

## Resolution of the Irish banking crisis: Hard-earned lessons for Europe

When I illustrate the scale of the Irish financial crisis to Scandinavian audiences I start with the number 64. After the Swedish credit and property bubble burst in 1992, a deep recession followed with three years of negative growth and unemployment rising to levels not experienced since the 1930s. To save the banking system from collapse the Swedish government recapitalised it by 64 billion crowns. In today's money this corresponds to about 12 billion euro.

For Swedes - and probably most others too - it is hard to fathom that Ireland, with a population just about half of Sweden's, has injected *64 billion euro* into its banks. This means that almost exactly ten times as much money has been spent per Irish person as per Swede.

Of course, not all of the 64 billion euro constitutes a cost to the taxpayer – far from it. In this respect the Irish can take some comfort from the experiences of other countries. In the US, all of the money invested in their enormous TARP relief programme in 2008-2009 has already been returned with interest. In Sweden it took longer, but in 2013 the Swedish government sold its last remaining shares in Nordea Bank - which began life as a merger of two failed banks in 1992. This brought the final cost of the Swedish bank rescue to about zero, or even a small gain for the state. But in Ireland we will not be so lucky. Suppose half of the bailout money can be recouped. That would still imply a cost of some 7.500 euro per Irish man, woman and child.

It is little wonder then that the post-crisis debate in Ireland, including the on-going parliamentary banking inquiry, have centred on the circumstances surrounding the Government's blanket guarantee in September 2008. When it decided to protect all creditors from losses the Irish government took a gamble that loan losses would be limited. It is true that other decisions that night, including a more limited guarantee or no guarantee at all, would probably have entailed substantial costs as well. It is also true that the indirect costs of the crisis – the loss of productive investment, skills, and jobs – an increase in unemployment by over 200,000 people - are even much higher. But the bailout decision will still go down in Irish history as a very costly mistake.

### **Resolution options**

How could the Irish authorities so badly misjudge the imbedded losses in their banks? And why did they choose to enact such an extensive blanket guarantee, covering all bank liabilities maturing within the next two years, including subordinated debt.

It was quite clear by 2007 that the Irish property market had become seriously overheated and a decline had already begun. It was also clear that the Irish banks and building societies, after almost a decade of supernormal growth, had dangerously overextended their exposure to real estate. However, no one could anticipate losses anywhere close to what subsequently occurred. As late as in December 2007, the OECD forecasted that the Irish economy would grow by 3 per cent in 2008 and a further 4.5 per cent in 2009. Most analysts believed that house prices were overvalued by 10-20 per cent, not more. Instead, Irish GDP fell by more than 10 per cent over 2008-09 and property prices would collapse to less than half of their peak value. Hence, any assessments of the economic value of Irish banks based on the economic forecasts at the time would prove entirely misguided.

Second, time was short. In the global funding freeze that followed the default of Lehman Brothers, Irish banks, together with the Icelandic ones, were the first to suffer. One bank in particular, Anglo Irish Bank, which by 2008 had captured almost 20 per cent of the market, found itself cut off from market funding. Anglo had been growing by over 20 per cent per year for a number of years,

principally through aggressive property lending, posting extraordinary profit margins throughout the boom. It was named "best bank in the world" by Oliver Wyman in January 2007. The now liquidated bank will represent the large majority of bail-out costs in Ireland – perhaps close to 30 billion euro. In terms of recklessness one could compare Anglo with the defunct Gota Bank in Sweden (nationalised in 1992 and merged into Nordbanken), just that the scale of Anglo's losses is ten times larger.

With hindsight, Anglo (as well as the equally reckless building society INBS) should never have been included in the blanket guarantee. Whatever the short-term benefits of a general guarantee, the costs in terms of credit losses arguably outweigh them.<sup>1</sup> However, with the very imperfect information the government had to hand one can appreciate both arguments. As in many countries after Lehman Brothers, the task of restoring trust in their banking market was urgent and a more conservative guarantee, perhaps covering only new debt issuance, only depositors, or indeed excluding certain banks, might have failed to do the job. Unfortunately, Ireland may also have been inspired by the successful blanket guarantees enacted in Sweden and Finland in the 1990s.<sup>2</sup>

What would optimal crisis resolution have looked like in retrospect? In the panic of September 2008 Anglo was certainly of systemic importance so intervention by the State was necessary. To avoid a disorderly failure and liquidation, a new insolvency law would have had to be passed that allowed for state conservatorship. The next step would probably have been to introduce some degree of depositor preference, so as to allow a division of the balance sheet into an entity for wind-down and a viable bank. Except for the covered deposits most of the liabilities would have stayed with the old bank, alongside a large chunk of the real estate portfolio. Then a wide-ranging guarantee would have been issued for the remaining banks, thus drawing a clear line between the bygone entity and going-concern banks. Still, the burning of bondholders would likely have jolted investors and necessitated significant emergency liquidity assistance from the Central Bank, which soon proved necessary in any case.

The strategy outlined would have involved a number of difficult legal and technical choices in a short span of time. Taking control of a formally solvent bank is not a decision taken lightly. Nor is the splitting-up of assets or design of contractual mechanisms by which creditors' and shareholders' are guaranteed to be "no worse off" (than under outright liquidation). But it can be and has been done – it resembles closely the measures Iceland undertook in the early phase of its crisis.

It is true that such a course of action may have rattled European financial markets further. It would at the same time have dispelled any notion that no bank was allowed to fail in the Eurozone, and directly led to sizeable losses for an unknown number of European banks. The question of what role, if any, the ECB played in the lead-up to the guarantee is a contentious one but suffice it to say that the ECB considered any bank failures at this time a very bad idea. It would still have been the right thing to do.

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<sup>1</sup> There were several voices arguing against including Anglo in the general guarantee at the time. Exactly who sided with which alternative is still a contentious issue.

<sup>2</sup> It is noteworthy that two full years later Price Waterhouse Coopers were hired to analyse the banks' loan books. Even though property prices had by then plunged by more than 30% from the peak, PWC reported that all banks were solvent. Remarkably, they reported that under their "highest stress scenario, Anglo's core equity and tier 1 ratios are projected to exceed regulatory minima (Tier 1 – 4%) at 30 September 2010 after taking account of operating profits and stressed impairments."

## Lessons for Europe

If Irish and European authorities were fearful of letting banks fail in 2008 one could understand it. But regrettably the official lenders still insisted on no bail-in of senior bank creditors a full two years later, when Ireland negotiated its Programme of Assistance. Irish officials had already been exploring whether and how it might be possible, after the expiry of the 2008 guarantee, to bail-in remaining unguaranteed senior bondholders of Anglo and INBS. They could have continued to plan for this and might possibly have been able to do so. The lenders again refused in March 2011 to countenance bail-in. The amounts at stake at this point were significantly lower than in 2008, perhaps 4-5 Billion euro, but this still equals about 3 per cent of Ireland's GDP, an important sum for a country engaged in painful fiscal consolidation.

For the Irish it is ironic that it was the infamous Deauville statement in October 2010, where Angela Merkel and Nicolas Sarkozy announced that private investors should be prepared to take losses in future bailouts, that removed any hope for Ireland of staying out of a Programme of Assistance. Yet in the Programme negotiations a month later, the Europeans insisted that creditors to the banks should not be bailed-in. It is very difficult to understand.

A lot has happened since. Ireland has exited its Programme and is ahead of deficit targets, aided in no small part by the subsequent reductions in interest rates and maturity extensions on its loans from Europe. Competitiveness has been restored and the Irish economy grew by 5 per cent in 2014, whereas Irish unemployment is now below the European average.

However, a lasting legacy of the Irish crisis is the vast number of mortgage and SME arrears. Seven years after the property bust there are still more than 100.000 people in arrears on their primary dwellings, which means one out of every seven mortgages. A lot of people genuinely cannot afford their mortgages any longer, as they have lost their job or suffered other financial losses. But others might ask what moral right the rescued banks have to require full payment since their creditors, among them foreign banks and professional investors, were compensated in full.

As you know, the Bank Recovery and Resolution Directive came into force in January this year. The Directive states that to support a failing bank, even in circumstances of severe systemic stress, capital and liabilities must be bailed in to the order of at least 8 per cent of the balance sheet before official funds may be used.<sup>3</sup> The bail-in principle had already been used when Cyprus negotiated its Programme of Assistance in 2013, when a significant levy was imposed on bondholders and depositors of Cypriot banks.<sup>4</sup> At least in the eyes of the Irish, Europe has turned 180 degrees on this issue. It is a welcome change though it came too late for Ireland.

Going forward, I think one of the most important lessons of the resolution of the Irish banking crisis is the necessity of adhering to the Resolution Directive, and to break Europe's deplorable tradition of bailing out banks and bankers at the expense of taxpayers. The credibility of European politicians, and the European project, depends on it.

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<sup>3</sup> The bail-in rules apply as of 1 January 2016 at the latest to all outstanding and newly issued debt. Member States can choose to apply bail-in before this date.

<sup>4</sup> It is worth recalling that several Cypriot banks suffered major losses as a result of the Greek PSI in 2012.