

TOWARDS A BANKING SYSTEM FIT FOR IRELAND'S PURPOSE

Pat Ryan,

The Society of Actuaries in Ireland, 20 January 2010

Topics

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- Changed banking environment
- Ireland's banking requirements
- Supply & price of credit
- Payments services
- Some pro-cyclicality issues
- Broad policy issues
- Myths, realities and challenges

From shareholder to stakeholder driven

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- Irish State pivotal stakeholder

- More utility-like

- Public interest
 - ▣ Key cog
 - ▣ Risks containment
 - ▣ Greater dependence on indigenous banks

Future emphasis in banking regulation

Basle committee December 2009

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- Capital
 - ▣ Tighter definitions
 - ▣ More for trading & securitisation
 - ▣ Countercyclical measures – accounting & flexing ratios
- Liquidity & Funding
 - ▣ **Liquidity** for an acute short-term stress scenario
 - ▣ **Stable funding** benchmarks varying by asset category
 - ⇒ shareholders' equity, high quality deposits or term funding to underpin specified weightings of asset classes

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What is desirable bank competition?

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- Big difference in significance between competition in:
 - Service & quality of expertise
 - Price for identical product
 - Price for a different product
 - Risk underwriting standards

The nature of banking

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- You *buy* assets
- You *sell* liabilities
- Banks are in the buying business
 - ▣ Marketing has a limited role
 - ▣ Marketing mind-set is inappropriate

Brian Ranson, *Credit Risk Management*

- Banks blow up when marketing mind-set prevails

Critical gaps

Broad brush picture

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	Liquidity Store	Credit Availability	Payments Services
Large corp/ MNC	L	M	H
SME sector	M	H	H
Not-for-profit	H	M	M
Public sector	L	M	H
Household-mortgage	L	H	M
Household-other	H	M	H

Importance: H = High M = Medium L = Low

Satisfactory

Needs
Improvement

Unsatisfactory

Ireland's Banking Requirements

Credit needs of SMEs

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- Mazars' Review of Lending to SMEs Mar–Sep 09 found:
 - ▣ Total loans €32.7bn, i.e. 2.6% down on preceding 8 months
 - ▣ Loan refusal rate:
 - Banks said 13.6%, Firms said 28%, Mazars suggest 18%
 - ▣ Value of SME loans on 'watchlist' or 'impaired':
 - June '08, 15% ; Feb '09, 22% ; Sept '09, 32%

Challenges with SME credit needs

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- Built in instability for business, & risk for banks, if too much permanent capital is provided by banks

- Human capital requirements considerable
 - ▣ Differentiating working capital needs from loss haemorrhaging
 - ▣ Meaningful relationships

- Substantial overhead requires significant scale

Sustainable housing finance

Old model found wanting

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- On-balance sheet financing requires stable liabilities
 - ▣ Longer term funding - more expensive - a bigger element
 - ▣ 'Sticky' retail deposits likely to remain expensive

- Securitisation, with safeguards, more important than ever
 - ▣ Asset Covered Securities (ACS) mechanism viable in long run
 - ▣ Irish current ACS legislative framework quite robust

Shape of competition

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Bank of Ireland



3RD FORCE

- Need for durable competition via both:
 - ▣ Third force commercial banking ~ Public & private sector firms
 - ▣ Third force retail banking ~ Household sector

- Distinctive emphasis
 - ▣ Commercial banking more human- & financial- capital intensive
 - ▣ Retail banking increasingly reliant on technology & systems
 - ▣ Delivery via branches, rep offices & electronic means may differ

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Bank credit supply challenges - 1 of 2

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□ Availability

- Bond swap by NAMA potentially a powerful liquidity boost
- Inevitable deleveraging of banks is a brake on supply
- Many borrowers also need to de-lever

Bank credit supply challenges - 2 of 2

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□ Price

- Current breakeven rate far above risk-free rate
- Normalised structure will return but not as of old
- Cost of capital underpin also a bigger factor

Marginal cost of bank senior funding

early-Jan 2010

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Source	Reference Rate	Indicative rate	Funding cost % p.a.	
			Excluded	Included
			Allowance for cost of Government's new guarantee fee structure*	
		%	%	%
Central Bank / ECB**	ECB	1.00	1.00	1.00
Market repo**	3 Month Euribor***	0.70	0.70	0.70
Commercial Paper	3 Month Euribor	0.70	0.90	1.40
Commercial deposits	3 Month Euribor	0.70	0.90	1.40
<u>Long term unsecured:</u>				
3-year	Swap	2.20	3.50	4.50
5-year	Swap	2.70	4.00	5.00

* Note that structure and fees assumed here and elsewhere of 0.5% & 1.0% for short term & long term debt are my estimates

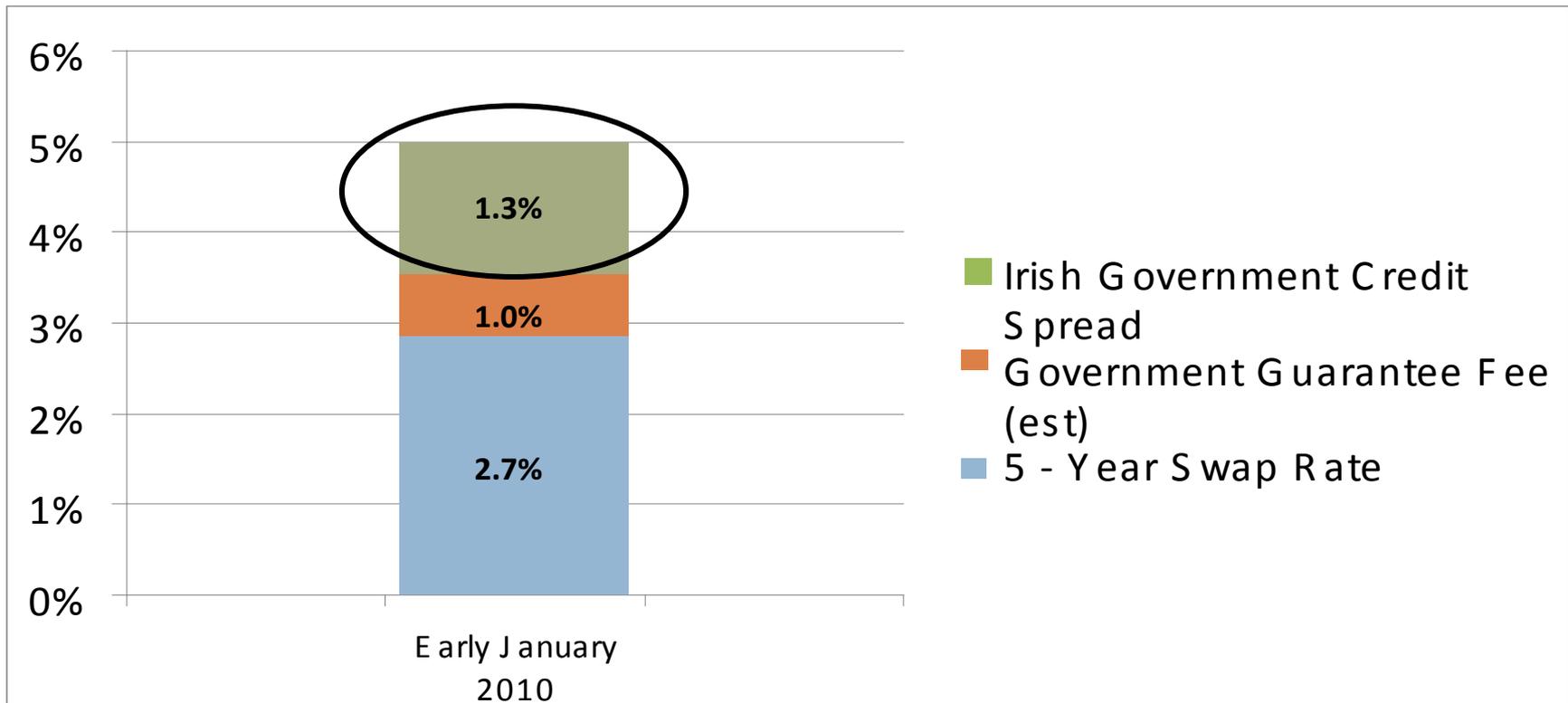
** Government guarantee not applicable

*** Effective rate at which banks lend to each-other

Supply & Price of Credit

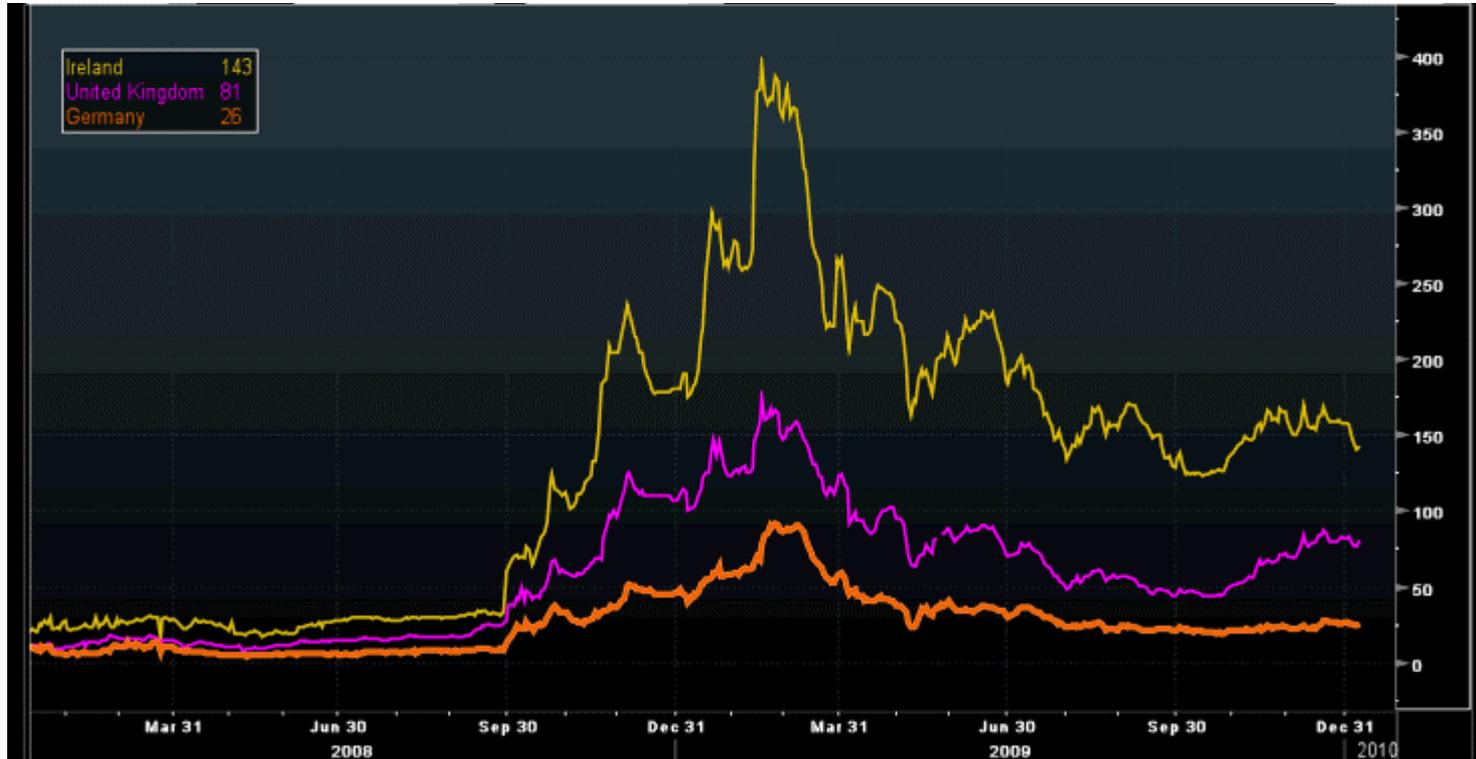
Components of 5-year bank debt cost

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Govt CDS 2008 & 2009

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Supply & Price of Credit

Economic lending rate for mortgages

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	Funding mix	Reference Rate	Applicable Rate	Margin over Reference Rate	
				Earl-January 2010	Likely Future conditions*
			%	%	%
Retail & Commercial deposits	40%	Euribor	0.70	2.25	1.50
Market repos etc	20%	Euribor	0.70	0.00	-0.10
Term funding	37%	Swap	2.70	2.30	1.80
Capital	3%	Swap	2.70	9.30**	9.30

		Gross figures	
Blended financing cost		3.53	3.03
Cost of 15% Liq Assets @ yield 0.70%		0.50	0.41
Servicing cost & provisioning, say		0.25	0.25
Economic lending rate		4.28	3.69

*Based on current reference rates, which will themselves be subject to change

** Medium-term cost of capital estimate (ref RBS) used for illustration, but fresh equity currently not available near that price

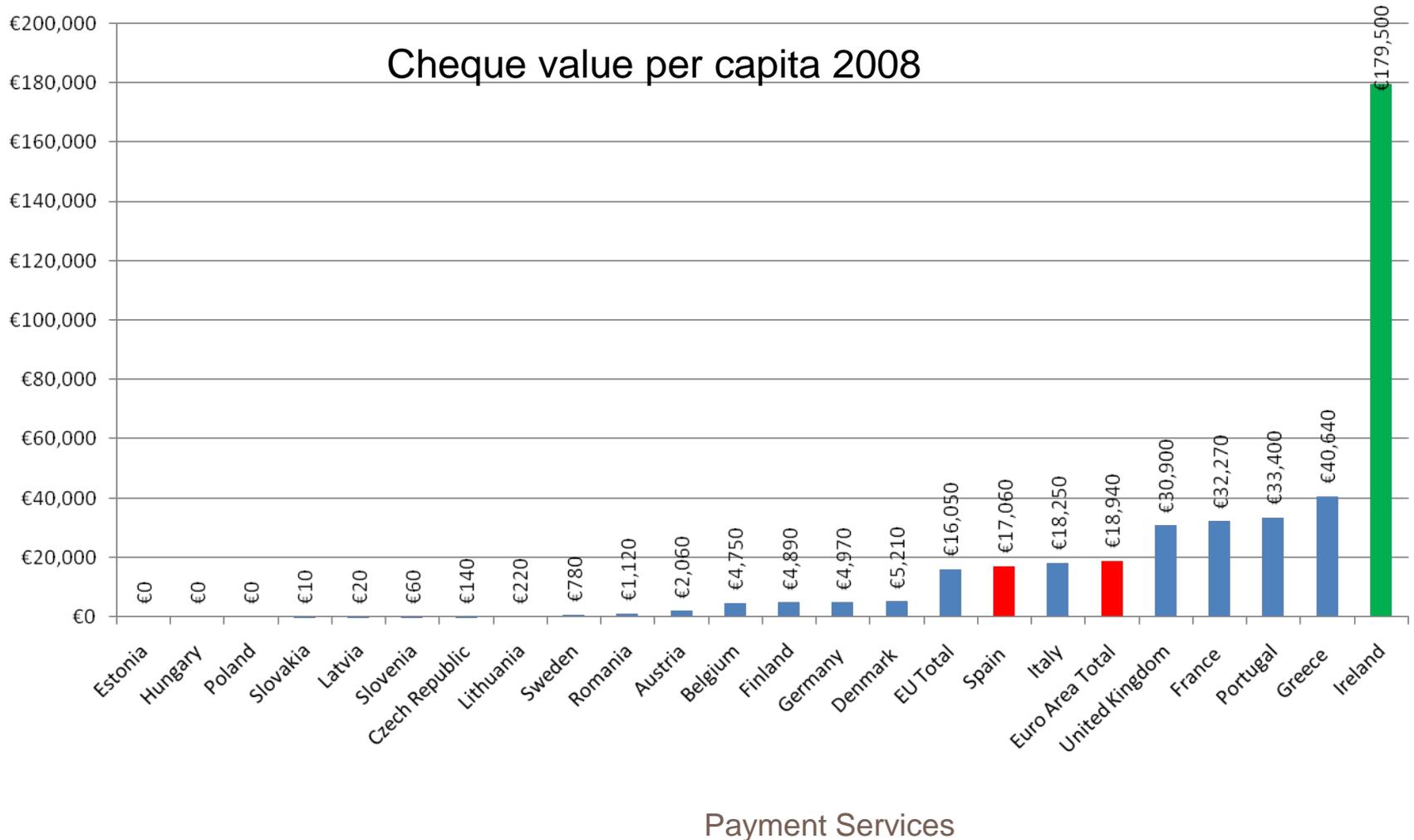
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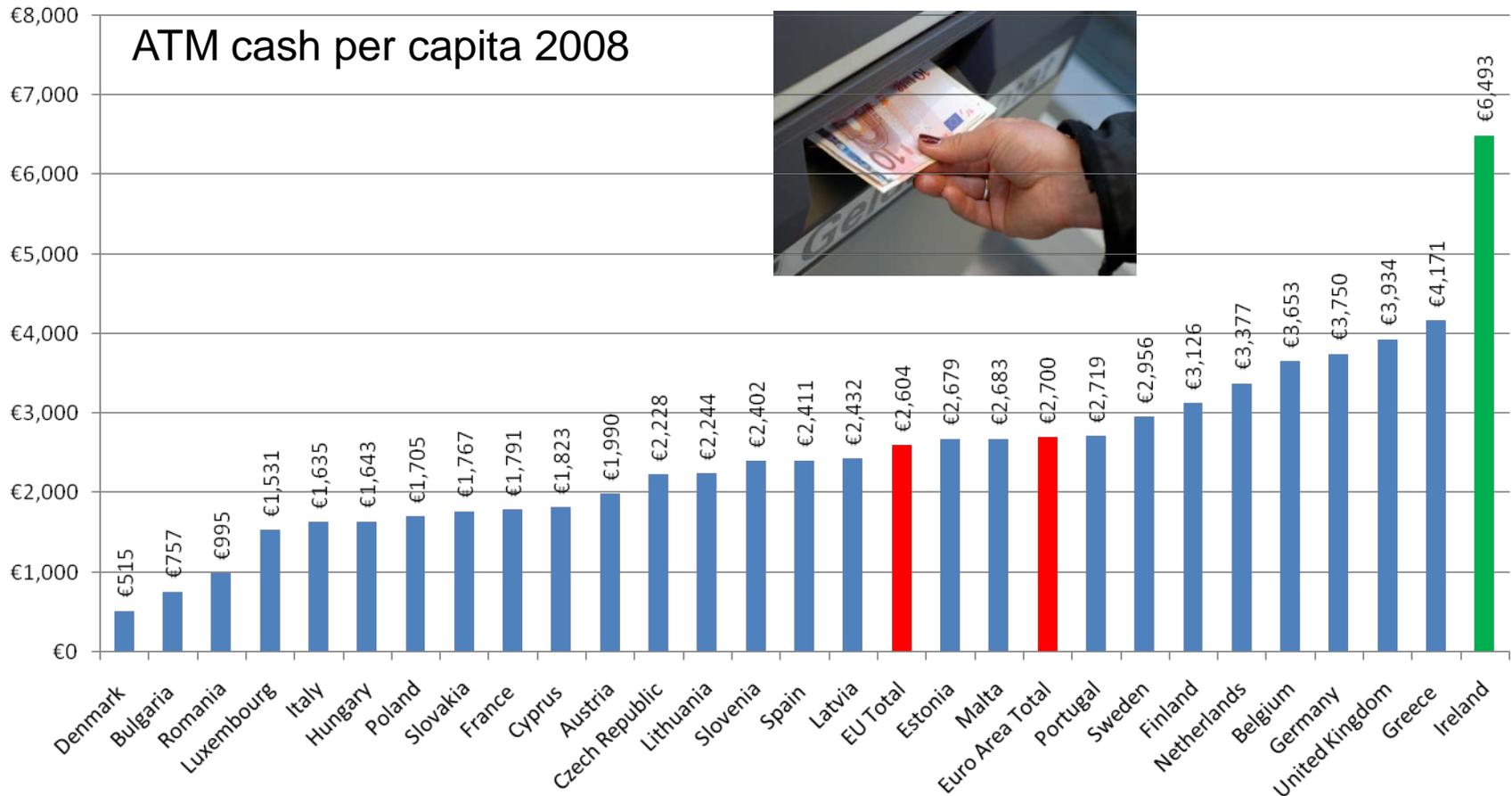
Ireland's addiction to cheques

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Ireland's love of cash

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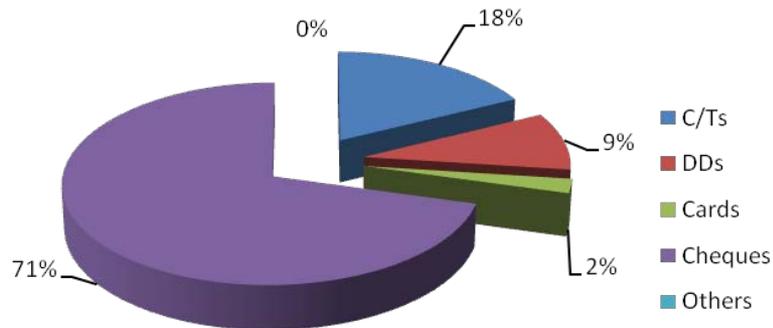


Payment Services

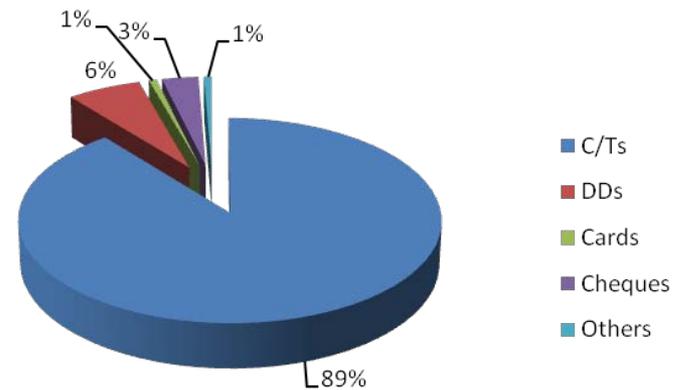
Ireland v Europe – payment methods 2008

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Relative Importance by Value - Ireland



Relative Importance by Value - EU



Payment Services

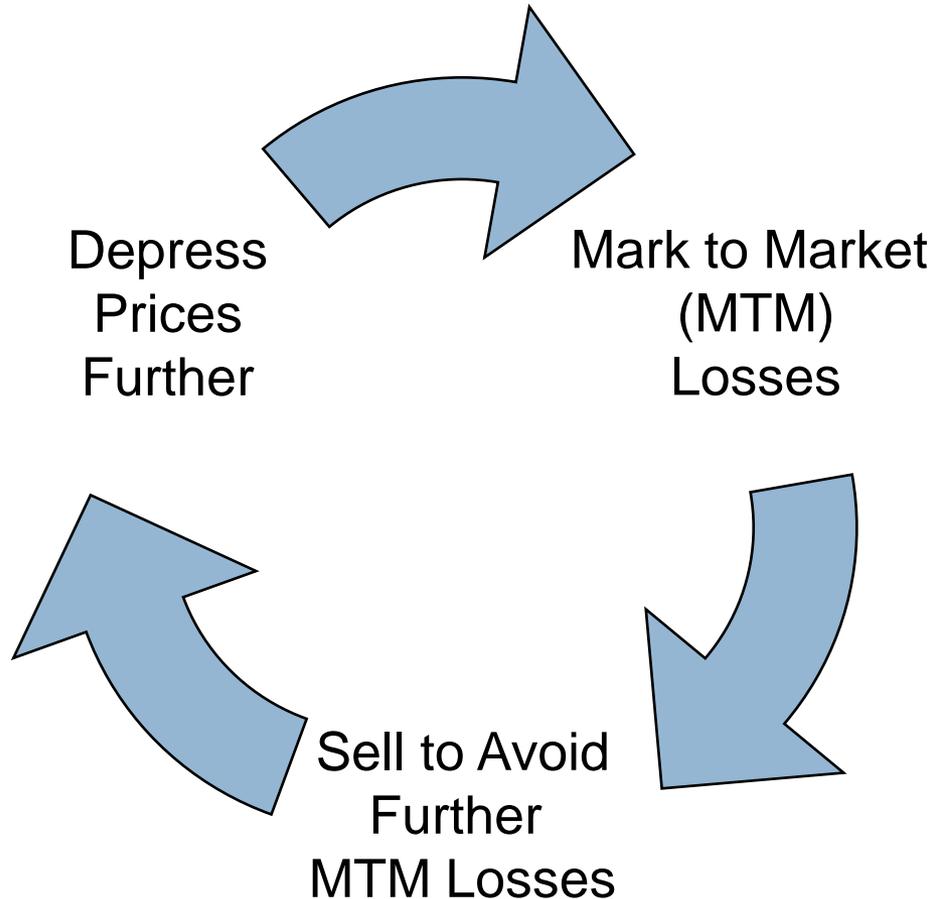
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Pro-cyclicality

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Some Pro-Cyclicality Issues

Pro-cyclicality of bad debt provisioning

-extreme, simplified example of effect of IAS 39 rule

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	Constant growth rate in loan portfolio %					
	+20	+15	+5	0	-5	-15
Accounting Measure of ROC %	22.4	20.8	16.7	14.0	10.7	1.4

- 'True' Return on Capital (ROC) is 14% in all cases

Proven vs. Expected Losses (EL)

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- Current provisioning practice is backward-looking
- Supported because it decreases discretion
- However, IASB ED published Nov 09 \Rightarrow EL method

Accounting neutrality

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Regarding the issue of pro-cyclicality, as a matter of principle, the accounting system should be neutral and not be allowed to change business models – which it has been doing in the past by "incentivising" banks to act short term.

The public good of financial stability must be embedded in accounting standard setting.

de Larosière

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Mixed messages to banks!

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- De-gear your balance sheet
- Hold greater liquidity
- Strengthen your funding
- Carry less risk
- Lend more in these fraught conditions
- Generate more capital
- How dare you seek to recover your cost of funding!

Policy

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- ▣ Macro-prudential framework
- ▣ The shape and size of Irish banks?
- ▣ IFSC
- ▣ Dependence on gross foreign borrowing
- ▣ Solvency erosion from pressure for 'below cost' lending

A bigger slice of pension investment

Paradox of investing abroad resulting in offsetting funds 'intermediated back' at Irish credit spread

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- Pension investment outflows at present:
 - Foreign equities
 - Eurozone bonds hedging Irish annuities
- Possible domestic substitutes:
 - Irish Government index-linked paper
 - State issuance of unsubsidised annuities
- Benefits include:
 - Spread saved available domestically
 - Possibly lower pension investment risk

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Myths

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- We will be safer with:
 - ▣ More risk committees
 - ▣ More regulation
 - ▣ More competition

.....*unless we think carefully about their application*
- He who shouts loudest is most deserving of a loan
- Pundits have all the answers
- Bankers have none of the answers
- Banking services can be free

Flawed assumptions – Turner Review

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- *Market prices are good indicators of rationally evaluated economic value*
- *Securitised credit increases allocative efficiency and financial stability*
- *The risk characteristics of financial markets can be inferred from mathematical analysis, delivering robust quantitative measures of credit risk*
- *Market discipline can be used as an effective tool in constraining harmful risk-taking*

Banking realities

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- Ireland's love affair with property has cost us dearly
- Reputation severely dented
- Funding and capital costs to remain elevated

Bank priorities

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1. Safety
2. Profitability
3. Growth

In that order!

We come from a culture where bigger is not better. You get bigger by being better, you don't get better by being bigger

John Stumpf, Wells Fargo
Financial Times, 24 August, 2008

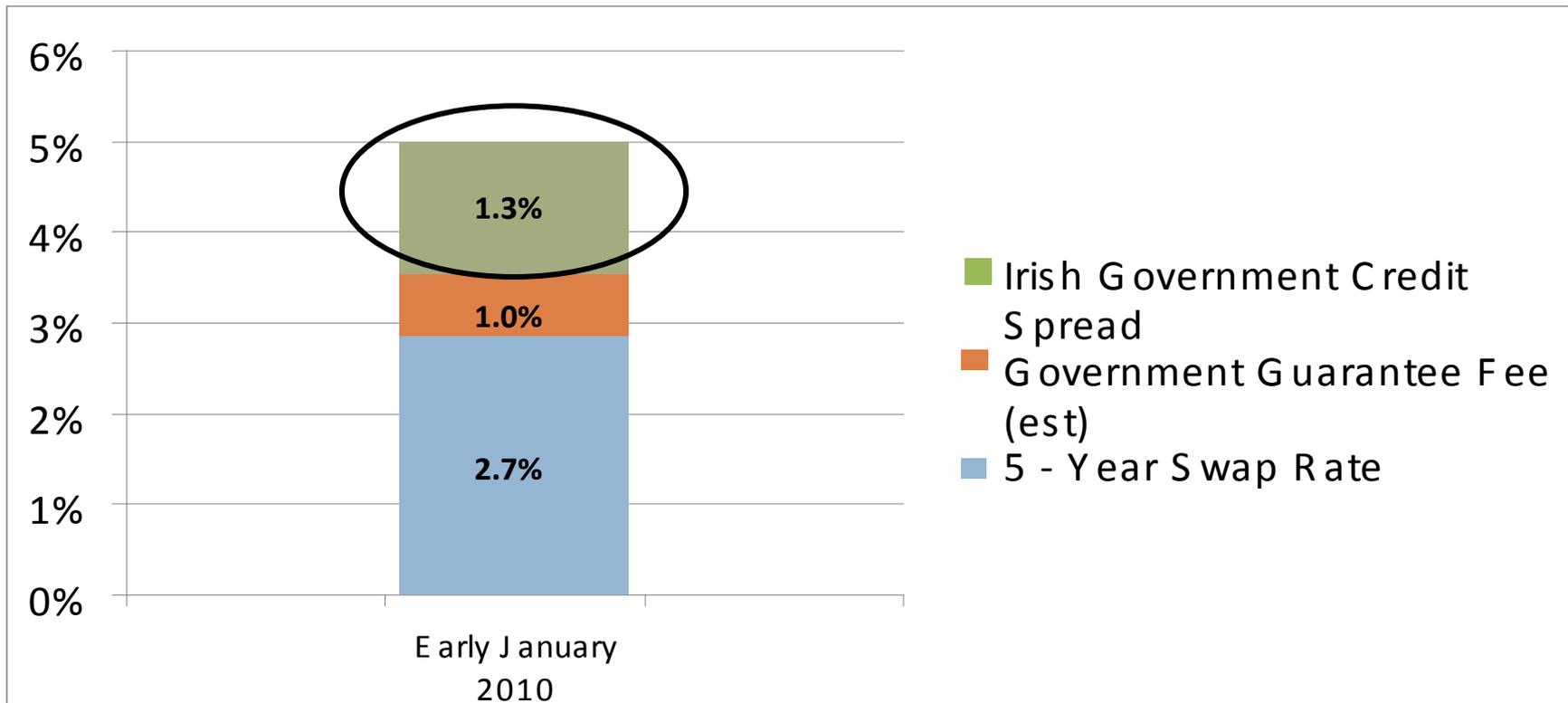
Final point

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- Today, the true cost of ‘raw material’ for loans in Ireland is well above official headline rates
 - ▣ This cost is greatly impacted by Irish sovereign credit spread
 - i.e. the cost burden of debt on individual Irish borrowers, as well as all taxpayers, is made heavier by Ireland’s credit standing

Components of 5-year bank debt cost

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Final point

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- Today, the true cost of ‘raw material’ for loans in Ireland is well above official headline rates
 - ▣ This cost is greatly impacted by Irish sovereign credit spread
 - ▣ The ECB rate (1.0%) is not under our control, but
 - ▣ Our actions can influence Irish credit spread (1.3%)
 - Is that not the key interest rate we should be getting excited about?
- What can **YOU** do to get it down?