundamental shift in attitudes to risk management and to the treatment of consumers. The financial crisis exposed a corrosive influence at the heart of the way the Irish banks were run and that has had to be decisively tackled.

The Central Bank has acted to initiate change in this area and has encouraged improved governance and standards of behaviour. We have introduced a corporate governance code, which is fully enforceable, designed to improve the rigour of oversight of bank management and to broaden the gene pool of bank boardrooms. A new fitness and probity regime is now in place to more rigorously police those who work in the financial services sector. Some 71 of the 73 executive and non-executive directors who were in place at the time of the guarantee have now or will shortly depart the system.

But the work of cultural change is by no means complete – indeed it still has a long way to go – and must necessarily be driven by the new boards of the Irish banks. They need to set the tone at the top and clearly articulate their expectations of ethical conduct amongst their management team and their staff at large. They need to ensure that the ranks of senior and middle management are subject to renewal and refreshment, to bring some fresh blood into the mix without the baggage of the past and with the motivation to lead the process of change. New standards of behaviour need to be backed up when hard cases of individual conduct come to a head, and not avoided. Recognition of the importance of good risk management, compliance and treating customers fairly needs to become embedded, hardwired into the processes, remuneration, objectives, communications and way of thinking in the Irish banks until it becomes second nature.

This is a hard-to-measure and difficult task but needs to be kept at the top of the senior management and Board agenda. It is important to speed the recovery of the banking system, by helping renew the social contract between the banks and society at large and, more tangibly, ensuring that lapses in risk management or consumer care do not lead to further losses, consumer detriment and reputational damage which impede the banks' and the economy's path to recovery.

Capital

Finally, then, let us turn to the banks' capital challenge and the question of whether or not they have adequate economic and regulatory capital to operate safely and provide the lending necessary for the economy. As I will explain, this is a complex question and is impacted by a number of factors, some of which appear favourable and some of which do not. Answering this question also involves a considerable number of judgement calls, including the question of the speed with which we want to get to the point that there remains absolutely no doubt about the banks' ability to meet both any future losses and the planned higher international capital standards that are coming down the track.

The factors impacting the banks' capital position are numerous and, of course, are closely related to the previous challenges that I've outlined. The extent to which problem loans are successfully recovered or necessarily written off or restructured will be a key factor, as will the extent of progress on balance sheet restructuring (and the costs this imposes along the way). The banks' ability to return to profitability will allow them to retain earnings so that the capital requirements of the future can be met on their own. But what other elements will bear on the capital challenge?

On the positive side, the current starting point is a strong one due to the significant capital injections that have taken place as a result of the previous stress tests of the banking system. Current capital ratios for the leading domestic banks include a healthy buffer above minimum requirements: for example, the total capital ratio for AIB is 19.9%, Bank of Ireland's is 14.3% and PTSB's is 21.5%. Above these requirements, the banks have a further buffer of contingent capital instruments to absorb additional potential losses, which is another positive. Also, as noted previously, since the last stress tests the losses on disposal of non-core assets has turned out to be less than predicted. And also in the positive, albeit tentatively, are some early signs of stability in the housing market, at least in the Dublin area.

However, there are also adverse developments which could impact the next in-depth assessment of capital. While housing prices may have shown signs of stability in the Dublin area, they are still significantly depressed and may have further to decline outside Dublin. The macro-economic environment remains very difficult, with domestic demand depressed and the continuing crisis in the Eurozone weighing on recovery and confidence. The position on mortgage arrears has continued to deteriorate since the last stress test (although, positively, are so far within stress levels) and the introduction of insolvency legislation creates uncertainty as to the future trajectory of losses. And, as I've mentioned in previous remarks, we know that in the medium term the Irish banks need to close the gap to meet new international capital standards under Basel 3 and CRD IV.

Since we are talking about the speed of the recovery of the banking system and the question of time, it is perhaps useful here to make the distinction between current capital requirements and what one might call the stressed capital position of the banks. Very simply put, the current capital position is the calculation of the banks' capital requirements against current prevailing minimum regulatory standards and in light of the bank's current accounting position. As I have just noted, the current capital position of the banks is healthy due to the significant injections of taxpayer and private funds that have taken place. This healthy position appears assured for the immediate future given the buffer between current capital levels and minimum European requirements. However, in the medium term the position becomes more uncertain, principally due to the anticipated strengthening of the minimum EU standards, uncertainty around profitability and uncertainty around the exact size of future losses in problem portfolios. This is where the stress capital position comes in: this is an exercise in projecting forwards the level of losses (and of profitability) – and doing so with an overlay of stress to provide an added degree of comfort and conservatism. As you know, this method has been used to good effect to force a significant recapitalisation of the system already.

How much uncertainty or risk is there in the medium term capital position for the banks? I'm afraid I'm going to disappoint you and say that we need to wait and see and do another thorough, rigorous and professional job of assessing that very question. This will take place during the course of next year and the Central Bank will again conduct its own independent assessment of the banks' loan losses, again with the assistance of Blackrock, rather than rely on the banks' own calculations. We will, as before, call it as we see it.

But in the design of this exercise – by ourselves, by the troika, by the European Banking Authority and by the prospective new Eurozone banking supervisor, the ECB (there will be a lot of chefs in this one!) – there will be some important judgement calls regarding the severity of the stress parameters and the methodology to be applied. Fundamentally, there is a public policy choice around living with a currently healthy capital position until the point of need of public support, if indeed that is the case. Call this a just-in-time approach to backstops, if you like. Or, alternatively, the stress design can be calibrated to frontload anticipated new regulatory requirements or potential tail events while discounting the prospect of the banks earning their own way to full capital health. The benefit of this latter approach is that it more speedily gets the banks to a position of undeniable capital resilience, so that they should have no deterrent from lending and the residual risk of future support at a later date is eliminated.

But this frontloaded design choice is of course potentially costly in terms of adding to the sovereign debt burden. And in this respect, there is a sixth and most fundamental challenge of all, namely breaking the damaging link between the banking system and the government finances. It is clear that this in itself is an essential component of the successful completion of the financial programme for Ireland and a speedy recovery of the Irish banking system. It is hard to think of the Irish banks returning to unsecured market funding before the government does so. And it is hard to think of the Irish banks' capital position being definitively resolved before the impact of bank debt on government finances has been resolved. This has been the lesson of the Irish programme so far. That huge strides have been made in tackling the banking system problems through decisive and costly actions, but that there are limits to the public policy measures that can be taken without European assistance.

The encouraging news is that this was recognised by European policymakers in the Euro group summit at the end of June. The damaging linkage between banking systems and sovereign finances has been recognised and it has been accepted that borrowing to recapitalise banking systems adds to the negative feedback loop between the two. I look forward to the outcome of the continuing discussions on the Summit conclusions so they are translated into a specific policy proposal that is indeed effective in breaking the banking-sovereign link. However, there are key steps that need to take place before this can be achieved, most notably the development of the banking union and centralised Eurozone banking supervision. But that is a topic for another day. For now, my point is that in addition to the five domestic challenges for the Irish banking system to more speedily achieve recovery, there is a sixth European challenge where there are positive signs but much work still to be done.

This dependence on European developments, however, is no excuse for the banks to delay in tackling the five challenges I have discussed. With apologies in advance for the risk of oversimplification, let me sum this all up in the following way. One way to think about this is that the Irish banks are now out of the critical ward, with more healthy vital signs, following radical surgery and an extensive transfusion of blood from the Irish taxpayer. But as they stagger back to work they are still weak and aren't contributing to society as they should. They need to demonstrate dedication in getting fully fit: they need to face up to their remaining ailments – by recognising losses – and continue to slim down – both their balance sheets and their costs. The banks now have the uncomfortable task of telling the neighbours who donated blood to them that they need to charge them more as customers. And the banks need to approach their new situation with a new culture to show they've truly changed their ways. These measures, which are in the hands of the banks' own management and do not depend on Europe, will help speed them to full recovery.