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So much for a line in the sand

It was meant to herald a fresh start, but the transfer of loans to Nama highlighted those banks in deepest difficulty

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There is an old joke about an American tourist who visits a Dublin restaurant. He sits down and calls over the waiter.

Curious, he asks why there is no lid on the restaurant's lobster tank. Isn't the owner afraid, the tourist asks, that the expensive lobsters will escape?

Not at all, replies the waiter. These are Irish lobsters, if one tries to escape the others will drag him back down again.

Last week's momentous series of events in the banking sector was much like life in the lobster tank.

The first passing of loans into the National Asset Management Agency (Nama), Ireland's "bad bank", the setting of tough new guidelines on capital by a new Financial Regulator and the finance minister Brian Lenihan's statement on the recapitalisation of the sector, were all landmark events.

It was "a drawing of a line in the sand", Lenihan declared. It was meant to be the basis of a new start.

For three institutions at least — Bank of Ireland, Allied Irish Banks (AIB) and the Educational Building Society (EBS) — it appears that way.

Bank of Ireland is expected to push the button as early as May on a rights issue that will raise up to €1 billion from the market. Deutsche Bank has already started to sound out domestic and foreign institutions on its behalf.

If the government converts €1 billion of preference shares into equity as expected, Bank of Ireland will end up 40% state-owned but, crucially, will avoid majority state ownership.

Richie Boucher, the chief executive said: "We would be looking to maximise the amount of private capital we can get from the market."

AIB also began disposing of its foreign assets, hiring advisers to sell its investment in a regional bank in America and its British and Polish banking franchises.

The bank believes it can achieve agreement on sales by the end of the summer and raise more than €5 billion. It will then launch a rights issue, similar in scale to Bank of Ireland's. In the face of widespread scepticism, AIB too believes it can avoid majority state ownership. That would represent a significant turnaround, given that government sources anticipate the state could end up with a 75%-80% stake in AIB.

Even EBS, the mutual minnow that got sucked into commercial property, is attracting interest. A consortium of private equity houses led by Cardinal Capital Group, an Irish fund manager, last weekend approached the society's chief executive Fergus Murphy with a proposal to invest.

EBS will require €800m in capital following the transfer of its loans into Nama and the introduction of the new capital rules. That is up to twice the size of earlier estimates, but private equity could pick up half of the tab.

The reviews for last week's restructuring plan for the banks are positive, with international debt rating agencies and the International Monetary Fund nodding approval.

Gerry Keenan, the chief executive of Irish Life Investment Managers (ILIM), said: "I think the actions by the minister and the regulator in relation to the banks are the correct actions with the greatest prospect of putting financial services in Ireland back on a sound footing.

"Like everyone else, I am horrified by the Anglo numbers."

Anglo chief executive Mike Aynsley last week revealed losses for the 15 months to the end of 2009 of €12.7 billion.

So last week, once again, the big story was the runaway disaster that is Anglo Irish Bank and, to a lesser extent, Irish Nationwide building society. The taxpayers' bill for the salvation of the two institutions is rising. It is €25 billion, with Anglo accounting for €22 billion of that figure.

Due to its huge losses relative to its size, Irish Nationwide, which is led by Gerry McGinn, requires roughly the same capital as Bank of Ireland, an institution 10 times its size.

Bond expert Jim Ryan of Glas Securities, said the hardline, "one step" approach to bank restructuring drew a positive reaction abroad and Irish sovereign debt "ticked up". Anglo remained "a potential negative", Ryan said, but the clear capital plans for the two main banks meant that Anglo would begin to become isolated in the minds of investors.

A clear distinction is emerging. And Bank of Ireland's Boucher was quick to reinforce it. "We don't have strategic challenges in Bank of Ireland, we don't have broken business models," he said.

Boucher, of course, has come top of the class. Bank of Ireland has begun to transfer €12 billion of assets to Nama, down from an original projection of €15 billion. The discount — or haircut — applied to the loans was 35%, the lowest for any institution. Boucher admitted "it's not a proud boast to say you are the least worst", but added: "We always believed, despite the fact that we had significant problems, that our portfolio would survive better in the discounting process."

ILIM's Keenan said the market would "look forward" to the Bank of Ireland rights issue.

If Bank of Ireland is looking the closest to recovery, its main rival still has some way to go.

Last weekend, AIB and Matthew Elderfield, the Financial Regulator, were involved in "robust debate" on capital levels, sources say. Colm Doherty, the group managing director at AIB, supports elevated levels of capital for Irish banks. But he has also argued that the banks should be given more time to amass those reserves.

Elderfield is standing firm on the level of capital required, 7% of the bank's total assets, and on his deadline of achieving that by the end of this year.

He has also insisted on substantial “capital buffers” to help AIB to absorb further economic shocks. These buffers have added a further €1.1 billion to AIB’s capital requirements.

More bad news followed for Doherty with the transfer of the first loans to Nama.

Analyst models had put AIB’s discount on Namadestined loans at 35%. The bank expected that the first tranche of almost €3.3 billion would get a haircut closer to 40%.

Nama’s 43% discount on the first tranche exceeded AIB’s worst estimate. Applied across the book, it would create losses of more than €9 billion. AIB’s shares tanked on the news.

There had been a widespread belief that AIB was on track to secure its capital needs through raising as little as €300m to €400m from the market.

The combined effect of the Nama haircut and the regulator’s stance pushed its total capital need to €7.6 billion, so it may now have to raise €1 billion from the market.

Despite this, AIB still believes it can escape effective nationalisation. The sale of its stake in M&T bank in America will most likely happen through a private placing in May or early June. It is estimated that M&T will reap a profit of almost €1 billion.

But the key element of the disposal programme will be the sale of Bank Zachodni WBK, its Polish operation. Analysts have put a broad value of €2 billion on AIB’s 70% stake. In the two days following the announcement, the value of AIB’s holding in the publicly quoted bank rose sharply and is now valued at €2.6 billion.

“This is the most interesting bank that could come on the market in Poland,” said one banker last week. “It’s got a decent size, critical mass, and a good deposit base.”

Zachodni is a foothold for newcomers, while “those that are already present in Poland may theoretically pay more as they could benefit from synergies”, said Marcin Materna, an analyst at Warsaw’s Bank Millennium. Societe Generale, BNP Paribas and HSBC Holdings are possible candidates.

The final leg of Doherty’s disposal plan is the sale of AIB UK , a small business bank in Britain, and First Trust bank in Northern Ireland.

Even if both make only book value, it will take €18 billion of loans off of the group balance sheet. That could be critical to AIB reaching its capital target.

The key concession wrung by Doherty from the Financial Regulator was that AIB does not have to bank the proceeds from its sales by the year end. If the bank gets sales agreed subject to normal regulatory approval, particularly in Poland, it will get credit for capital purposes even if the cash has not hit the balance sheet.

“Clearly, the market hopes AIB can find some rabbit in the hat that will prevent them having to take the full [government] preference shares or more,” said ILIM’s Keenan.

Regardless of whether the state takes a majority position, AIB will be “a valuable investible proposition one way or the other”, he said.

MAKING the top banks “investible” is not the point. Lenihan has announced the top two will advance a further €3 billion to small and medium-sized enterprises, commit €10m to the government’s Enterprise Ireland venture funds and €100m in lending to renewable and energy-efficiency sectors.

Higher lending commitments in the last bank restructuring, in February 2009, failed to stimulate lending. There are those who believe that the capital levels demanded by the new regulator will prove a disincentive to lending. The more banks shrink their balance sheets, the less capital they must hold.

“On the one hand, the government wants banks to lend more, yet through the regulator, they want to make banking safe, therefore lend less,” said Cormac Butler, an equity trader. “If banks are prevented from lending, expect more bankruptcies and therefore a greater banking risk.”

Inevitably, the cost of banking will rise. Goodbody stockbrokers estimated that lower interest rates in 2009 provided a €5.5 billion boost to Irish business.

It may be a while before the economy gets free of the tank.

How Anglo changed the banking universe

The Cern laboratory in Switzerland and its Large Hadron Collider would be challenged to measure the depth of the black hole at Anglo Irish Bank.

The size of the capital shortfall at the now state-owned operation has grown from €1.5 billion at the end of December 2008 to an astonishing €22.5 billion at the end of March 2010. It may get deeper.

The bank reported losses of €12.7 billion for the 15 months to the end of last year, including provisions for loan losses of €15 billion.

Without Anglo there would have been a banking crisis in Ireland, similar to crises in other economies. But the bank took the country’s problems to a new level.

Last week, the bank’s new chief executive Mike Aynsley, an Australian, came closest to fingering why Anglo went so bad. “Hubris played a very, very big part,” he said.

Sean FitzPatrick, David Drumm and his followers became so enmeshed with entrepreneurs and enterprise, that they began to think and act as though they were entrepreneurs themselves.

These were bankers who forgot they were bankers. The bank board was stacked with Anglo executives, former executives or entrepreneurs. The dividing line between those who take risks, and those whose primary job was to manage, control and measure risk became blurred.

Brendan Murtagh is a classic example of Anglo’s attitude to risk. He was a director and large shareholder in Kingspan, the maker of insulation panels and floor tiles.

At the peak of the boom, Kingspan shares reached €22. Murtagh was a very wealthy man. He invested and became a key shareholder in a property company, Howard Holdings.

Anglo lent to Howard and took personal guarantees from Murtagh as security.

Kingspan and Howard were both exposed to the commercial property. So when the market turned, both Howard's property assets and the Kingspan shares went in the same steep downward direction. Anglo's "comfort" security was gone. It was poor risk management.

In many property deals, Anglo would lend to wealthy individuals to fund their equity participation in a syndicate. It would then lend the syndicate the money to purchase a property.

As a result, the loan to value on the deals was in effect 95%-100% and the bank was totally exposed to the fall in value of the property.

Brendan McDonagh, chief executive of the National Asset Management Agency (Nama), said last week that it was the emergence of these types of deals that led to the steep widening of discounts on loans transferred by Anglo and Irish Nationwide.

"In some cases where banks said they were lending at 75% loan to value, that ended up close to 100% loan to value," he said.

He added that Nama is attaching no value to personal guarantees.

Maarten van Eden, Anglo Irish Bank's chief financial officer, says that another big problem was that Anglo was lending-driven.

Rather than raising deposits to then lend to clients, Anglo did things the other way around. The bank went out and sought deals and then "back filled" with funding. And unfortunately for the Irish taxpayer, funding was both bountiful and cheap.

Aynsley tells the tale of a pub entrepreneur he met shortly after arriving in Ireland. The businessman did not bank with Anglo, but was courted by it.

He recounted to Aynsley how he was met at a pub auction by a Anglo loan officer with a cheque for €500,000 "for the deposit if you need it".

Anglo has also made €5 billion of loan loss provisions outside of its Nama-bound commercial property book.

The bank has large exposures to entrepreneurs such as Seán Quinn and Barry O'Callaghan, of EMPG. In both cases, the bank's security was limited and largely on the men's shares in businesses.

The reason why the other Irish banks set off in pursuit of Anglo was not just the short-term impact of a year's record profits, or the lure of commercial property. What AIB particularly feared was the loss of a generation of Ireland's wealthiest business leaders to Anglo, a tectonic shift in Irish banking.

In the new Irish banking universe, there will be a different attitude to this kind of name lending and to risk. And not just at the new Anglo.