The Economic and Social Review, Vol. 56, No. 1 Spring 2025, pp. 135-138

PANEL RESPONSE: FINANCIAL SECTOR POLICY

Reflections on the Irish Banking Crisis

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I INTRODUCTION

The titans of global banking often like to portray themselves as buccaneering free market entrepreneurs, but the reality is that banking systems everywhere are deeply intertwined with government. While the role that banks play as financial intermediaries is crucial for both savers and borrowers, the combination of fraction reserve banking with maturity mismatch means that, left to itself the banking system is innately unstable.

To keep the show on the road, government-provided backstops such as deposit insurance and a lender of last resort function are required. Governments also need to regulate and supervise the banking sector very carefully because bankers largely prioritise short-term profitability over long-term stability – most banking crises are not accidents but require a combination of bad supervision by governments and bad behaviour by bankers.

More than any other European economist, Patrick Honohan has unique experience both in witnessing how banking systems can collapse and in putting various banking sector Humpty Dumpties back together again.

II BACK TO 2009

Distance can soften the memories somewhat, so it is worth reflecting on the horrendous position of the Irish banking sector when Patrick was appointed Central Bank governor in September 2009:

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- The poor supervision of the Irish banking sector under the previous regime—and particularly the sanctioning of a huge exposure to commercial property during a clear property bubble—was the single biggest economic policy mistake in Irish history.
- And the September 2008 decision to guarantee the liabilities of the domestic banks placed almost all of the cost of resolving this situation on the Irish taxpayer.
- By late 2009 and all throughout 2010, investors and foreign depositors that provided funds to Irish banks were convinced that, on a standalone basis, the Irish banks were insolvent, some wildly so. Their ability to repay their debts relied on the Irish government's ability to back them and then this too came into question.
- By the time of Patrick's appointment, the Central Bank was also supplying large amounts of funding to the Irish banks and this accelerated to extraordinarily high levels by late 2010 as Ireland applied for an EU-IMF programme.

Again, it is easy to think that the signing of an EU-IMF programme in late 2010 was an inevitable turning point to restore stability but the reality was more complex:

- Money continued to flow out of the banks for several months after the deal was signed.
- Irish government bond yields on continued to rise during the first half of 2011, peaking above 12 per cent in July 2011, a level that indicated markets believed a sovereign debt restructuring was more likely than not. And the Irish banks had a decent exposure to Irish sovereigns via their holdings of normal sovereign bonds and the newly-created NAMA bonds.
- Subsequent events in Greece and Cyprus showed investors were in no way irrational to believe that financial crises in the euro area could end up involving sovereign debt defaults, haircuts for depositors and capital controls

III PATRICK'S ROLE

The successful conclusion of the programme, the restoration of the banking sector to stability and the macroeconomic recovery was not in any way inevitable. And Patrick Honohan played several key roles in all of this. I will quickly highlight five key contributions.

First, Patrick was the first official to admit that negotiations were underway for a deal and that he expected these negotiations to be successful. While this was just an admission of the truth, it took bravery to be the first senior official to admit that such a deal was necessary and required at a time when senior politicians had been denying the inevitable for some time.

Second, Patrick played a key role in fending off requests from the ECB for an overly rapid downsizing of the Irish banking sector in order to get the Emergency Liquidity Assistance repaid as soon as possible.

Third, Patrick oversaw the release of the Financial Measures Programme (FMP) report in March 2011. This detailed report provided an unprecedented level of transparency about the financial position of the Irish banks. Looking at the data on deposits and central bank funding, this report seems to have been the key point in stabilising the banking sector and, ultimately, with concerns about banks receding, in stabilising concerns about sovereign default.

Fourth, Patrick played a key role in figuring an acceptable way out of the dreaded promissory note fiasco that had been the poisonous legacy of Anglo Irish Bank and the guarantee. Interestingly, the ex post reality is that the government ended up paying off the Anglo-related debt about as fast as the original promissory note deal had envisaged but the new arrangements had greater ex ante flexibility. It also did not hurt that the arrangement involving the Bank's special portfolio and the NTMA was so complex that there was not a financial journalist in the country that understood the subsequent transactions, so the issue disappeared from the news pages.

Fifth, Patrick oversaw the introduction of new leadership and a new approach and culture for financial supervision at the Bank, as well as the introduction of prudential rules to avoid some of excesses of the mortgage market seen previously. Neither of these changes were easy but both were in the long term interests of the country.

IV COULD IT HAPPEN AGAIN?

We can never say never but I am confident that we have much better structures in place that will prevent this kind of all-consuming banking crisis occurring in Ireland in the foreseeable future. I would point to three things.

First, the regulatory rules for banks put in place since the Basel III agreement, while by no means perfect, are a step forward from what prevailed in the past. Banks are better capitalised and are required to be more careful about their funding arrangements.

On this, I will note that a regular story in the finance pages on the Irish newspapers complains about the Central Bank of Ireland or ECB being "tough" in its regulatory treatment of Irish mortgages and this leading to relatively high mortgage interest rates here. This is an indirect reference to Irish mortgages having a high risk weight when calculating risk-weighted assets. However, I'm afraid this reflects the fact that Irish mortgages are risky. The crisis showed that the Irish legal system does not enforce collection of mortgage arrears in a similar way to other countries; thus increases the Loss element of the Loss Given Default calculation.

As is often the case in economics, nice things for some people lead to not so nice things for others.

Second, the supervisory culture in the euro area, now led by the ECB, appears to be more professional and questioning in its approach than during the early 2000s at the Central Bank. The "dog not barking" of the absence of European bank failures during the recent monetary tightening (unlike in the US) is perhaps a more concrete piece of evidence for the success of the ECB's approach.

Third, there is a new approach to dealing with failing banks. One of the reasons for the patchwork of different approaches to dealing with banking problems in Europe from 2008 onwards was there was no agreed template for how to wind down failing banks or deal with their creditors. The 2015 Banking Recovery and Resolution Directive (BRRD) has given us a new common rulebook across the EU designed to limit the cost of failing banks for the taxpayers. The type of guarantee offered by the Irish government in September 2008 would be illegal today, and rightly so.

The BRRD procedures have not yet come into contact with a systematic banking crisis and the rules might end up being bent in such an outcome. But they are well-designed to ensure that the failures of standalone non-systemic banks such as Anglo Irish should not land huge burdens on future taxpayers.