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Lessons Learned: Patrick Honohan

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Yale Program on Financial Stability Lessons Learned

Patrick Honohan

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Patrick Honohan, an economist, was governor of the Central Bank of Ireland and a member of the Governing Council of the European Central Bank (ECB) from September 2009 until November 2015. Early in his tenure, he led a team that investigated the causes of the Irish banking crisis that broke out in 2008 during the Global Financial Crisis. Resolving the problems of bank failure and over-indebtedness that emerged in that crisis dominated his term of office. In late 2010, Ireland had to request financial assistance from the "troika" of the International Monetary Fund (IMF), the European Commission, and the European Central Bank (ECB). The resulting EUR 85 billion (USD 122 billion) rescue program helped stabilize the economy, which returned to growth after 2012. This Lessons Learned is based on an interview conducted with Honohan in February 2021; the full transcript may be accessed here.

The actions that governments take to fight a crisis are only as good as the government's ability to make good on its promises.

On September 30, 2008, the government of Ireland guaranteed the liabilities of the nation's major banks—one of the most drastic actions taken by any nation in those years. Eventually, two of those banks were nationalized. As Honohan described,

> This was just two weeks after Lehman Brothers, and all of the banking systems were in trouble, and the sense that, as I've been told by many of the participants in other countries, they said, "Wow, Ireland's guaranteed all their banks, we're going to have to do the same too! Because this is setting the scene."
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> But very soon, the attitude changed. People realized, "Actually, the position of the Irish banks is much more grievous, relative to the size of the population, than in most other countries, and this guarantee could cause terrific problems."
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> It was not clear that the Irish government had any good options at that point. The Irish banks had relied very much on borrowing in the international financial markets, and these borrowings needed to be rolled all the time. And on the week of the guarantee, the banks had effectively lost access to those international financial markets. . . .
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> Within a very short period of time, it was likely that the banks would not be in a position to meet the depositors' claims.

Guarantees and liquidity can stabilize a crisis situation, but the work of understanding and correcting the underlying weaknesses must still be done to return the system to long-term stability.

A year after the government guaranteed the bank liabilities, Honohan became governor of the Central Bank of Ireland. The country still had "one of the weakest banking systems in the world," he said, "with great uncertainty over, 'How deep was the hole?'" The guarantee had bought the government time, but Honohan realized that long-term stability was not certain. He said,

> We knew that the property boom had taken the banks out of their comfort zone. They thought they were in their comfort zone, but they weren't! And that had already ended at the end of 2007. Property prices were falling, because of the general downturn. And, because the property market had collapsed, the government's revenues were collapsing, and therefore the government's spending was being constrained, and unemployment was soaring.
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> The economy was in terrible trouble. Nobody knew who would be able to repay their loans. Even the banks didn't know because they had done such a poor job of documenting and underwriting those loans. So, they didn't really know how good the quality of the collateral they had was, and the recoverability of those loans. So, that was the first big task: "How deep is the hole?"

Why was that important? He explained,

> At this stage, what I felt was, first of all, let's not underestimate the problem, because typically, in these kinds of crises, at first people think—"it's not too bad, it's an upset, but it's not too bad." And then after some time, with more and more evidence of losses and loan losses and difficulties, there tends to be an exaggeration. It's quite difficult to determine what the scale of the problem is. You would like to capitalize the banks adequately to meet whatever losses might emerge. You would like to have a situation where the banks had a lot more equity capital, risk-absorbing capital, in their balance sheet. And obviously in the environment where loss of confidence was general, such capital could only come from the state.
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> The state had guaranteed the liabilities of the banks, but it hadn't given them the wherewithal to absorb the losses. Unfortunately, over the previous year or so, the finances of the state had suddenly gone into a tailspin; whereas, as I mentioned, previously they had been at triple-A, and the debt ratio was extremely low. So, the ability of the government to source the funds to inject into the banks to provide that capital was now quite limited. We couldn't just say, "Well, we don't know how deep the hole is, but let's throw in as much . . . let the government throw in enormous amounts of capital, far more than could possibly be needed." That wasn't really an option, so you start having to calculate that impossible-to-calculate element.

Ireland established the National Asset Management Agency (NAMA) to take the developer loans, centralize them, attempt realistic valuations, and eventually sell off the loans. As Honohan recalled, NAMA had loans worth about 30 billion euros, with face value of about 70 billion euros. "This is real money; this is serious stuff," he said. "When you consider that the

Irish economy at that stage was an economy of 150 billion euros GDP, so you're talking about a substantial block of money there."

Understanding the magnitude of the collapse, and how lapses by regulators and the government permitted that collapse, necessitate a more systematic approach to evaluating what stabilizing efforts were needed.

Early in his term at the central bank, Honohan led an investigation into the regulatory and financial stability policies leading up to 2008. That investigation looked at the actions of the Financial Regulatory Authority, the central bank, and the industry. The 200-plus-page Honohan Report found weaknesses across the regulatory system. He said,

> Possibly the most important finding was that the regulators had adopted a sort of deferential and trusting approach to almost all of the banks. They didn't really expect to find that a bank was doing something terribly risky and going to get into trouble, and therefore they didn't find it. And even if they did find evidence, they didn't realize what they had.
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> To give an example, in late 2007, this is what I found: The central bank had realized, "Things are quite seriously wrong now, so let's find out what banks are lending to the big property developers." They took the five biggest property developers, well-known who they were, and the five biggest banks, and they asked each of the banks, "Tell us what you have lent to each of these five named companies."
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> They pooled the information, but they didn't really do anything with the startling finding that each of the banks had grossly underestimated what the other banks had lent to their clients. . . . They would ask one bank, "Well, how much have you lent to this person?" The bank would answer, "Well, I've lent 200 million to him." They'd ask, "How much do you think other banks have lent?" The bank would say, "Well, maybe another 200 million?" But the other banks would have lent around 1,000 million.

The report went beyond the banks and the regulatory structure, said Honohan; it also looked into how government policies and attitudes might have contributed to the growing boom. He continued,

> Actually, the government had stoked up the boom with incentives for construction and so forth. There was a sense that for Ireland, which had had a long run of economic success from the early 1990s, nothing could go wrong, and that you should just sit back and enjoy the boom. However, from the early 2000s, what had been truly a good advance in competitive, export-driven growth had morphed into a property boom. The property boom was the economy by the mid-2000s. And that had not been fully absorbed by policymakers in Ireland.

In 2010, Honohan said, they attempted a first evaluation of how much more money the government would have to put into the banks. That evaluation underestimated the needed capital. NAMA continued evaluating the loans and found additional problems.

In November 2010, Ireland agreed to a EUR 85 billion rescue plan with the troika—the IMF, the European Commission, and the ECB. As part of the rescue, Ireland had to strengthen the capital structure of its banks. "Of course, the only way you measure capital is to know how much your assets are and how much your liabilities are," Honohan said.

> Now the liabilities are clear enough, because you can see people have deposits and bonds. But the assets, what are they worth? In a big downturn, you don't know. At least NAMA had taken away, or was in the process of taking away, some of the banks' most doubtful assets. But still, you didn't know how good their remaining assets are. I mean, the loans to hotels, the loans to residential mortgages, the loans to small businesses, catering for the domestic economy, which was in a tailspin. So, if you don't know what your assets are, you don't know what your capital truly is. You produce a balance sheet, but you really don't know how trustworthy those numbers are. And so to pile on more capital just to be on the safe side is a natural thing to do—if you have the resources to do so. But we were worried that [the troika] wanted the government to take on more commitments than it could afford.

Ireland engaged BlackRock, the asset management and consulting firm, to assist in the deep-dive the troika wanted, said Honohan.

> So, [BlackRock] said, "The banks got to give you loan-by-loan information." Now, even in the United States at that stage, banks were not providing that level of detailed information to regulators. But they were able to say, and we were able to say to the banks then, "Okay, you must give us loan-by-loan data."
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> And [the banks] said, "Well we don't actually have that data; we don't collect it like that. I mean, we have done it somewhere, but there's masses of documentation; we don't have it in a readily available form." "Well, if you don't have it, this is going to end up much worse for you, because you're going to have to put in even more capital, because there's an unknown there." Oh, suddenly, a couple of the banks were able to say, "Well, actually, if we do this and this and this, we can actually give you more or less what you're looking for."

After the review, according to Honohan, for the first time, the central bank had a granular picture of the asset portfolio of the banks and could schedule out the needed assistance. The effort also had lasting impact for the future:

> I mean, we changed the whole way that we as regulators dealt with the banks. We were much more intrusive, and much more questioning of their business models, and demanding to be convinced that what they were doing was safe and was not going to mislead us as to their viability. So that involved internal reconfiguration, restaffing of the regulatory function.

Pay attention to booms.

Like others who have studied or fought financial crises, Honohan is wary of booms, like the property boom that eventually caused such pain for his country. He explained,

> Booms are risky things. Booms are when people have decided that they'll take a chance, and booms can end very badly. So, restraining overexcited financial institutions, overexcited politicians from getting overextended, is the key. Then, if a crisis comes, it'll only be a small crisis. In Ireland, and in Iceland, and in Greece, and in Cyprus, these booms were allowed to continue well beyond . . . survivability. Even in the United States, people moan and complain, and they say, "Oh, the banks were bailed out." To which the answer can be, "Yeah, the US banks were bailed out, but actually, how much did it cost the public in the end? How much did it cost the federal budget? Nothing, it was all paid back."
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> I'm not saying that that justified all the measures that were done . . . . The over-lending situation in the US had not gotten anything as bad as in Ireland in quantitative terms. And so, just a little bit of restraint can have huge benefits. Don't let things get out of hand. Be aware of the scale of possible collapses.

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