TOWARDS A BANKING SYSTEM FIT FOR IRELAND'S PURPOSE

Pat Ryan,
The Society of Actuaries in Ireland, 20 January 2010

Topics

- 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

- Irish State pivotal stakeholder
- Banking becoming more utility-like in nature
- Public interest perspective on banking
  - Key cog in economy
  - Minimise complexity
  - Risks containable
  - Greater dependence on indigenous banks

Future emphasis in banking regulation

Pointers from Basle committee on banking supervision Dec 2009

- Capital
  - Much tighter definitions of qualifying capital
  - More capital for trading books & securitisations
  - Countercyclical measures – accounting & flexing ratios
- Liquidity & Funding
  - Sufficient liquidity for an acute short-term stress scenario
  - Stable funding benchmarks varying by asset category
    - $\Rightarrow$ shareholders' equity, high quality deposits or term funding to underpin specified weightings of asset classes

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What does Ireland want from banking?

- Play its part in the competitiveness needs of Ireland
  - First rate services to business and household sectors
    - Needs of domestic SMEs, other firms, agri, public bodies, FDI etc.
    - Household banking needs of wide spectrum of citizens
    - Sustainable housing finance
  - Cost-effectiveness
- Restore trust and the reputation of Irish banking
- Minimise pro-cyclical effects on the economy
- Minimise vulnerabilities to banking fallout

What is desirable bank competition?

- Big difference in significance between competition in:
  - Service & quality of expertise
  - Price for identical product
  - Price for a different product
  - Risk underwriting standards
- Hazards of chasing market share in banking $\Rightarrow$ **contrast:**

  "We believe that Australian banking sector's less fiercely competitive environment relative to some of the global peers has contributed to less risky lending standards " S&P July 2009

The nature of banking

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

Brian Ranson, *Credit Risk Management*

- Banks blow up when marketing mind-set prevails
- *"Don't congratulate me when I buy, congratulate me when I sell!"*

Henry Kravis, KKR

Serving the competitive sectors

- Different priorities between large firms and SMEs
- Large firms can obtain credit requirements widely
  - More focus on domestic & international payments services
- SMEs
  - Credit availability & its cost a critical requirement
    - Localised providers important
    - Requires substantial input of banking experience & skills
  - Modern, economical and speedy payments services also key
  - Advisory services also useful in many instances

Critical gaps

Broad brush picture

	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

SME banking

- Characteristics of transformational approach
  - Back to basics
    - Cashflow based lending, meaningful relationships
  - Segmented (micro – lifestyle – international)
  - Aligned with State agencies and realities of sophisticated enterprise sector
  - Outside expertise required (c.f. agri in 1970s)
  - Bundling of services for busy entrepreneurs
  - This service is costly to provide

Credit needs of SMEs

- 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%
  - Turnover down on preceding period in 78% of firms
  - Value of SME loans on 'watchlist' or 'impaired':
    - June '08, 15% ; Feb '09, 22% ; Sept '09, 32%

Challenges with SME credit needs

- Built in instability for business & risk for banks if too much permanent capital for firms is provided by banks
- Human capital requirements considerable
  - Differentiating working capital needs from loss haemorrhaging
  - Specialist function needed to serve **international ambition** & **high potential start-up** SME segments
  - Using local presence to serve other segments
- Substantial overhead requires significant scale

Sustainable housing finance

Old model found wanting

- 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
    - Will be increasingly relevant funding method as markets recover
    - Law may need some tweaking in line with pfandbrief changes
  - Dilution of residual balance sheet quality puts cap on its role

Shape of competition

Bank of Ireland AIB **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
    - e.g. discussion above on SME sector
  - Retail banking increasingly reliant on technology & systems
    - National broadband penetration should facilitate a step change
  - Delivery via branches, rep offices & electronic means may differ

Financial capital needed

- Increased quality & quantity of capital - the future norm
  - Only Core Equity now widely accepted as 'Credible capital'
  - Market expecting Core Equity/RWA* to be $\geq$8% in future
  - However, Basle Committee imply somewhat less
- Capital for third force commercial bank is substantial
  - Obtaining suitable human capital also challenging
- Capital needed for third force retail bank less onerous
  - In case of mortgages, which are big part of lendings:
    - Balance sheet burden moderated via credible securitisations
    - Capital ratio for balance sheet element much lighter

* RWA = Risk Weighted Assets

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Bank credit supply challenges - 1 of 2

- Availability issues
  - Bond swap by NAMA will be a powerful liquidity boost
  - Inevitable deleveraging of banks is a brake on supply
    - Pro-cyclicality effect is a luxury the economy can't afford just now
    - Regulators need to be on side on this
    - Challenges of topping up bank capital
  - Many borrowers also need to de-lever
    - Reducing Irish business over-reliance on bank finance for permanent funding will have to wait
    - Banking system cannot be substitute for bad trade credit practices

Bank credit supply challenges - 2 of 2

- Price issues
  - Current breakeven rate far above risk-free rate
    - EU-required Government guarantee fee rates big cost factor
    - Directly affected by Ireland’s credit standing
      - e.g. spread on Irish Govt guaranteed 5-year debt is 1.3% p.a. at present
  - In due course, 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

Source	Reference Rate	Indicative rate	Funding cost % p.a.	
			Allowance for cost of Government's new guarantee fee structure*	
			Excluded	Included
		%	%	%
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

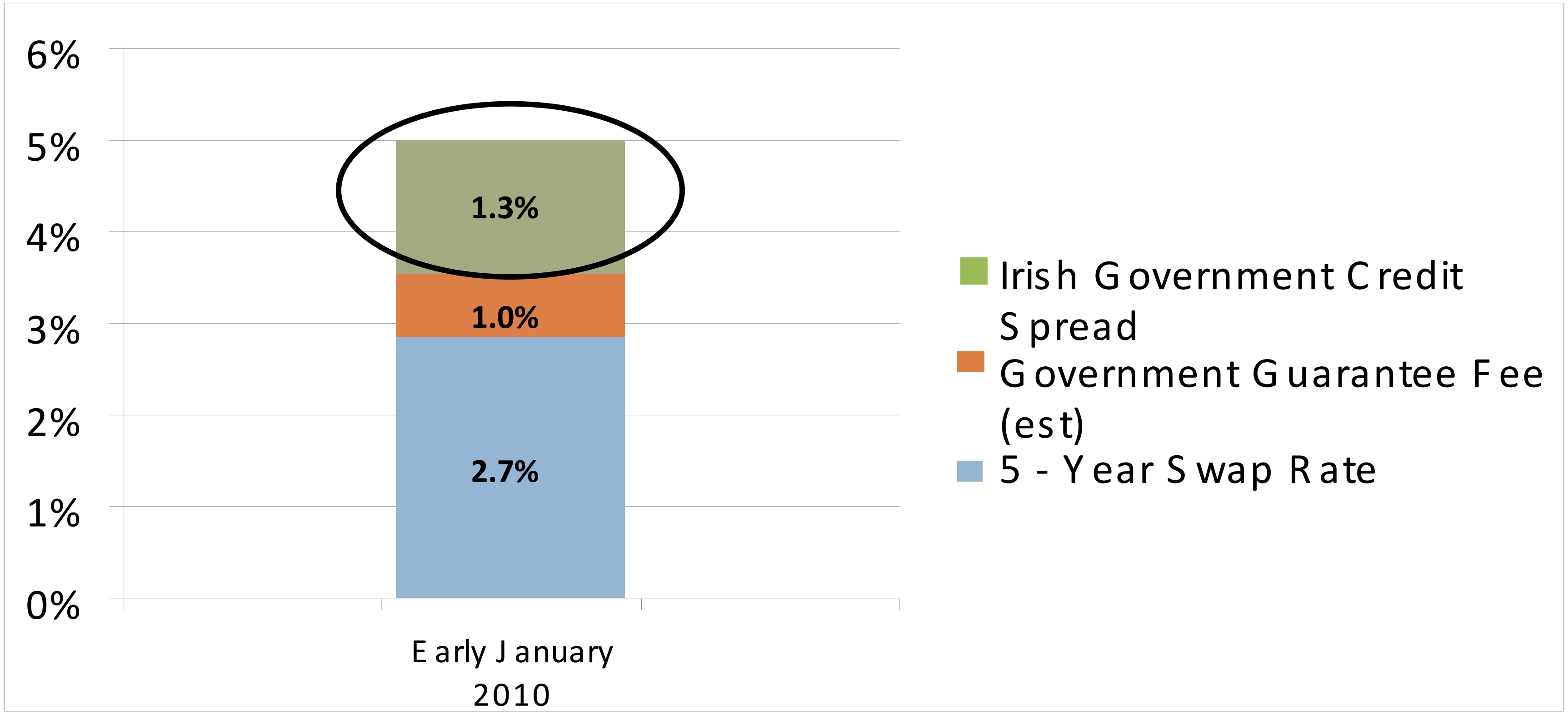
** Government guarantee not applicable

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

Components of 5-year bank debt cost

	early-Jan 2010
	% p.a.
5 Year interest rate swap	2.7%
Government guarantee fee	1.0%
Credit spread on Irish Government guaranteed risk	1.3%
All-in cost to Irish bank	5.0%

Components of 5-year bank debt cost



Govt CDS 2008 & 2009

Capital underpinning bank loans:

The add-on cost

	ADDITION TO LOAN MARGIN TO COVER COST OF CAPITAL		
Capital Ratio Reqd. by Markets / Regulators %	Price of capital less cost of senior funding % p.a.		
	10	15	18
8	0.80%	1.20%	1.44%
12	1.20%	1.80%	2.16%
15	1.50%	2.25%	2.40%

Economic lending rate for mortgages

	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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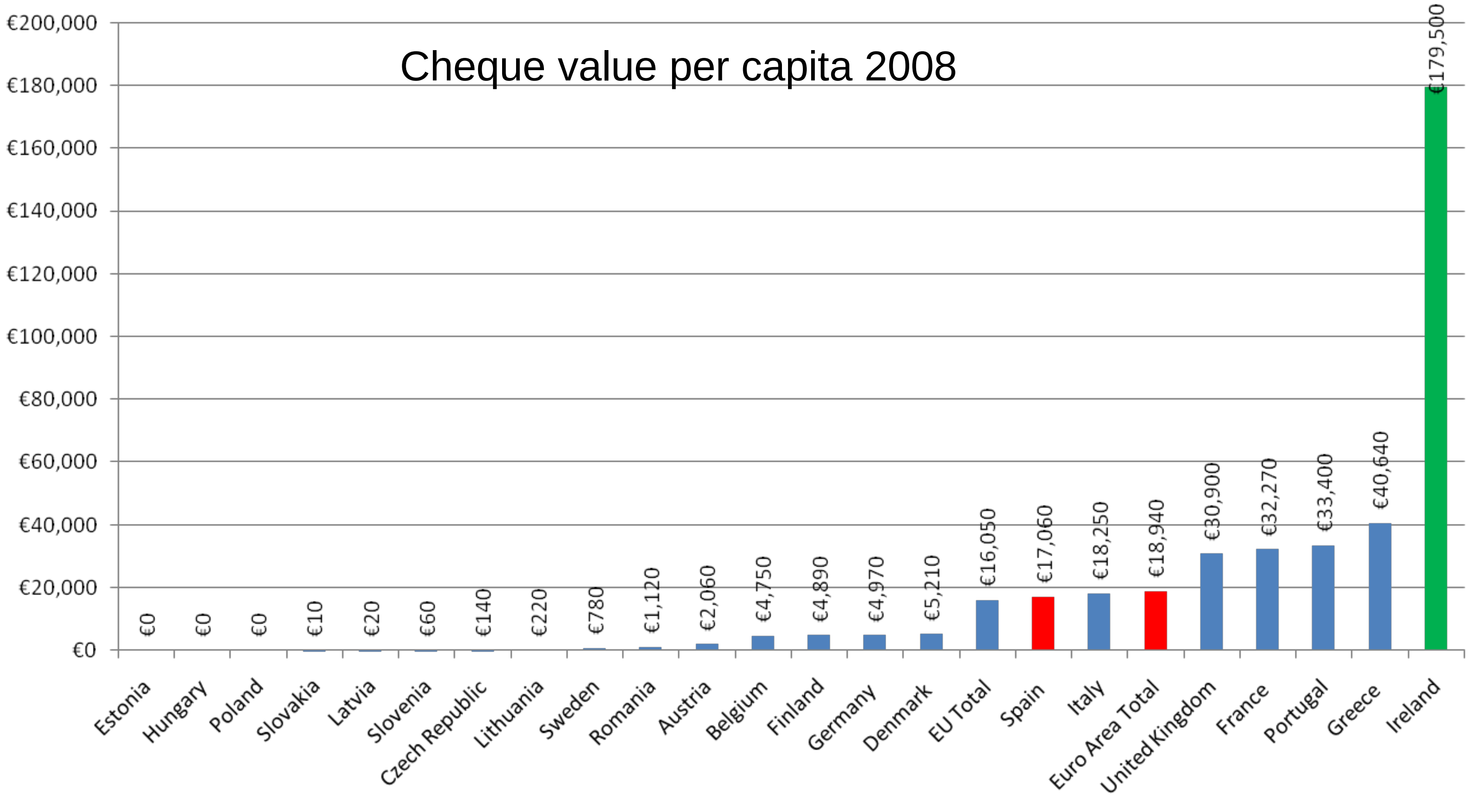
Payments productivity

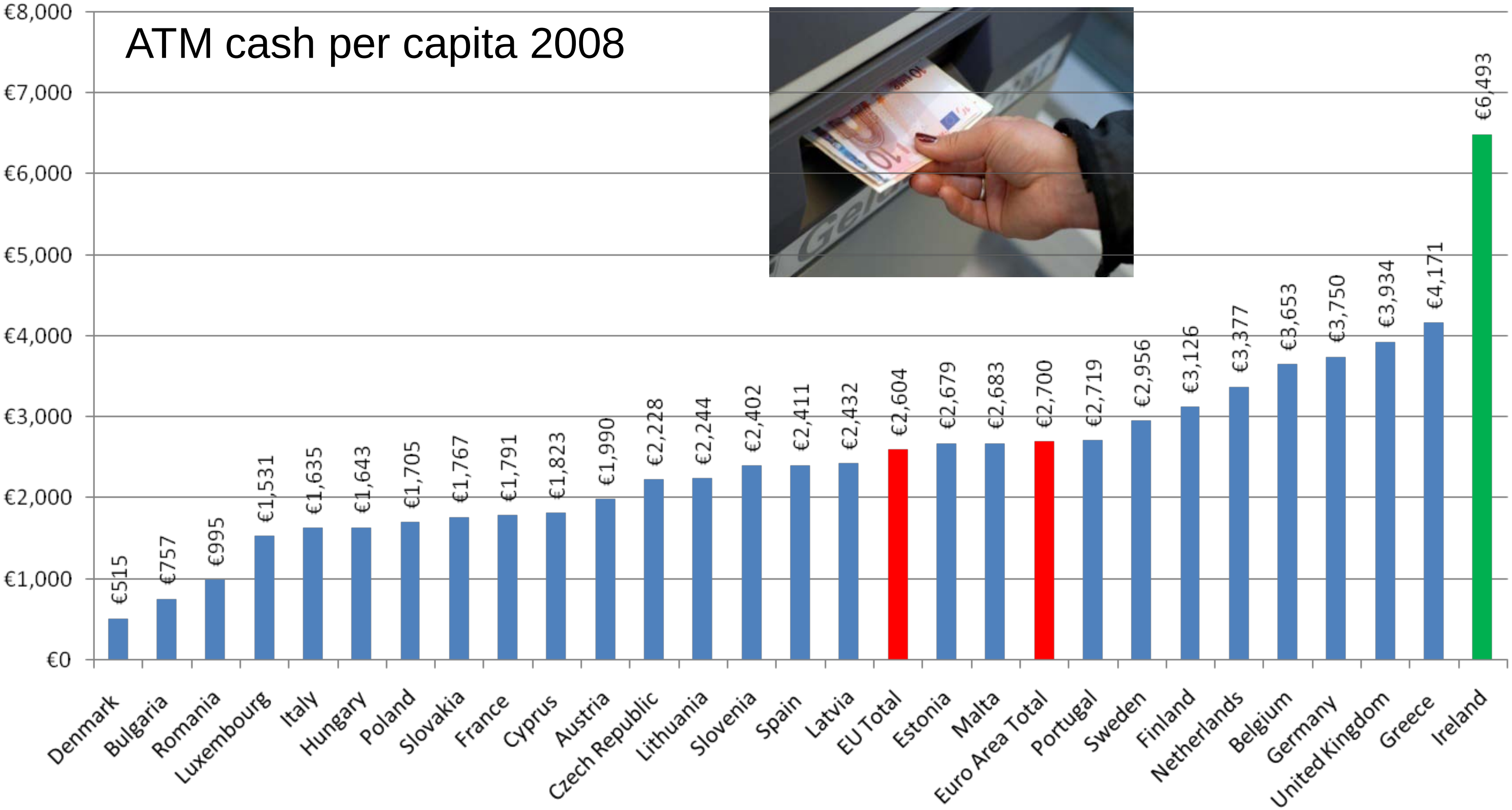
- Ireland lagging behind in usage of electronic payments
  - Over-reliance on cash & paper costing economy est€1bn pa
  - Public policy now encouraging catch-up
  - Rapid take-up of online banking will help
- Modernising money transmission services will:
  - Enhance efficiency & competitiveness of economy
  - Facilitate financial inclusion
- Single Euro Payments Area (SEPA)
  - Big productivity gains on way in cross-border payments

Ireland's addiction to cheques

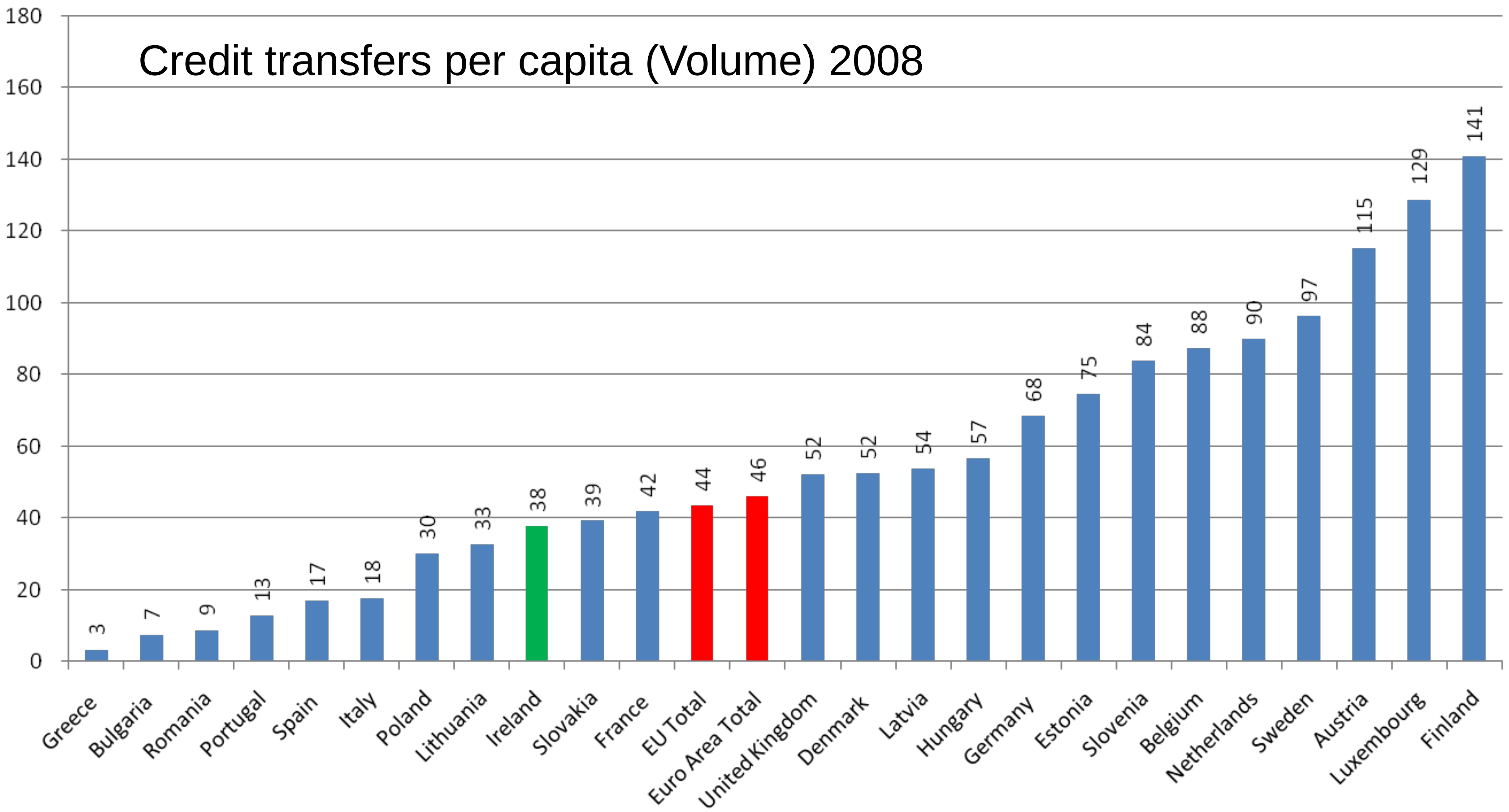


Source: ECB Payment Statistics November 2008

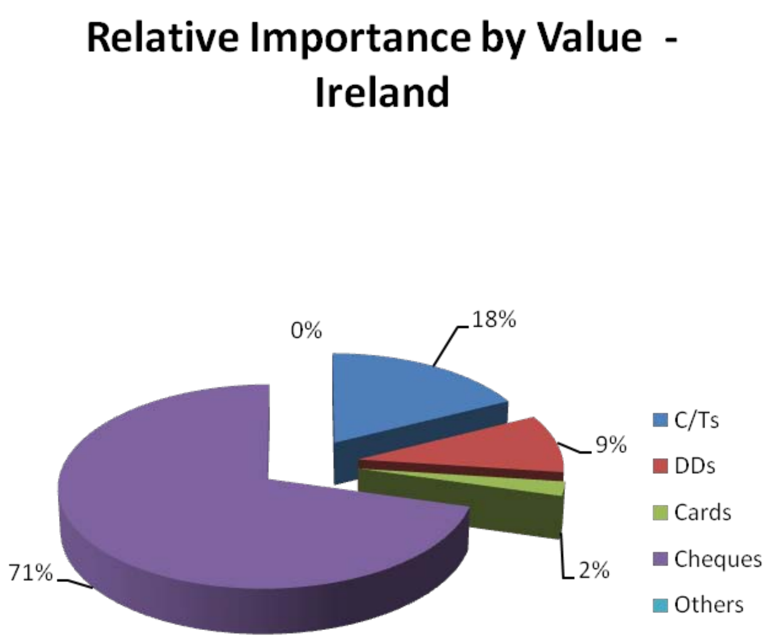
Ireland's love of cash

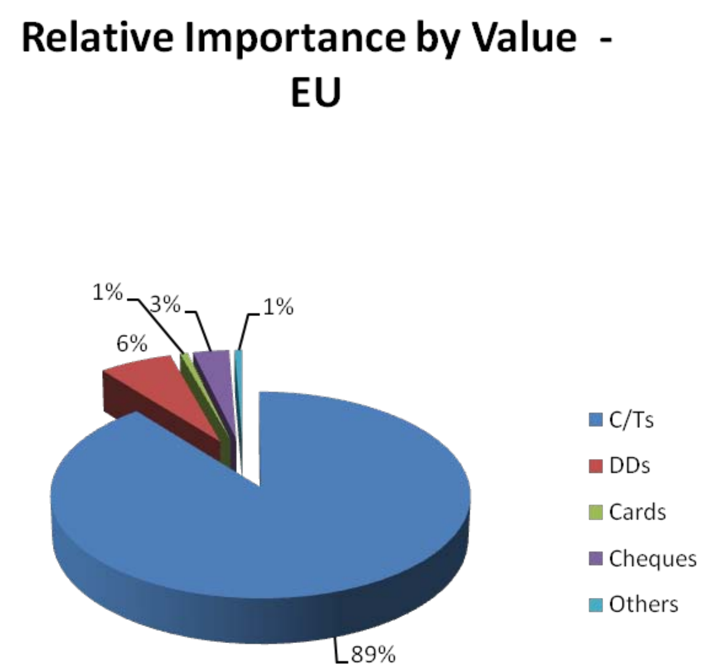


EU – Electronic credit transfers (vol.)



Ireland v Europe – payment values 2007





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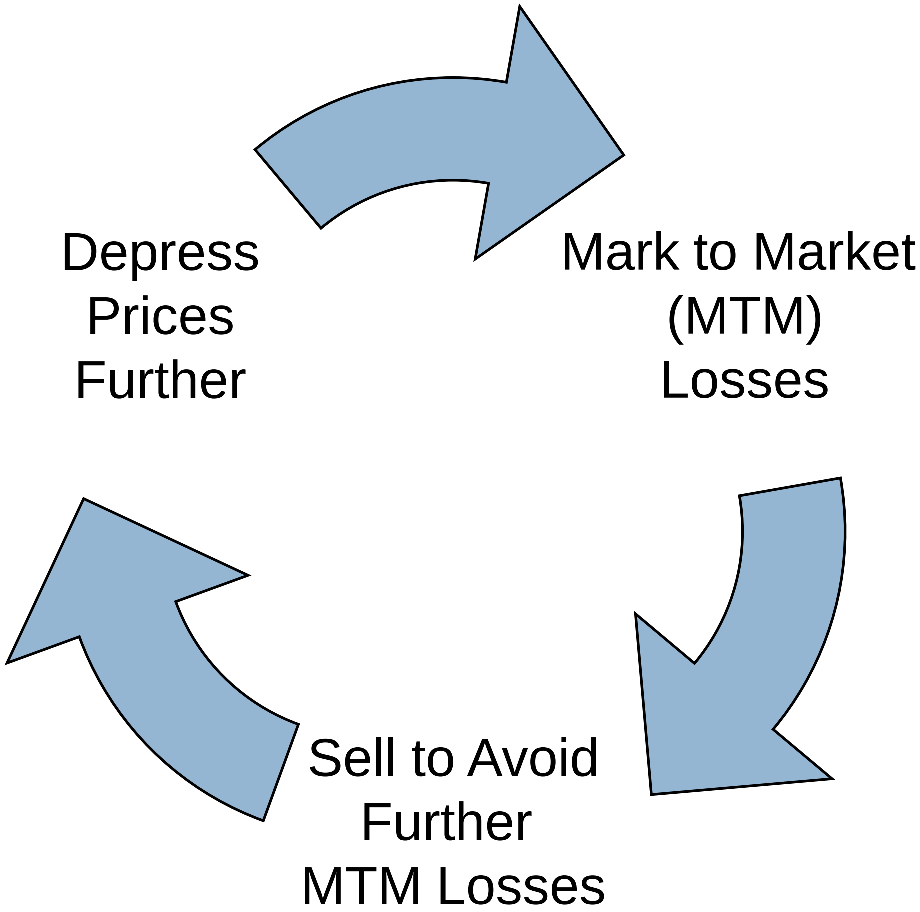
Pro-cyclicality



Pro-cyclicality of bad debt provisioning

-extreme, simplified example of effect of IAS 39 rule

	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

- Assumptions:
  - Underlying losses are continuously 2% p.a. over life of loan
  - Losses start being accounted for 3 years after commencement of loan
  - Bank senior debt is 4% p.a.
  - Lending rate is 7% p.a. plus margin for administration etc. costs
  - Capital = 10% of loans outstanding

Proven vs. Expected Losses (EL)

- Current provisioning practice is backward-looking
- Supported because it decreases discretion
- Fails to recognise future losses that are sure to happen but we don't know exactly when
- However, IASB ED published Nov 09 $\Rightarrow$ EL method

- Dynamic provisioning in Spain:
  - Statistical provision based on expected losses
  - Calculated as the difference between the bank's provisions and the standard basis

Accounting neutrality

Regarding the issue of pro-cylicality, 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. This would be facilitated if the regulatory community would have a permanent seat in the IASB

Accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment

de Laroisière

'Leaning into the wind'

The crisis has revealed the strong pro-cyclical impact of the current regulatory framework, stemming in particular from the interaction of risk-sensitive capital requirements and the application of the mark-to-market principle in distressed market conditions. Instead of having a dampening effect, the rules have amplified market trends upwards and downwards - both in the banking and insurance sectors.

Important that banks, as is the present rule, effectively assess risks using "through the cycle" approaches which would reduce the pro-cyclicality of the present measurement of probability of losses and default

de Laroisière

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Mixed messages to banks!

- De-gear your balance sheet
- Hold greater liquidity
- Strengthen your funding
- Carry less risk
- Lend more in these fraught conditions
- Generate more capital
- Imperative of recovering costs is not acknowledged

Policy

- Appropriate macro-prudential framework
- What is the right shape and size for Irish banks?
  - Enforcement of sectoral concentration & funding rules
  - What size their overseas ventures?
- Implications for IFSC policy
  - Hazards of home regulator responsibility for big institutions
- Becoming more self sufficient in credit provision
  - ?e.g. instruments to reduce pension foreign investment needs?
- Pressure for ‘below cost’ lending will undermine solvency

A bigger slice of pension investment

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

- Pension investment outflows at present:
  - Substantial requirement for foreign equities
  - Also large requirement for annuities, much of which is priced via reinsurance based on eurozone bonds
- Possible domestic substitutes:
  - Irish Government index-linked paper – less risky than equities
  - State issuance of unsubsidised annuities - index-linked & fixed interest – based on Irish bond yields
- Benefits include:
  - Spread saved on foreign debt set against domestic costs / pensions
  - A lower investment risk possibility for Irish pensions

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Myths

- 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

- *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

- Ireland's love affair with property has cost us dearly
  - Vigorous enterprise sector vital to restoring solvency
- Reputation severely dented
  - Major shift in shareholder / stakeholder balance
  - Micro / macro financial regulation gap
- Funding and capital costs to remain elevated
  - Implications for pricing / capital generation
  - Extended timeframe required for 'de-risking'

Bank priorities

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

Soundness

- Culture – balancing prudence & sustainable business
- Customer relationship ethos
- Public utility and social value aspects
- Too safe, rather than too big to fail
- Sure touch, proactive, not necessarily more, regulation
- Regulation balance – fiduciary v development drive
- Meaningful internal governance

Banking challenges

- Earn back trust
- Harness transformational opportunity of current crisis
  - Rebuild reputation/business through innovative response to enterprise/SME/personal banking needs
  - Cost effectiveness - ‘de novo’ competition from third force
- Sure-footed regulation
  - Avoid burden of pro-cyclical measures at current phase
  - Balance needs of economy with restoring financial health of the banking sector (stakeholder focus)

Final point

- 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
  - 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?