

# ThePost.ie

## The key hurdles now facing Ireland

29 August 2010 By Cliff Taylor

It was a bad week, sparked in large part by the decision of ratings agency Standard & Poor's to downgrade our debt rating.

By last Friday evening, the interest rate premium quoted on ten-year Irish government bonds, compared to those of Germany, had risen to 3.7 per cent, its highest level since the euro came into being.

So what are the things which are unsettling investors? They are the key hurdles which Ireland has to jump on the course it has set for itself.

We set them out below.

### **1. Anglo: not an open-and-shut case**

Above all else, in recent weeks, investors have become increasingly concerned about just how much money Anglo Irish Bank will consume.

This took centre stage a few weeks ago, as the EU cleared the government to put in an extra €10 billion on top of the €4 billion-plus already committed, a total of over €24 billion. Anxieties were fuelled by the Standard & Poor's estimates that, in fact, Anglo might cost up to €35 billion.

A key issue now for the government is to clarify once and for all the likely cost of Anglo, something it will only be able to do when the EU Commission rules on the bank's proposed rescue plan next month.

Much of the public debate on Anglo Irish Bank can be summed up in one phrase:

"Why are we planning to spend €24 billion to rescue this bank?"

Putting the question this way shows a fundamental misunderstanding of the issue.

The vast bulk of the money which has been spent - and will be spent - is not going to 'rescue' Anglo Irish Bank.

It is going to clear up the extraordinary mess which the bank's practices of recent years have left behind. A small part of the total - perhaps €2 billion - might be used to provide capital to a revived and much smaller Anglo, depending on what the EU decides, but the vast bulk of the cash is to clean up the mess.

The fundamental problem with Anglo is the gap between its assets and its liabilities.

The full extent of this won't be known until all the losses are transferred to Nama and a full examination is completed by the Financial Regulator of the non-Nama loans, but the government has estimated the gap to be filled by the state at around €24 billion.

Somebody has to fill this gap. So let's look at who might do it.

Are there liabilities which Anglo can decide not to pay?

First in line when a bank loses money are the shareholders.

In the case of Anglo, they have already been completely wiped out.

Next in line to fill the hole in a bank's balance sheet are other investors called subordinated bondholders.

This is the point at which most people's eyes start to glaze over.

But it is straightforward enough.

These are investors who lent the bank money and accepted a higher rate of interest in return for being next in line to take a hit after the shareholders.

The amount of subordinated debt left in Anglo, according to its 2009 annual results, is €2.4 billion.

The EU Commission will have a big say in what happens here, but it appears likely that none - or very little - of this money will be repaid.

However, it is only one tenth of the overall government estimate of the Anglo bill. After the subordinated bondholders are another group.

These are called 'senior debt' holders.

These are also investors who loan money to a bank.

They accept a lower interest rate than subordinated debt holders on the basis that they are taking less risk.

Anglo's latest accounts show that it has about €15 billion of senior debt, though this figure will have fallen in the intervening period. Should these bondholders take some of the losses?

The government, so far at least, has argued not.

The view has been that renegeing on senior debt - probably done by enforcing some kind of debt

forequity swap on bondholders - would damage Ireland's reputation, making it difficult for the government and the other banks to raise funds from investors.

Interestingly, the influential Financial Times came out in support of forced debt-for equity swaps in Irish banks in an editorial last Friday. Government sources argue that, under current EU and Irish law, senior debt holders have the same rights as depositors and that it would be legally almost impossible not to repay them, unless depositors were also hit.

We should also note that much of the senior debt now in Anglo was raised under the guarantee introduced by the government in September 2008 and then extended into the later eligible liabilities guarantee.

As of the last accounts, €7.4 billion had been raised under the guarantee and this figure is now probably above €10 billion. Outstanding pre-guarantee senior debt may be down to €4 billion-€5 billion.

Central Bank governor Patrick Honohan hinted in his report on the banking crisis that, had the government not covered existing debt in its guarantee, these bondholders might have been negotiated with to save some money. ] The government would argue that it is too late for that now. Some critics argue otherwise. Finally, we come to depositors.

There were €27 billion of these as of last December and probably fewer by now, as larger corporate depositors pull out, with the possibility of the guarantee on their money lapsing by the end of September.

Retail deposits up to €100,000 will remain covered.

Few would argue with the assertion that, under all circumstances, depositors must be repaid.

There is one final complication in the Anglo situation.

The reason the bank cannot be shut immediately, the government has argued, is that the deposits would all have to be repaid immediately, along with money loaned by the European Central Bank and the Central Bank of Ireland to provide funding.

So the close down, as well as trying to minimise the gap between assets and liabilities, will also have to ensure that there is not a sudden call for the owner - the state - to provide funds as the liabilities all crystallise at once, while the assets would take years to sell.

Critics of the 'keep Anglo open' approach believe some arrangement could be made to transfer the deposits to another institution, as part of a wind down over a period. As with all the big decisions on Anglo, the EU will again have a big say here.

The bottom line is this.

Unless there is a change of tack and some attempt not to repay the senior debt holders, the vast

bulk of the Anglo bill will fall on the taxpayer. At least being able to estimate this with confidence would provide some reassurance to the financial markets.

## **2. Bank funding and the ‘wall of money’**

The focus is generally on money raised by the exchequer. But the banks need to raise money too, to finance their day-to-day operations.

In particular, there have been fears about the large amount of bank bond funding due to mature just before the end of September - the date the original bank guarantee runs out.

The figures are confusing here and a little opaque.

In April, in the Dáil, the Minister for Finance said that some €70 billion in bank funding was due to expire before October, of which €57 billion was senior debt and €17 billion was short-term interbank funding.

Other research has pointed to the concentration of these maturities in mid-to late September, with Citibank, for example, estimating that €13 billion is due to mature next month alone.

In reality, the figures may not be quite so daunting.

The banks are shrinking their balance sheets, as loans are transferred to Nama, and thus need less funds to conduct their business.

Also, they can use the Nama bonds they receive in return for their loans as collateral to allow them to borrow cash from the European Central Bank, providing an alternative source of funding.

However, if the banks are to return to normal operations, they will have to raise funds on the open market sooner rather than later.

Irish bonds experts Glas Securities estimate that the banks need to raise around €15 billion by the end of the year. In theory, ECB cash in return for Nama bonds could meet the bulk of this, but this would just be an extension of the kind of “life support” which the ECB is providing, which should be decreasing.

An additional problem is that, as things stand, the bank guarantee on corporate deposits of less than three months will finish at the end of September.

There is a risk that some of these mobile deposits will leave the Irish banking system, putting further pressure on funding.

The wall of money argument may be overstated, but bank funding is a major issue in the months ahead.

### **3. The future of AIB is still uncertain**

It is often forgotten in the public fuss over Anglo, but AIB has still not made much progress on its route to recapitalisation, due to be completed by the end of the year.

According to the Financial Regulator, it needs to raise €7.4 billion in new capital by December.

No announcements have been made so far on the planned disposal of assets, though talks are under way in relation to planned sales at home and abroad.

However, with AIB currently valued at just €1 billion on the stock market, a significant injection of state cash and majority government ownership appears to be on the cards.

### **4. The Nama exposure**

Nama is finally up and running, and the transfer of loans is proceeding.

The writedown on the first tranche was 50 per cent, rising to over 55 per cent on the second tranche.

Investors will remain concerned about the long-term risk of losses emerging on this. S&P angered the government by including the Nama liabilities, but giving no credit in its calculations for the value of the loans being taken on, on the basis that little would be sold over the next few years.

The best the government can do here is to ensure that the transfers are finished on schedule at the end of the year and then emphasise the clear value in some assets, such as a substantial land bank in the City of London, for example.

### **5. Closing the budget gap**

Ireland got a lot of credit on international markets for the budgetary measures it took last year.

However, even after doing this, the underlying level of borrowing - before taking account of the bank bailout - is still likely to be 11-12 per cent of GDP this year. Now investors are focusing on the difficulties for the government of closing the gap further.

There are two issues here.

The first is the international fear that the world is heading for a double-dip recession and that government programmes to slash spending and hike taxes in many countries will intensify this.

The second issue is whether the government can deliver on its promises to take €3 billion off the deficit in this budget and achieve further major savings in each of the next two budgets.

Central Bank governor Patrick Honohan suggested, in a recent speech, that some of the measures

to be taken in the December budget should be announced well beforehand in a move to reassure the markets.

It will be interesting to see whether the government follows this suggestion.

© Thomas Crosbie Media 2010.