Stabilising and Healing the Irish Banking System: 
Policy Lessons

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Household debt-to-GDP
Irish Banking Crisis

- Macro-finance approach

- Classical drama in three acts
  1. Run-up to the banking crisis
  2. Confrontation: stabilisation of the banks
  3. Resolution: healing of the banks - climax already reached?

- Policy lessons
  1. Macroprudential policy
  2. Crisis-management: stabilising
  3. Crisis-management: restructuring
Act 1: Run-up

- Minsky model of boom-bust:
  1. credit expansion, characterised by rising assets prices;
  2. euphoria, characterised by overtrading;
  3. distress, characterised by unexpected failures;
  4. discredit, characterised by liquidation; and
  5. panic, characterised by the desire for cash.

- Borio (2014) / Claessens, Kose and Terrones (2014):
  - Not only credit,
  - But also housing
Figure 1. The Financial and Business Cycles in the US
Property: housing + CRE

House Prices Ireland (2002=100)
Run-up: credit-fuelled property bubble (like US and Spain)

Three features stand out

1. Groupthink among policy makers and bankers
2. Loosening of credit standards -> high LTVs well above 90%
3. Role of cross-bank credit
Credit: sources

- Ireland: from EU; Spain + Portugal: also domestic
Household debt-to-GDP
Policy lessons

1. CBI should stabilise credit and housing cycle -> time-varying LTVs, which should not exceed 80 / 90% (LTVs and countercyclical capital buffer are residence based)

2. CBI may consider Financial Stability Committee with external members + published minutes
Assessment framework

Public policies

- Government
- Central Bank
- Financial Regulator

Intermediate objective: Stable banking system

- Irish banks
- Foreign banks

Ultimate objective: Economic growth

- Firms
- Households
Act 2: Stabilisation

- Blanket guarantee for 2 years
  - Expiration was tipping point

- 4 rounds of recapitalisation
  - Need to do comprehensive + bottom up with externals

- NAMA
  - Bad asset management company worked very well
  - Could also have been used for smaller (below € 20 mn) loans
2. Stabilisation - 2

- Senior debt holders: write down or rescue
  - Irish authorities / IMF: write down
  - ECB (and US): rescue because of contagion
    - Then also burden sharing (direct recap from EFSF)
    - But is was given to Irish government -> policy mistake

- Mergers and nationalisations
  - Tough measures -> closures
  - 2 broad banks + 1 small bank (loss of competition)
    - Alternative: 2 broad banks + 1 medium-sized banks
3. In Banking Union with ECB supervision of large banks, ECB and ESM should provide direct liquidity and capital support to large banks (= burden sharing)

4. Ireland followed best practice with NAMA to run down bad assets

5. Assessment of capital needs of banks should be comprehensive with external consultants and bottom-up
Act 3: Restructuring – healing banks

- NAMA instrumental in writing down bad loans
- But small loans (below €20 mn) kept at banks
  - Almost no write-offs
  - 25% NPLs (impaired loans) with high provisions (53%)
- Debt overhang
  - SMEs: 34% no debt; 66% has debt
  - So, 66% (debt) * 25% (NPLs) = 16.5% of SMEs with payment arrears
Non-performing loans

Spain | Ireland | Italy | Portugal

2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013

0 | 5 | 10 | 15 | 20 | 25 | 30

For leaders in finance
Panel A: Mortgages in arrears as a percentage of total mortgages in arrears

Mortgage arrears (number)
Mortgage arrears (value)

Panel B: Mortgages in arrears as a percentage of total arrears (value)
3. Healing - 2

- Targets for restructuring mortgages
  - But largest component is capitalising arrears
  - Does not help to solve problem

- Debt overhang
  - 1.650.000 private households in Ireland
  - 760.000 PDH mortgages, 118.000 in arrears
  - So, 118k/1.650k = 7.2% of households in arrears
**Limited new lending**

**Figure 13.** New lending by banks to NFCs
Policy lessons

6. Irish took some bold restructuring decisions with closures, but be mindful that banking system remains competitive post-crisis

7. Taking NPLs is first step in healing banks (Ireland pro-active); necessary second step is to write-off loans (very slow)

8. Recapitalisation of ailing banks may be needed for economic growth. When providing bank support, government should set targets for partial write-off of bad loans to corporates and households
Conclusions

- After bursting of property bubble, successful management of banking crisis by Irish authorities

- On balance:
  - Strong focus on stabilisation of banks
  - Less emphasis on restructuring loans (25% NPLs)
    - Still SMEs and households with debt overhang

- In Banking Union, burden sharing needed
  - ECB as Lender of Last Resort
  - ESM for direct recapitalisations