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Profiling the Cross-Border Funding of the Irish Banking System

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Abstract

Between 2002 and 2008, there was a surge in foreign funding flows to the Irish banking system. This unprecedented increase in inflows was a key driver of the credit boom in Ireland. In the wake of the domestic banking and global financial crises, the Irish banking system experienced a sharp decrease in its foreign wholesale funding. This Economic Letter addresses two primary questions: (i) who funded the Irish banking system during the boom?; and (ii) how did foreign funding contract in the post-September 2008 environment? The UK and the international interbank market are found to be the predominant funding sources for the Irish banking system during the credit boom. Funding originating from banks in the UK accounted for the most pronounced contraction.

1 Introduction

The recent global financial and domestic banking crises highlighted how internationally integrated the Irish banking system had become. In the period prior to these crises, the Irish banking system experienced a surge in foreign funding inflows, which were a key driving factor behind the credit boom in Ireland. [2]

The period following the collapse of Lehman Brothers and the Irish Government's guarantee of Irish-owned banks' liabilities in September 2008 witnessed a steady contraction in the foreign funding of the Irish banking system.[3]

This Letter examines the evolution of the geographic and sectoral profile of the Irish banking system's foreign funding. The structure is as follows: Section 2 outlines the factors determining cross-border banking in Ireland; Section 3 provides a brief description of the data; Section 4 presents a geographic and sectoral profile of the bilateral linkages of the Irish banking system; Section 5 provides an overview of the contraction and compositional shift in foreign funding in the wake of the global and domestic financial crises, and Section 6 concludes.

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[2]BIS (2010), Honohan (2009).

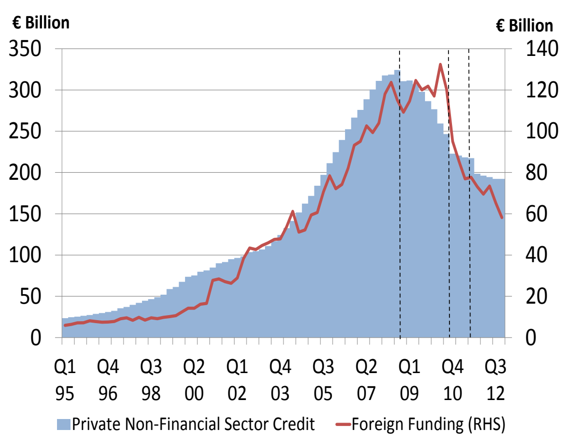
[3]Credit Institutions (Financial Support) Act 2008 was a blanket guarantee of the six Irish-owned banks' deposits and covered debt securities between 30 September 2008 and 29 September 2010. Irish-owned banks included Allied Irish Banks PLC, Bank of Ireland, Irish Bank Resolution Corporation (until liquidation in February 2013), EBS Building Society, Irish Life and Permanent PLC, Irish Nationwide Building Society, and their subsidiaries.

2 Determinants of cross-border banking

The level of the Irish banking system's foreign borrowing trebled between 2002 and 2008. Over the same time horizon, domestic credit to the non-financial private sector grew at a similarly rapid pace, rising from 80 per cent of GDP at end-2002, to 177 per cent of GDP by September 2008.

The peak in domestic credit growth broadly coincided with the Irish banking system's greatest reliance on foreign borrowing. This suggests cross-border funding played a role in fuelling the Irish credit boom during the mid-2000s (Figure 1).

Figure 1: Foreign Funding and Domestic Credit



Source: Bank for International Settlements.

Notes: (i) The dashed vertical lines represent the collapse of Lehman Brothers and the Irish Government bank guarantee (September 2008), the EU/IMF Irish Programme (December 2010) and the escalation of the European sovereign debt crisis (Q3 2011). (ii) The private non-financial sector comprises households and non-financial corporates.

Fundamental economic and regulatory reforms as part of Economic and Monetary Union brought a greater degree of global integration to the Irish banking environment [Kelly and Everett (2004)] while the introduction of the euro increased financial integration among member countries with the removal of exchange rate risk. Notwithstanding these developments, the growth in the foreign funding of the Irish banking system remained relatively muted until the early 2000s.

At this time, the Irish banking system – no longer reliant on traditional sources of funding, such as domestic retail deposits – increasingly availed of new sources of finance to facilitate growing credit demand. Funding of domestic credit was increasingly facilitated by wholesale foreign borrowing via money market instruments, certificates of deposit, commercial paper, and foreign retail deposits. In addition, the establishment of the Irish securitisation market provided the opportunity to borrow from foreign creditors through issuance of securitised debt instruments.

The international leverage of the Irish banking system during the pre-crisis period is not unique. Globally, an environment of low risk, innovation in financial instruments, and increasing financial integration among developed countries led to an unprecedented increase in international banking flows.[4]

3 Data description

The analysis in this Letter is based on unpublished Irish data sourced from international banking statistics collated by the Bank for International Settlements. Two pertinent caveats associated with the underlying data are: 1) a compositional shift in the statistical reporting population; and 2) the location of ultimate asset ownership.

The statistical reporting population of banks is defined by the nationality concept, i.e., country of headquarters. The introduction of the covered bond (Pfandbrief) market in Ireland prompted a number of European banks to amend their corporate structures.[5] Consequently, a number of banks active in the Pfandbrief market were considered as Irish headquartered banks for statistical reporting purposes, and formed part of the Irish data between 2002 and 2011.[6] These Pfandbrief banks were not active in the Irish retail credit market.

[4] Milesi-Ferretti and Tille (2011); Forbes and Warnock (2012) and Merler and Pisani-Ferry (2012).

[5] The enactment of the Asset Covered Securities Act 2001 established the covered bond market in Ireland. This legislation facilitated the issuance of covered bonds (mortgage or public sector credit covered bonds similar to German Pfandbrief securities) by banks with offices resident in Ireland.

[6] Since 2011, the reporting population for these international banking statistics is consistent with those Irish-owned banks covered under the Credit Institutions (Financial Support) Act 2008, as these Pfandbrief banks are no longer headquartered in Ireland.

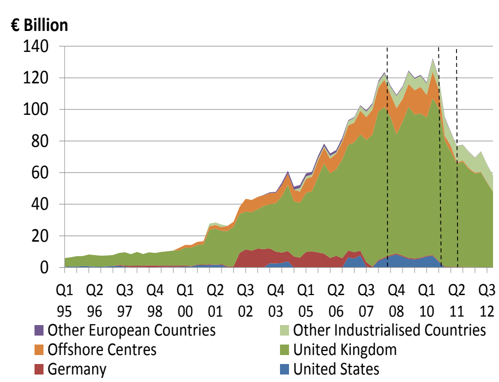
The second caveat concerns the counterparts to the foreign funding of the Irish banking system. Available statistics contain information on the first counterpart investor to this cross-border borrowing. International data limitations prevent *looking through the veil* of transactions via offshore centres and intra-group funding, and thereby partially distort the geographical profile of foreign borrowers. No explicit consolidated data, excluding intra-group positions, are currently collected for the foreign liabilities of banks.

4 From whence it came ...

The distance between countries is a key factor driving banks' cross-border flows [Portes and Rey (2005) and Buch (2005)], with greater distance negatively impacting the flow of bank funding between countries.[7]

Throughout the 2000s the UK remained the predominant source of foreign funding for the Irish banking system, representing 77 per cent of foreign funding by mid-2008 (Figure 2). After the UK, creditors in the US and offshore centres accounted for the most substantial shares of foreign funding at 13 and 5 per cent, respectively, by mid-2008.

Figure 2: Geographical profile of foreign funding



Source: Bank for International Settlements.

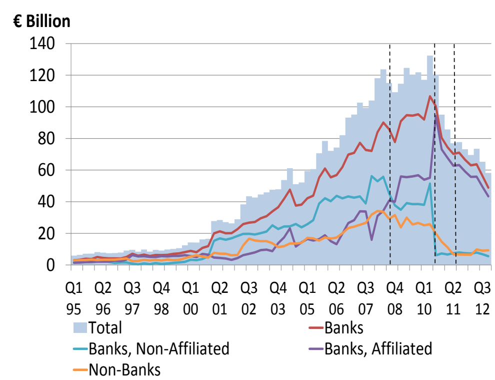
Notes: (i) See Figure 1, Note (i). (ii) Other Industrial Countries include Canada, Australia, South Africa and South Korea. (ii) Offshore Centres include Bermuda, Bahamas, Isle of Man, Jersey and the Cayman Islands.

Germany was the source of approximately 11 billion or 25 per cent of total foreign funding at end-2002. Thereafter, absolute German funding fell quite quickly to below 5 billion, or 5 per cent, by end-2006 and to below 1 billion or 1 per cent by end-2007. Pfandbrief banks headquartered in Ireland accounted for nearly eighty per cent of this funding.

The relative unimportance of other euro area countries as a source of the Irish banking system's foreign funding is surprising. This finding is in contrast to studies showing increasing financial integration among other euro area countries in the 2000s [Waysand et al (2010)].

While the geographic profile of foreign funding remained broadly unchanged between 2002 and 2008, the sectoral profile of foreign funding changed significantly with an increasing reliance on the international interbank market becoming evident from the beginning of 2000s (Figure 3). The expansion in foreign funding was also attributable to increased inflows of foreign retail deposits from the non-banking sector.

Figure 3: Sectoral profile of foreign funding



Source: Bank for International Settlements.

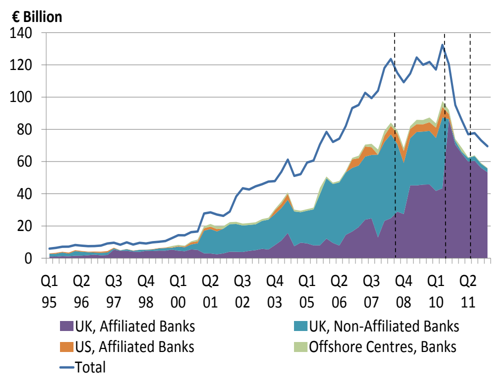
Notes: (i) See Note (i), Figure 1. (ii) Monetary authority funding is considered as a resident-resident transaction vis--vis the Central Bank of Ireland and is not included in the foreign funding of banks. (iii) Non-affiliated banks refer to foreign banks outside the banking group. Affiliated banks refer to parents, subsidiaries and branches within the same banking group.

The interbank market in the UK was the primary source of wholesale funding for the Irish

[7] Other important variables influencing cross-border banking include common language and past colonial relationships.

banking system (Figure 4). Between 2002 and 2008, non-affiliated banks (i.e. unrelated banks outside an Irish banking group) in the UK accounted, on average, for forty per cent of total foreign funding.

Figure 4: Main geographic and sectoral profile of foreign funding



Source: Bank for International Settlements.

Notes: (i) See Figure 1, Note (i). (ii) Offshore Centres include Bermuda, Bahamas, Isle of Man, Jersey and the Cayman Islands.

5 And where it went ...

The global financial crisis brought about an abrupt reversal in funding flows across the international banking sector. While retrenchment in cross-border banking flows was evident across all advanced countries, the impact was most severe for countries with greater levels of international financial integration [Milesi-Ferretti and Tille (2011). Although, the geographic profile of the Irish banking system's foreign funding remained broadly unchanged, the sectoral profile changed significantly.

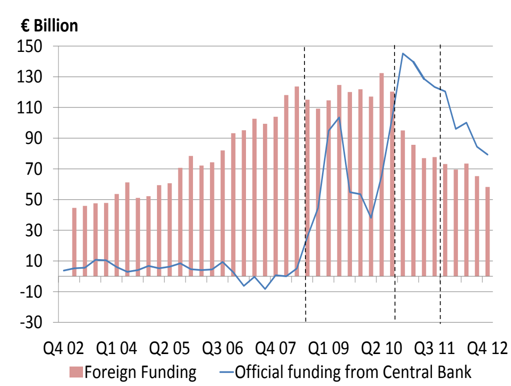
The intensified turbulence in the interbank market, in the wake of Lehman Brother's collapse, exacerbated the perceived underlying weakness in the Irish banking system, with Irish banks finding it increasingly difficult to rollover international wholesale funding. These developments, along with a shortage of collateral needed to avail of monetary authority funding, culminated in the Irish Government's guarantee of Irish-owned banks' liabilities on 30 September 2008 (Honohan, 2009).

Foreign wholesale funding withdrawals amounted to 8 billion, representing a decline of seven per cent in the three months subsequent to the guarantee. This contraction in wholesale funding was driven by non-affiliated foreign banks, particularly those located in the UK. This contraction was partially offset by lending from the foreign non-banking sector which increased marginally in the aftermath of September 2008 (Figure 3).

The composition of the Irish banking system's foreign funding shifted over the next two years as it became heavily dependent on foreign affiliated banks. By early-2009, funding contractions began to reverse, particularly in the case of UK-sourced retail and wholesale funding. Irish banks' outstanding stock of foreign borrowing increased from 109 billion at end-December 2008 to 132 billion by mid-2010. Three quarters of this increase reflected inflows from UK intra-group bank affiliates.

As the expiration of the original Government guarantee approached, greater than anticipated banks' loan losses led to additional capital requirements for banks [Honohan (2012)]. These losses were pushed upwards by the rising scale of discounts applied under transfers to the National Asset Management Agency. This was compounded by increased reliance on official funding from Autumn 2010, due to the inability of Irish banks to raise funds to replace maturing debt that had been guaranteed in September 2008 (Figure 5).

Figure 5: Foreign funding and official funding



Sources: Central Bank of Ireland and Central Statistics Office.

Notes: See Figure 1, Note (i).

This factor combined with the deteriorating conditions of the Irish fiscal balance sheet, ultimately led to Irelands entry into the EU/IMF Financial Measures Programme on 16 December 2010.[8] Foreign funding of the Irish banking system declined during the fourth quarter of 2010 and access to foreign funding continued to decline throughout 2011 and 2012. From the peak of 132 billion in 2010, the foreign funding of the Irish banking system had declined by 74 billion at end-December 2012.

6 Conclusions

Throughout the 2000s, the interbank market in the UK was the predominant creditor to the Irish banking system. In the wake of the events of September 2008, there was a compositional shift in the profile of the Irish banking system's foreign creditors. Declines in foreign funding in the fourth quarter of 2008, driven by non-affiliated banks, led the Irish banking system to become increasingly reliant on borrowing from affiliated banks abroad.

In the run up to the expiry of the original Government guarantee and Irelands entry to the EU/IMF Financial Measures Programme in December 2010, there was a rapid retrenchment in foreign funding. In addition to this contraction, these developments reflected the disposal of foreign assets, including overseas affiliates, as part of the deleveraging strategy pursued by Irish banks and a large increase in reliance on official funding from the Central Bank of Ireland.

More recently, the first half of 2013 saw a number of developments that are indicative of a return towards a relatively normal funding environment for Irish banks. These include the ending of Emergency Liquidity Assistance due to the liquidation of Irish Bank Resolution Corporation in February 2013, the expiration of the Eligible Liabilities Guarantee Scheme in March 2013, and the re-entry of Bank of Ireland to the bond market in June via issuance of an unsecured senior bond. At the international level, increased investor confidence and the re-ignition of international investors' risk appetite will increase the access of the Irish banking system to foreign funding.

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[8] European developments at this time also played a key role (including the announcement of the Deauville Agreement).