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Irish 'Vicious Circle' Leaves Banks With Higher Costs (Update2)
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(Adds bill sale in fourth, ninth paragraphs.)

By Joe Brennan and Dara Doyle

Aug. 26 (Bloomberg) -- Raising money just got a whole lot tougher for Ireland's cash-strapped banks.

Standard & Poor's this week cut the country's credit rating to AA-, the lowest since 1995, just as 30 billion euros (\$37.9 billion) of government-guaranteed bank debt is due to roll over. Lenders may have to turn to the European Central Bank, said Alan McQuaid, chief economist at Bloxham Stockbrokers in Dublin.

"The timing is awful," McQuaid said. "If the banks can't refinance, then they become more reliant on the ECB, which hurts the perception of Ireland, which in turn drives sovereign spreads wider. It becomes a vicious circle."

S&P said on Aug. 24 it may cost as much as 50 billion euros to recapitalize Irish banks, which almost toppled during the credit crisis and are saddled with bad debt. The cut pushed up the extra yield demanded by investors to hold 10-year Irish government bonds over German to a record. It held there today even as Ireland sold short-term bills at a lower cost.

"The sovereign debt crisis had been put on the back burner for several weeks," Norval Loftus, chief investment officer of London-based Allegra Asset Management, said before the country's debt auction today. The S&P rating cut "was like an aftershock for the euro bond markets," he said.

Default Swaps

The cost of insuring against default on Irish bank bonds stayed close to the highest since March 2009.

Credit-default swaps on the senior debt of state-owned Anglo Irish Bank Corp., which was taken over by the government in 2009, was at 584 points, matching yesterday's high, according to data provider CMA. That means it costs 584,000 euros annually to insure 10 million euros of the lender's bonds for five years.

"We're staying away from Irish debt at the moment," said Kommer van Trigt, a fund manager at Robeco Group in Rotterdam.

"The big problem for Ireland is the banking sector. You could argue whether it will become a problem that the country might not be able to handle on its own."

Other investors are more sanguine. Ireland's National Treasury Management Agency sold 200 million euros of securities due Feb. 14, 2011, at an average yield of 1.978 percent, compared with 2.458 percent in an Aug. 12 sale. The agency also sold 400 million euros of April 18, 2011, debt at an average yield of 2.348 percent, down from 2.81 percent.

"This is a very positive result," said Brian Devine, an economist at NCB Stockbrokers in Dublin. "These are still attractive yields for investors."

'Worrisome'

Irish banks have about 30 billion euros of government-guaranteed debt securities to roll over in September, Nomura International Plc said in a report on Aug. 17.

The premium investors demand to hold Irish 10-year debt rose partly on the "worrisome bank guarantee roll, also known as the funding cliff," London-based analysts Guy Mandy and Nick Firoozye said in the report.

The difference in yield between Irish and German 10-year bonds was unchanged at 344 basis points today. The spread has widened 78 points since the European Commission approved the injection of more cash into Anglo Irish on Aug. 10.

The Irish Financial Index, which has fallen 54 percent over the last year, rose 2.1 percent as of 10:53 a.m. in Dublin trading, with Allied Irish Banks Plc rebounding 1.6 percent.

Frankfurt Help

As part of the euro area, Irish banks can resort to the ECB in Frankfurt. The central bank offers lenders unlimited cash against eligible collateral at the benchmark lending rate of 1 percent for up to three months.

Still, they may not have to raise as much as 30 billion euros after selling troubled real-estate loans to the National Asset Management Agency, set up by the government to help cleanse the financial system of toxic debt.

"On the face of it, it may look like Irish banks are facing a wall of maturing debt in September," said Michael Cummins, a director at Dublin-based Glas Securities, which specializes in fixed-income markets. "But NAMA has a twofold impact on bank liquidity."

First, lenders including Bank of Ireland Plc and Anglo Irish are selling loans with a nominal value of 81 billion euros to the agency, meaning they have fewer assets to finance.

Second, the banks are receiving government-backed bonds to replace real-estate loans, he said.

"These 'NAMA Bonds' can be refinanced with the ECB or act as a liquidity buffer," said Cummins, who reckons the banks may seek to raise 15 billion euros by the end of the year.

April Precedent

While some Irish lenders have sold debt securities in private sales in recent months, no government-guaranteed lender has sold a benchmark bond since April, when Irish Life & Permanent Plc found buyers for 1.25 billion euros of bonds.

Investors yesterday demanded a record 382 basis points, or 3.82 percent, of extra yield to hold the 3.125 percent bonds due 2013 sold by Irish Life & Permanent, according to Royal Bank of Scotland Group Plc prices on Bloomberg.

The danger for Ireland is that increasing reliance on ECB may in turn impact on government debt.

Central Bank Governor Patrick Honohan said last week that the Anglo Irish bailout may cost about 25 billion euros. S&P said the figure may be 35 billion euros.

"Anglo Irish has proved to be an even larger black hole than anyone imagined," said Bill Blain, joint head of fixed income at Matrix Group in London.

“There are worries that the cost of banking recapitalization is now beyond the reach of the government.”

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