

Recovery through Reform

A New Era of Responsibility in Banking and Access to Credit for Business and Families

A Radical New Approach by Fine Gael

Where there seems to be a broad consensus

- Despite the Guarantee, lending standards to both households and businesses have tightened, particularly by foreign-owned banks and to a lesser degree by domestic institutions covered by the Guarantee (like most EU banks, Irish banks are seeking shelter in their domestic market)
- The Irish economy will not recover without a functioning, well-capitalised banking system and business access to credit, and any recovery will quickly be choked off if investment plans cannot be financed
- Even after recapitalisation of BoI and AIB (forthcoming), the big Irish banks likely remain too financially weak to finance economic recovery
- Ireland is different to many other industrialised countries in that “toxic assets” are mostly domestic property developer-related loans, not complex foreign securities
- There are two related problems:
 - Continuing difficulties in accessing liquidity and rolling over debt
 - Deteriorating loan quality and difficulties in meeting capital requirements
- The financial regulatory system needs to be overhauled to restore domestic and international trust in our banks

The NAMA Proposal Has Too Many Weaknesses to Inspire Confidence

1. There is no obvious basis for the valuation of the loans and underlying assets, with the risk of taxpayers left shouldering huge losses
2. The suggestion that losses incurred by NAMA (i.e. if it pays too much for the assets) can be recovered from the banks through some form of levy makes no sense. There is no point setting up NAMA if risk is not transferred to it.
3. Besides from ordinary shareholders, under the NAMA approach there is no sharing of losses by the providers of other capital (e.g. sub-ordinated debt) and risky funding (e.g. unsecured bonds) who made good profits in the good years, but who will walk away scot-free under this proposal. Losses are to be shared entirely between ordinary shareholders and tax-payers (with the balance as yet unknown). Bailing out the unsecured creditors creates dreadful incentives for future risk-taking by banks – plants the seeds for the next crisis.
4. This approach will not draw public support, because uncertainty over asset pricing and future work-out of the developer loans by a State agency is feeding concerns about the relationship between the State, banks and big property developers
5. The banks that made the loans may have better incentives, skills and information than a new state agency to recover loans made to developers. International evidence suggests that legal and political constraints in loan recovery by state agencies make it likely that loan losses will be higher under NAMA.

6. The prospect of NAMA taking over responsibility for loan work-out may lead to banks delaying proceeding against non-performing borrowers. Delayed enforcement proceedings and transfer of ownership raises the risk of weakening collateral and “looting” (“mishandling” of vital title deeds etc.)
7. The additional €50-€70 billion in Government debt that the Gov. needs to raise to fund NAMA has potentially negative implications for our sovereign credit rating and debt servicing costs (perhaps up to €3 billion per year)

Some of These Weaknesses are Addressed by Nationalisation

- Nationalisation appears, at first, to solves valuation problem of bad loans transferred to NAMA post-nationalisation
- It may facilitates forced restructuring of banks to attract new liquidity and capital
- It allows much swifter restructuring than can be achieved when dealing with private investors

But Nationalisation Creates its Own Problems

- Nationalisation makes is almost certain that the tax-payer will have to honour all obligations to creditors of the bank, even those long-term capital and debt liabilities (subordinated debt, preference shares, long-term bonds) that will remain even after the Guarantee expires in September 2010. If the banks nationalised ultimately prove to be insolvent, this will have unknown costs for the tax-payer.
- Witness the commitments from Government to bond-holders following the nationalisation of Anglo Irish Bank, and the windfall gains accruing to those investors at that time. There would be huge national reputational issues for a state-owned bank renege on commitments to international investors.
- Nationalisation does not fully solve the problem about how much to pay for the banks’ distressed assets, because the amount that would have to be ultimately paid for the entire banks (following some sort of compensation and judicial process) must in part depend on a valuation of those assets. There is a danger that nationalisation will lead to over-compensation of shareholders by Irish courts..
- Nationalisation threatens politicisation of lending decisions by state-owned banks. Evidence from other countries suggests that smaller businesses that are not well politically connected lose out to bigger companies and organisations with better political connections.
- Re-floitation of nationalised banks could cost up to €100m.

Neither NAMA nor Nationalisation - Fine Gael Believes that a radically Different, 2-Track Approach should be followed

“There may be no easy routes out of this crisis, but until we are ready to draw a clear line between the banks that have become parasites feeding off the tax payer and ways to support resumed lending to enterprises and households, there will not be a sustainable recovery in the Irish economy.”

In resolving the bank crisis, is it important to put the interests of Irish tax-payers and bank customers ahead of bank investors and creditors.

Track 1 – Establishment of a National Recovery Bank

The first step is to establish a National Recovery Bank. This would be a wholesale bank funded by the ECB which would stand ready to provide the necessary liquidity to the covered banks to get credit flowing. It would be willing to buy at a fair market price the small business lending books or the mortgage books of covered banks. The key features of the National Recovery Bank would be as follows:

1. The necessary capital would be provided by the State, and could initially be in the range of €2 billion.
2. It would be established under Irish Asset Covered Security (ACS) legislation, allowing it to cheaply raise additional funding of €30-€40 billion, initially from the ECB and over time from private markets when they re-open.
3. Existing banking relationships would be maintained (customer whose loans are transferred to the NRB would still have their loans serviced by the retail bank)
4. It could be established and operational within four to six weeks, and inject new lending into the economy without delay.

The advantages of this proposal are several.

- It immediately gets credit flowing – a straight fusion into the blood stream of small business
- It brings more funding into the Irish banks from the ECB than they can avail of now under their current structures and operating practices.
- It helps banks to strengthen their balance sheet by swapping parts of their loan book for cash.
- The assets purchased are not difficult to value, so it does not require complex and lengthy valuation exercises and negotiations with the banks.
- It creates a solid spine to underpin the present and future banking for the economy at a time when the existing banks are intent on shrinking their own balance sheets to protect their independence.
- It allows the existing relationships between businesses with their banks to continue, but in a new prudent framework dictated by the state bank.
- It leaves the toxic property-related loans in the hands of the private banks who made them, and who will better skills and incentives than any state agency to recover as much as possible from those loans

Track 2 – Orderly Retrenchment, Bad Loan Work-Out and Recapitalisation

1. The Government confirms that the Guarantee of liabilities will be withdrawn from covered Banks in Sept. 2010.
2. The Government ensures a replacement of the top-tier of management in each of the covered banks and between now and September 2010, they are instructed by the Regulator to focus on shrinking their balance sheets and strengthening liquidity and capital, using all means available to them, such as:
 - Intensive work-out of distressed loans
 - selling high-quality performing loans to the National Recovery Bank
 - Selling other non-core assets, such as overseas subsidiaries
 - retiring debt and some forms of non-equity capital at low prices

- negotiating with bond-holders for debt-to-equity swaps (incl. Gov. preference shares)
3. Some issues of term-funding (1-5 years) may be guaranteed by the State during this period to ensure adequate duration of funding for the banks in the run-up to the expiration of the blanket Guarantee.
 4. In Aug-Sept 2010, new stringent stress tests carried out by Regulator to test for bank solvency. The banks that continue to have a high probability of insolvency at that time are put into “administration” and are split between new “good banks” and bad “legacy banks” with separate legal structures and balance sheets.
 5. The new “good banks” will assume all the short-term liabilities e.g. all deposits and other short-term inter-bank and money market liabilities.
 6. Other unsecured liabilities with maturity dates past September 2010 (all forms of capital and longer-dated debt) would remain with the legacy banks.
 7. In compensation for assuming these liabilities, the “good banks” would also take possession (at market prices) of the branch network and remaining parts of the loan book (assets) that can be easily valued, such as mortgages and business overdrafts.
 8. Any difference between the assets and liabilities assumed by the “good banks” would be filled by Government loans e.g. if “New AIB” assumed €50 billion in deposits and other short-term liabilities from “old AIB”, but only received €30 billion in assets, the State would also put €20 billion of Government debt on the asset side of its balance sheet. Conversely, “old AIB” would assume a new liability to the Government of €20 billion (this debt would be senior to all other claims by creditors)
 9. “New AIB” and the other good banks would have a clean balance sheet and would be generously capitalised to maximise the confidence of the transferred depositors and owners of other short-term liabilities. The new capital would be underwritten by the State, with shares offered to other private investors, including shareholders of the legacy banks at discounted prices. The aim would be to restore a market listing for the new bank and return to private ownership as quickly as possible.
 10. The vast majority of the staff would transfer to the “good banks”.
 11. The “legacy banks” left behind would remain in private ownership. Their banking licences would be withdrawn and they would no longer engage in any new lending (beyond what is needed to facilitate work-outs of their loan-books). Their shares might continue to be quoted on the stock exchange.
 12. The purpose of the legacy banks would solely be to work down the remainder of the loan book (mostly the distressed developer-related debts and associated collateral) and recoup maximum value from it over time. It would be managed in the interests of the existing capital owners and other creditors. If enough money is recovered over time from property developers, they would be fully repaid (any Government debt would be repaid first).
 13. If the legacy banks prove to be insolvent, at some point they will be unable to service their obligations. At this point, normal bankruptcy proceedings would apply. This may involve significant haircuts for unsecured creditors, and / or debt-to-equity swaps.

The advantages of this proposal are several.

- If the banks prove to be insolvent, it will be investors in the bank (ordinary shareholders and other owners of risky long-term capital and funding) that will

absorb the vast bulk of the losses – not the taxpayer. It is only right that bank losses are absorbed first and foremost by those who took on the risk of funding the risky lending policies of the banks.

- It puts in place for incentives that will help to prevent future financial crises – investors and funders of banks will monitor bank lending policies more closely
- This model does not require the State to insure the banks against their bad debts, nor to buy bad loans from the banks, in a way that requires the State to put a price on bank assets that cannot be valued in current market conditions, and lead to the likelihood that the tax-payer will end up paying over the odds.
- This model offers a much better chance of quickly kick-starting the economy and protecting jobs. This is because it uses scarce tax-payers' resources for stimulating new lending by banks, rather than for absorbing the losses from the banks' existing loan book.

Post September 2010 equity and debt of AIB and BOI

	Audited equity	Pref shares Govt	Total equity	Post 2010 subordinated debt	Equity + Subordinated debt	Post 2014 senior debt (only disclosure in accounts)	Minimum post 2010 "locked in" equity and debt	Senior debt due after between 03/2009 and 12/2013	Maximum post 2010 "locked in" equity and debt
BOI	6.4	3.5	9.9	7.6	17.5	13.2	30.7	12.0	42.7
AIB	10.3	3.5	13.8	4.5	18.3	2.6	20.9	11.9	32.8
	16.7	7.0	23.7	12.1	35.8		51.6		75.5

* Excluding 760 million maturing at unknown date in 2010