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Introductory remarks by Governor Patrick Honohan at Oireachtas Banking Inquiry

11 March 2015

In my letter of February 12, I sought to clarify parts of my evidence to the Inquiry on January 15. I have prepared these short introductory remarks on the presumption that the Inquiry has invited me back on this occasion to amplify my views on the alternative courses of action that might have been taken by the Government at the end of September 2008.

Perhaps I should recall explicitly that I myself had no involvement in the guarantee decision. So my views are based on what I learnt from preparing my May 2010 Report on Regulatory and Financial Stability Policy, as well as on many conversations with other experts and on my general knowledge of banking crises in other countries.

Critique of the decisions of end-September 2008

There are several features of the decisions at end September that can be criticised even allowing for the limited information then available to the decision makers.

- First, the guaranteeing of some of the subordinated debt. Providing an explicit guarantee to subordinated debt holders is not only potentially costly to the State but undermines the rationale for allowing banks to meet part of their regulatory capital with subordinated debt. This was a definite design flaw. True, thanks to steps subsequently taken, the payout to subordinated debt holders of Anglo in the end was a small proportion of the total fiscal cost; however, they were not negligible.

- Second, guaranteeing existing outstanding debt (senior bonds and term deposits). This was not necessary to underpin the banks' continuing access to funds. Nor did the government guarantees introduced by other countries in 2008 offer any significant backward looking protection in this way. It is true that imposing losses on such bondholders would have had a damaging reputational effect on Ireland as a whole, as well as impacting local holders of such bonds; but that is a different question. The decision to impose such losses could not have been lightly taken; but offering a pre-emptive guarantee on already outstanding ("old") debt ahead of a full assessment of what it might cost was essentially gratuitous. Furthermore, because much of this debt entitled the holders to immediate accelerated repayment in "an event of default", the Government were effectively precluded from liquidating or extensively restructuring the guaranteed institutions because they would have to repay the guaranteed debt forthwith (which they would have been unable to do). This effectively postponed drastic restructuring action until the end of the guarantee period, by which time the Government's entry into the EU-IMF programme was imminent.
- Third, failure to consult. The Irish decision to provide a blanket guarantee, without prior consultation, triggered immense pressure for guarantees all over Europe. Other governments resented the Irish action and this has made it difficult for the Government to make its case for burden-sharing with Europe.
- Fourth, failure to seize immediate control over the management of Anglo. It should be assumed that the existing management of a bank whose business model has lost the confidence of the market and which has run out of cash have neither the expertise nor the incentive to recover the situation safely. The public authorities should have intervened immediately to take control of the bank, for which nationalisation was the available tool. Fortunately nationalisation did follow in January 2009 without evident value destruction having taken place in the intervening period.

How much does this matter?

Having made those criticisms, it is important to keep the scale in perspective. The decisions on the night of the guarantee did of course have consequences for Ireland. But there has been a tendency to overstate the extent of the impact of that night's decisions on the subsequent welfare of the nation. It would be hard to deny that most – I would hazard a figure of at least 80-90% – of the overall hardship that followed the bursting of the bubble, was (albeit unbeknownst to the decision-makers that night) already inescapably embedded in the situation. The damage had been made unavoidable by the unrestrained credit and property boom. (The fiscal austerity measures that have had to be taken are not just due to the €40 billion or so in additional net debt that can be linked to the guarantee, but also reflect the far larger impact of the ending of the construction boom on the Government's tax revenue and spending needs. And the fiscal costs are only one aspect of the total damage to Ireland).

In my letter to the Inquiry of February 12, I have distinguished between a hypothetical "hindsight" scenario (1), in which the Government would have been convincingly advised of the actual likely magnitude of the cost of a guarantee, and the actual scenario (2) with only the information available at the time.

In the actual case the Government had no information at hand indicating that any of the banks were about to experience losses far in excess of their capital reserves. What I have suggested as the best course of action (given the lack of such information Scenario 2) – buying time for negotiation with partners, seizing control over the two failing banks, and limiting the scope of the guarantee – could hardly (unless those negotiations had proved remarkably successful) have reduced the direct fiscal bill by more than a few billion – a fraction of the actual damage.

The alternative (under the hindsight Scenario 1) of bailing-in some of the bondholders and depositors of Anglo and INBS would have imposed additional disruption to economic activity and capital formation which would have offset a lot of the savings to the State from not paying the creditors.

I conclude that the need for "austerity measures": the scale of tax increases and expenditure reductions that have proved necessary since, could have been reduced somewhat, but not all that much, by anything done at the end of September 2008.

Maintaining perspective

As I have remarked recently, the boom and the bust both damaged our economy. The boom, and the decisions that were taken during it, meant that Ireland had to adjust down from living standards that could never have been sustained, with sizeable and capricious shifts in the distribution of wealth.

The style of banking in Ireland, its regulation and broader economic policy were strongly influenced by comparable styles adopted at that time in countries often used as exemplars for Irish decision makers, and in particular the US and UK. But the scale of the excesses in Ireland put its banking crisis in a different league (though not as bad as Iceland).

The extent and nature of the guarantee decision frustrated subsequent efforts to minimise the costs and speed the recovery. But the bulk of these costs could not have been avoided by a different course of action on the night of the guarantee.