NICVA CEE Masterclass

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The Banking Sector and the Financial Crisis.

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**The Banking Sector and the Financial Crisis in Ireland.**

**1. The Banking Sector in Ireland**

For Most of the last century the banking sector in Ireland was dominated by four main banks:-

Bank of Ireland;

Allied Irish Banks;

Ulster Bank;

Northern Bank (Danske Bank).

There were other banking institutions in particular Building Societies which demutualised and were then taken over by other banks (Irish Permanent, EBS, Irish Civil Service Building Society), and one other bank Anglo Irish Bank which grew rapidly and then collapsed. This bank was taken over by the Irish State, merged with a building Society called Irish Nationwide, renamed the Irish Bank Resolution Corporation and was then liquidated on 6th February last. Most of these latter banks in contrast to the four main banks had very little business in N.I. Other banking activities are carried out at a local level by Credit Unions and the Post Office.

**What Banks Do**

Banks are a vital part of any modern economy. They perform a number of key functions:-

(1) A repository and access to liquid assets;

(2) transferring funds;

(3) provision of financial services and retention of records;

(4) provision of short term credit and lending.

Solutions to the banking crisis have ensured the first three functions have been maintained, but not the last, despite large capital contributions and repeated assertions.

**Why Banks are Regulated**

Financial products and banking services are different from other goods and services:-

 They are ‘credence goods’.

There are large ‘information asymmetries’, resulting in fraud, ‘misselling’ of products

“conduct of business” issues can result in ‘systemic risk’

Failure of regulation was key factor in the banking crisis, particularly in Ireland.

**2. The Financial and Property Crisis and their Impact.**

Slide (1) shows loan compound growth in excess of 40% per annum for some Irish financial institutions 2003-2006 (Source: Regling and Watson).

 Slide (2) shows loans for construction and property to be over 75% of total loans for two financial institutions (Source: Regling and Watson).;



Slide (3) loan to value ratios for Irish residential mortgages in particular the growth of 100% mortgages ((Source: Regling and Watson)..

Not surprisingly with a collapse in property prices, bank profits also collapsed as shown in Table (4). State support for the banking sector was so large that coupled with a fall in tax receipts, the Irish State was forced into a ‘bailout’ with the IMF, Ecb and EU (the Troika).

Table (1)

Profitability of Banks in Ireland 2007-2012

€ million

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2012 | 2011 | 2010 | 2009 |  2008 | 2007 |
| Danske Bank N.I.Danske Bank Ireland | -111.2-112.0 |  -255.4 -793.6 |  -112.0 -617.8 |  -111.2 -661 |  1.0 -552 |  37 0.013 |
| Ulster Bank1 |  | -2811 |  -3322 | -1233 |  -168 | 344 |
| Bank of Ireland |  |  -190 |  -950 | -1813 |  -0.007 | 1933 |
| Allied Irish Banks |  | -5108 | -12071 | -2662 | 1034 | 2511 |
| Total |  | -9157 | -17072.8 | -6480 |  315 | 4825 |
|  |  |  |  |  |  |  |

Note 1 Refers to Ulster bank Group Source: Annual Report and Accounts

Chart (1) shows GDP and GNP growth has fallen.

Note the divergence between GDP and GNP.

Chart (1)

GNP and GDP Growth 2000 -2011



Source:- ESRI, available at:- http://www.esri.ie/irish\_economy/

While Unemployment has risen and is forecast to remain high.

 Table (2)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
| GDP constant prices | 5.876 | 5.404 | 5.445 | -2.109 | -5.456 | -0.766 | 1.431 | 0.353 | 1.394 | 2.486 | 2.836 |
| Unemploy-ment rate | 4.37 | 4.444 | 4.558 | 6.305 | 11.825 | 13.632 | 14.39 | 14.813 | 14.41 | 13.677 | 13.095 |
| Employment | 1.963 | 2.048 | 2.123 | 2.1 | 1.929 | 1.848 | 1.81 | 1.795 | 1.803 |  n/a |  n/a |

 |

Source : IMF WEO data base

**3. Why We need New Forms of Banking**

**T**he bank recapitalisation in Ireland amounted to €62.8 billion by March 2012 approximately 38% of General Government gross debt. Without any bank recapitalisation Irelands Debt/GDP ratio would be approx 65% of GDP (ignoring any interest savings)- amongst the lowest in the eurozone.

* Recapitalising the banks has not resulted in increased credit for the private sector. Table (1) shows that credit continues to fall for Irish resident firms. This is especially so for SME’s
* In contrast for the eurozone as a whole there has been credit growth on an annual basis (although at low rates) since December 2010 until March 2012. Since then credit has declined.

Holton and Mcann (2012) from survey evidence, argue that the share of ‘discouraged SME’s , who do not apply for credit in the belief that they will be rejected is the second highest in the euro area, and the share of SME’s that were rejected when applying for a loan or overdraft is also the second highest in the euro area.

This very different pattern between Ireland and other euro area countries, may be partly explained by very different financial systems. In particular the existence of regional banks and specialist banks in other eurozone countries such as France and Germany.

Very different ownership structures may also be important. One example is the greater prevalence of control enhancing mechanisms, such as shares with multiple voting rights (France Netherlands and Germany) and pyramid structures (Belgium, Netherlands, Germany, France) compared with ‘Anglo-Saxon’ type financial systems such as the UK and Ireland (Institutional Shareholder Services, 2007, fig. 4.10, 4.13).

Pyramid and group type structures, mayprovide alternative sources of finance and reduce the risk from bank lending.

Table (3)

Annual Rate of Change in Credit to Eurozone and Irish Enterprises

(Excluding Financial Companies)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Eurozone Non-financial Corporations | Irish Resident Private Sector Enterprises (excluding financial intermediation) | Irish SME’s (excluding Financial intermediation) | Irish SME’s (excluding Financial Intermediation and property related sectors) |
| September 2012 | -0.14 |  |  |  |
| June 2012 | -0.6 | -3.0 |  -2.9 |  -4.6 |
| March 2012 |  0.3 | -2.3 |  -4.9 |  -6.3 |
| December 2012 |  1.1 | -2.6 |  -5.4 |  -6.2 |
| September 2011 |  1.6 | -4.5 |  -8.2 |  -8.9 |
| June 2011 |  1.5 | -5.3 | -12.5 | -10.6 |
| March 2011 |  0.8 | -4.4 |  n.a. |  n.a. |
| December 2010 |  0.1 | -4.4 |  n.a. |  n.a. |
| September 2010 |  -0.6 | -2.1 |  n.a. |  |
| June 2010 |  -1.6 | -1.9 |  n.a. |  |

Source: Central Bank of Ireland, Business Credit and Deposits various issues, Table A14 and A14.1 and ECB Monetary Developments in the Euro Area various issues.

The absence of credit particularly affects SME’s.

* Large firms are cash rich. Apple has reported holding cash holdings of $97 billion at the end of 2011 (Reuters 26th January, 2012), Google $40 billion (Davidoff, 2011).
* Moodys (2012) estimated that  US non-financial corporate cash holdings amounted to $1240 billion at the end of 2011. Apple Inc., Microsoft, Cisco, Google and Pfizer held $276 billion.
* Cash and near cash instruments held by non-financial corporations in the eurozone increased from €1608 billion in Q1 2007 to €1907 billion in December 2011 (Source:- ECB Holdings of M3 by sector). Bloomberg estimate that 466 European companies held $691 billion in cash in September 2010 (Bloomberg November 30, 2010).

It is also well known that “Financial intermediaries and markets allocate credit less well under conditions of stress, with a bias against small firms who need to be carefully assessed and against new firms who have no track record” (Posen, 2011).

The problems with small firm financing is widely recognised. All countries in the EU have policies to overcome market bias in the provision of finance to small firms. These policies often include subsidised loans in the form of a ‘loan guararantee scheme’ (for example in the UK). Because of the risk of displacement loan guarantee schemes (and the provision of finance to small businees) is best done through a dedicated institution[[1]](#footnote-1). In several EU countries these dedicated institutions are limited both to a specific sector (for example agriculture and related enterprises) and geographically. The reason why dedicated institutions results in more efficient credit allocation, is that a universal bank will always have lower risk/more profitable lending opportunities than lending to SME’s.

**(4) Policy Changes**

As a result of the crisis there have been a number of policy changes in particular new EU institutions.

A major flaw in the design of the eurozone was the relative absence of institutional structure.

Several euro wide institutions have now been established and more are proposed.

These have proved contentious, for example whether the proposed new banking regulator would regulate all banks or just the largest. In particular the Heads of Government agreement in June 2012 has considerable implications for Ireland, in particular the IFSC. Firms based in the IFSC (and other low tax financial centres), have been a central part of the financial crisis. It is likely that low corporate tax rates and financial centres will be subject to greater regulation and taxation for example via a Financial Transactions Tax. As a result of the financial and economic crisis in the eurozone more institutions have been established and more are proposed. For example a European system of financial supervision consisting of :-

European Systemic Risk Board (http://www.esrb.europa.eu/about)

European Banking Authority (http://www.eba.europa.eu/);

European Insurance and Occupational Pensions Authority (EIOP);

European Securities and Markets Authority (ESMA);

Joint Committee of the European Supervisory Authorities (ESAs);

ESMA securities market regulator (regulating in particular credit rating agencies) (<http://www.esma.europa.eu/>) In particular in relation to the sovereign debt crisis two further institutions were established.

EFSM – European Financial Stability mechanism (see http://ec.europa.eu/economy\_finance/eu\_borrower/efsm/index\_en.htm)

ESM European Stability mechanism see http://www.ecb.int/pub/pdf/other

The Heads of Government agreement on 29th June was of particular interest. It was brief (approx 300 words) but contained a commitment that the “Eurogroup will examine the situation of the Irish financial sector” which implies that some of the financing already provided by the State to Irish banks would instead be provided by the ESM/EFSF, with consequent beneficial effects on the level of government borrowing. The subsequent fall in Irish bond yields can be partly attributed to this statement. Further falls have been due to the statement by the ECB President in July of unconditional support for the Euro within the mandate of the ECB[[2]](#footnote-2), and to the policy announcement by the ECB to engage in sovereign bond purchases in the secondary market (Draghi, 2012b)[[3]](#footnote-3).

The other key points in this agreement were:-

* A single supervisor for the Eurozone;
* Recapitalization of banks from the ESM (and in the interim EFSF);
* This would be conditional and formalized in a Memorandum of Understanding (MOU);
* The ECB will serve as the agent of the EFSF/ESM in conducting bond support activities, without entering a “bailout programme”

 New institutional arrangements are also required within Ireland. It is irrational to expect a universal bank to lend to SME’s given expected risk/return relationships, level of resources required by the lender, and specific industry and embedded knowledge. Acquiring and maintaining such expertise is costly, and cannot be easily acquired and replicated.

In addition, new funding sources for investment including SMES’s and business start ups arising from the EU growth pact agreed on 29th June (for example possible EIB funding, project bonds and the use of structural funds – Irish Times, 29/6/2012) are more likely to result in additional finance (rather than replacement finance) if channeled through new/alternative banking.

One possible source of new institutional lending is via cooperative banks. In other European countries co-operatively owned banks are large with an aggregate of €5658 billion in assets in 2010 and an estimated 5% of total deposits (European Association of Co-operative Banks Key Figures, 2010) but have accounted for a relatively low proportion of the costs of the financial crisis. One estimate is that on a global basis (European Association of Co-operative Banks, 2010, p. 9), cooperative banks accounted for under 3% of total global costs of the financial crisis (European Association of Co-operative Banks, 2010, p. 9).

For comparative purposes Table (4) shows profits and losses for a selection of universal banks and mutually owned banks for the three year period 2008-2010. The best performing bank shown in Table (4) is a UK based cooperatively owned bank, Co-op bank.

Table (4)

Profits/Losses and Assets of Some Major Banks 2008-2010

|  |  |  |  |
| --- | --- | --- | --- |
|  | Reported Profits/Lossesvarious currenciesMillion | Begining period total assets Various currenciesMillion | % of beginning period assets lost/gained |
| RBS  |  Stg. -38,531 | 2,218,693 |  -1.7 |
| UBS |  Swiss Francs -21,292 | 2,014,845 |  -1.06 |
| Lloyds TSB  |  Stg. -3,075 |  436,033 |  -0.70 |
| Co-op Bank  |  Stg. 370.2 |  6,200 |  5.97 |
| Rabo Bank  |  Euro 8,575 |  612,120 |  1.4 |

Source: Annual Report and Accounts

In Ireland mutually owned financial institutions and credit unions also have an important role as recognised in the Report of the Commission on Credit Unions. They have suffered lower losses as a proportion of assets than conventional banks. In aggregate while return on assets has fallen from 3.5% in 2007 to 0.6% in 2011, most credit unions remain profitable, 79% reported a surplus in the period to September 2011 (Commission on Credit Unions, 2012, p. 31).

Table (5) shows credit union income and costs for the period 2006-2010

Table (5)

Credit Union Income and Costs 2006-2010

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2006 | 2007 | 2008 | 2009 | 2010 |
| Income | 788.23 | 860.4 | 809.96 | 847.75 | 772.42 |
| Costs | 321.51 | 358.62 | 448.61 | 571.33 | 626.77 |
| Surplus | 466.72 | 501.78 | 361.35 | 276.42 | 145.65 |

Source: Commission on Credit Unions, 2012

There are a number of reasons for the relative superior performance of credit unions in Ireland compared with conventional banking.

Alternative banking models such as mutuals, credit unions, suffer from fewer agency type problems for example conflicts of interest between depositors and borrowers and shareholders. Profits accrue to members.

Remuneration cannot be by stock options reducing the incentive to excessive risk taking

A stock market quotation can result in excessive emphasis on short run performance versus long run performance

Locally based organisations can suffer less from reduced information asymmetries

The economic performance of a locally based lending institution will be more aligned with the local economy with consequent positive incentive effects.

There may also be benefits from credit unions in terms of reducing financial exclusion ( more appropriate opening hours, less formality, etc.

However not-for-profits, such as mutuals also suffer problems.

There are governance issues, one share one deposit means there is relatively low participation by shareholders/depositors.

An incumbent management can stay entrenched without any accountability.

Finally micro-finance also has an important role to play in some sectors.

**5. Conclusion**

The financial and economic crisis has underlined the need for alternative sources of credit, in particular for SME’s .

**References**

Regling K. and Watson M. (2010) A preliminary Report into the Source of Irelands Banking Crisis, available AT :- http://www.bankinginquiry.gov.ie

Stewart, J (2012), Institutional Change and the Euro: Some Implications for Ireland, IIIS Discussion Paper no. 416, Trinity College, Dublin. Available at http://www.tcd.ie/iiis/documents.

Stewart J. (2010), Mutuals and Alternative Banking; A Solution to the Financial and Credit Crisis in Ireand? London: Carnegie Uk Trust, available at

1. The UK Government has announced it is to develop a” state backed institution”, to make loans to small and medium sized companies, Guardian newspaper 24th September, 2012. [↑](#footnote-ref-1)
2. The President of the ECB stated “the ECB is ready to do whatever it takes to preserve the Euro. And believe me it will be enough” (Draghi, 2012a). [↑](#footnote-ref-2)
3. From June 29 to July 6, Irish 10 year bond yields fell by 13%, in contrast to bond yields in Italy, Greece, Portugal and Spain which either rose or fell slightly over this period. From the end of June 2012 to the end of October 2012, Irish 10 year bond yields fell by 31%, Portuguese bond yields fell by 25% and Greek bond yields by 39%. Source: Financial Times/Thompson Reuters 10 year Government benchmark bonds. [↑](#footnote-ref-3)