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Funding crux for the banks

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There has been a lot of focus on the €20 billion-plus which the government needs to raise this year, of which around two-thirds is already raised.

But what about our banks? We need the government to be able to raise money to keep the state operating. However, we also need the banks to be able to raise money to keep themselves operating.

Banks cannot get all the cash they need from depositors. To get the rest, they borrow from the markets in various forms. Of course, Ireland's banks became too reliant on this source of funding during the boom years, borrowing money abroad and shovelling it out at home.

Now, they are trying to reduce their dependence on cash raised in the markets.

They also had hoped to wean themselves off the need for a guarantee from the Irish government to raise funds, though whether this is possible will depend on market conditions in the months ahead.

The key date in the short term is the end of September. Our banks have billions in borrowing maturing over the coming months – and particularly in September, when the guarantee given in September 2008 runs out and €25 billion-plus in bank bonds mature.

A separate guarantee on some borrowings – the so-called “eligible assets guarantee scheme” – runs out in its current form for the banks at the same time, though it is likely to be extended to December.

Just how much cash do the banks have to raise? The best way to analyse this is to break it down into long-term and short-term debt.

In looking at longer term borrowing – for a year or more – bond expert Glas Securities estimates that the banks had €51 billion in maturing longer term (ie, a year or longer) bonds this year, out of total bond liabilities of €115 billion. Some €25 billion of this is due to be repaid in September. This is a large bloc of money to be refinanced at one time.

Glas estimates that the banks have so far raised some €18 billion this year in bond issues, again almost entirely by the eligible liabilities guarantee, which also expires around September, but for which the state is now seeking an extension until December.

Glas reckoned that, overall, the banks would try to raise €30 billion to €35 billion this year, meaning a fair amount is still left to be raised.

The fact that the banks do not have to replace the full €51 billion in maturing long-term bonds is because they are becoming smaller. They are transferring assets to Nama and lending out less at home and abroad. So they need less funding.

The Nama process also gives them access to a new source of funding, as the bonds they are given by Nama in return for their assets can now be used as collateral to get cash from the European Central Bank (ECB). Given that the banks will get around €43 billion in Nama bonds, this is a significant source of cash, though it will only come on stream gradually this year and next, as the assets are transferred.

A few months ago, the goal of the two big banks would have been to try to start weaning themselves off the ECB as a source of funds, and to try to move out from under the cloak of the government guarantee, raising funds without being underwritten by the state. The current market conditions make this impossible, at least for the moment.

Bank of Ireland, for example, has indicated its desire, following its recent rights issue and capital restructuring, to start raising non-guaranteed funds. In current market conditions, this will have to be put on hold.

It remains to be seen whether conditions will ease by autumn. AIB, meanwhile, is further behind, having still to map its recapitalisation.

A particular and unique problem relates to Anglo with €9 billion of maturing debt in 2010 and already heavily reliant on ECB and Central Bank cash. There is, as we know, a big hole to be filled here and finance minister Brian Lenihan has indicated that substantial additional state funds will be needed.

Whatever about Anglo, the government, the banks and the EU would have hoped that, by the end of this year, the main banks would be able to raise cash without a guarantee, a key goal of the restructuring plans submitted to Brussels. In particular, issuance of new bonds would be needed in the autumn, around the time the original guarantee expires.

If all this issuance is still under guarantee and the markets remain nervous, it will not bode well for a return to normal banking conditions in 2011. Were the markets to deteriorate further, the banks could even struggle to raise cash at reasonable rates. In a nightmare scenario, a withdrawal of deposits, most likely by large corporates, could lead to a funding crisis.

The banks also need to raise short term cash “ for periods of less than one year “ as another way of meeting their funding gap. We do not know the full total amounts involved here.

A calculation by UCD economist Karl Whelan, drawn from the annual reports of the banks, shows that around €77 billion in bond investments fall due by December, or shortly afterwards. This would include the €51 billion mentioned above as long-term debt, plus further short-term bond instruments which the banks use to borrow, such as commercial paper programmes and commercial deposit programmes (generally counted as money market instruments despite being

termed "deposits"™).

As well as these, the banks would have other short-term funding on the interbank markets.

In terms of short-term funding, market nervousness is also having an impact. US investors, in particular, are now loath to lend to EU banks, making it difficult to raise cash through US commercial paper programmes.

Meanwhile, other bank lenders are now only prepared to advance cash for shorter time periods " for example, lending for one month, rather than three.

This is similar to what happened in September 2008 after the Lehmans bust and, if continued, will leave the banks increasingly reliant again on ECB funding, as they were back then.

And again, short-term funding is still covered by the government guarantee, a fact that is particularly unpopular in Brussels and which is unlikely to continue into 2011, even if some guarantee remains on longer term borrowings.

So, if market nerves do not settle, the risk for the banks is twofold. First, they may struggle to raise long-term funding, particularly to replace the debt which matures in September, and will not be able to wean themselves off the government guarantee.

Second, for short-term funding, they will be forced to roll over more and more funding at regular intervals, leaving them exposed if another full scale crisis hits and " again " overly reliant on central bank support. If there is any pressure on deposits as well, then they could hit difficulties.

The current "chassis"™ in the markets thus threatens the path of the banks back to normal operations. We must hope that the improving market tone seen in the last few days is a sign of things to come.

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