Banks must pay fair price for very valuable insurance policy

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The charge to the banks for the Government guarantee should be high to compensate for the risk the taxpayer is taking on their behalf, writes Alan Ahearne

IRISH BANKS, like banks everywhere, are inherently prone to instability. This is because banks' assets, which largely take the form of loans to businesses and households, cannot be converted into cash quickly and easily. In contrast, banks' liabilities, such as customer deposits and short-term borrowings from other financial institutions, are highly liquid and can be withdrawn suddenly.

In normal times this mismatch of assets and liabilities does not pose a problem, because depositors feel secure leaving their money on deposit and banks are willing to lend to other banks. But these are not normal times. The global financial system is under unprecedented stress. Banks' access to funds on interbank markets has effectively evaporated over the past two weeks.

Pressures on the financial system soared to crisis levels on Monday night after the US House of Representatives voted to reject the Bush administration's $700 billion rescue plan. The vote came on a day when contagion had become a frightening reality, as problems in the US financial system spread to Europe. Yesterday morning, the Government responded to the market turmoil by guaranteeing with immediate effect most of the liabilities of the six main Irish-owned financial institutions for the next two years. The State guarantee will also extend to subsidiaries of these banks. The financial exposure for taxpayers is enormous. The guarantees cover roughly €400 billion in deposits and debts, equivalent to about 210 per cent of Ireland's GDP.

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The lion's share of the liabilities covered consists of deposits. The blanket guarantee by the Government means that deposits at the banks should now be regarded as completely safe. Such a move is not unprecedented. Governments in other countries have in the past guaranteed all deposits when their banks ran into trouble, such as in the Nordic countries in the early 1990s.

Most depositors here were already covered by the recently revised deposit insurance scheme for up to €100,000. However, many individuals and businesses hold deposits in excess of €100,000. Had the Government not offered an unlimited guarantee, we may have seen over coming days a significant shift in the uncovered portion of these deposits from the private financial institutions into An Post. Funds would also likely have moved from the smaller institutions to the two larger banks, Allied Irish Bank and Bank of Ireland, which many perceive as being too big to fail. The unlimited guarantee greatly reduces the risks of an old-fashioned "bank run" precipitated by fearful depositors, along the lines of what occurred last year in the UK in the case of Northern Rock.

The Government's scheme also guarantees banks' debts such as covered bonds, senior debt and dated subordinated debt. This part of the scheme may prove more controversial, especially the extension to cover subordinated debt. The risk to the taxpayer of guaranteeing covered bonds and senior debt is probably small, since these loans are often secured by collateral. The risks of an Irish financial institution not repaying its subordinated borrowings are greater - and therefore so is the exposure of the taxpayer.

Of course, the immediate threat that faced one or more Irish financial institutions presumably stemmed from their inability to access short-term funding. In other words, Irish financial institutions faced a bank run by fearful capital markets and other banks. A run on a bank's liabilities is likely to bring down a bank, irrespective of whether those liabilities are deposits or loans from other banks.

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A crucial question is what the Government will get from the six financial institutions in return for offering unlimited guarantees. On this score, the Government has so far been vague. All the Government has said is that "the guarantee is being provided at a charge to the institutions concerned and will be subject to specific terms and conditions so that the taxpayers' interest can be protected". The charge to the financial institutions should be set at high levels to compensate for the risks that taxpayers are being asked to take. If a bank or building society refused to pay those charges, then that institution should not have been included in the scheme. What is important to realise is that, contrary to what some commentators have said, the provision of a blanket guarantee is not without cost to the State. The Government is putting at risk public funds to provide financial institutions with an extremely valuable insurance policy.

Interest rates on Irish Government debt may increase to reflect the greater risk that now faces the State finances. These rates will probably move higher over coming months if conditions at one or more of the covered financial institutions deteriorate. These higher interest payments will mean fewer funds available to the Government to spend on health, education, and other items.

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In addition, Irish financial institutions will now face lower borrowing costs than would otherwise have been the case, owing to the fact that their debts are State-backed. These financial benefits should be passed on to the State in the form of a charge.

Moreover, in a scenario where an Irish bank becomes insolvent, the Government would have to make good on its guarantees and assume the bank's liabilities. A key question is whether under this scenario the Government would also take control of the assets. In other countries, governments have chosen to nationalise troubled banks rather than guarantee liabilities. By nationalising a bank, a government gets both the assets and liabilities. A government guarantee scheme should include provisions that the State is given contingent assets to match the contingent liabilities that it takes on board.

Another question raised by the scheme is how it will affect the behaviour of Irish financial institutions over the next two years. Put another way, how will banks and building societies manage their assets now that their liabilities are State-guaranteed?

One concern is that since an important source of market discipline has been removed, financial institutions may show excessive forbearance in dealing with troubled borrowers. The Japanese experience in the 1990s after the property bubble burst there shows that such behaviour can be disastrous for both lenders and the economy. Moreover, will financial institutions be allowed to continue to pay dividends? Will there be limits on executive pay, as in the US plan?

There is also a question as to what extent financial institutions will now be able to raise new funds using risky assets such as mortgages or loans to developers as collateral.

Backed by the Government guarantee, banks and building societies might now be in a position to unload riskier assets. This may be good for the financial institutions, but would increase the risks to the taxpayer. The Financial Regulator's role in supervising and regulating the Irish financial system has just become a lot more complicated.

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