

# The irish government's reponse to the banking crisis

[Finance](#), [Banks](#)



## Table of Contents

Introduction

Causes of a bank failure & reasons for a Government to intervene

Government dealing with a bank failure

Evolution of the European financial stability policy in relation to bank failure:

Conclusion

Bibliography

## **Introduction**

Although there is no exact procedure in place for a Government to follow when faced with a failing bank or financial institution, the method of deciding how to respond has become arguably more transparent in recent years.

Previously, bank owners were condemned to a life of hardship as a form of punishment for their failure, whereas today, governments and central banks review a bank failure on a case-by-case basis before deciding how to react.

They try to account for a number of different factors before deciding on the plan they will follow. They will either, intervene and assist the recovery of the bank or supervise the liquidation of the financial institution.

However, the way in which people analyse banking and property crashes has not changed in recent years. In 1860, John Stuart Mill, a famous economist, stated: " a crash doesn't destroy wealth, it merely reflects the extent to which wealth has already been destroyed by stupid investments made

during the preceding boom" (McWilliams, 2015). This leaves us asking, why do banks fail and why do we not learn from previous mistakes? While discussing these questions, you will note I will continuously refer to Anglo Irish Bank. Anglo Irish Bank collapsed in 2008 along with other banks, leaving the Irish economy in a state of panic. I will also analyse how the Irish government reacted to this banking failure and how the evolution of the European financial stability policy.

## **Causes of a bank failure & reasons for a Government to intervene**

Banks, majority of the time, are considered the safest place to keep your money. However, banks can fail from time to time and the reason for this failure can vary, but the fundamental principle remains the same. A bank fails when they are "no longer able to meet the obligations" (Pritchard, 2016). The central bank declares the required reserve ratio, 'the obligations', which varies from institution to institution depending on its reserve base. The reserve ratio enables the bank to hold, for example 10%, as a required reserve and the remaining 90% can be invested by the institution through loans to other customers, creating further wealth for the financial institution.

While the government is obliged to play a leading role in supervising the banking sector to ensure they are following the regulations, this does not always hold true which may lead to a banking crisis. However, it is not always the government's fault, there can be many macroeconomic factors which can lead to the failure of a bank. Such reasons should be investigated

by governments, or central banks, before deciding how the bank to act. A bank insolvency can be due to internal failures or due to an external or market shock. Depending on how insolvency occurs will determine the governments response.

For example, a bank with poor operating performance, excessive risk-taking practices, or poor internal control. Should a government intervene? Or is it considered a waste of tax-payer's money? Arguably, if the government financially assist this bank, failures are likely to reoccur in the future, unless drastic measures are taken to change the institutions internal systems. If the government bail the banks out every time, there is no disincentive to engage in high risk-activity.

On the other hand, if a bank fails due to an international/national crisis, an unprecedented circumstance, such as the 'bursting of the bubble' in 2008, it may be necessary for a government to intervene. Take for example, the way in which the Irish government responded to the failure of Bank of Ireland and AIB, in comparison to how they dealt with Anglo Irish bank after the financial crash.

Before the 2008 financial crash, Anglo Irish Bank was deemed as "a role model for Irish banks to emulate" (Nyberg, 2011, P. ii). The bank was "growing strongly on the basis of relationship banking, providing loans to a limited number of entrepreneurs and operation in the riskier parts of the property market." (Nyberg, 2011, P. ii) In the pursuit of greater profits and increased levels of growth in the bank's size and market share, the

managers and bank executives adopted excessive risk taking practices, without taking into account if their “ preferred customers” were able to repay the loans.

AIB and Bank of Ireland were similar to Anglo Irish in the way in which they were all subjected to the rapid decline in Irish property prices and they all took part in excessive risk-taking practices. However, the Irish government were forced to respond differently to Anglo Irish. Brian Lenihan, Minister for Finance at the time, stated in a debate carried out in the Dáil in January 2009 that “ *While recapitalisation is the appropriate solution for AIB and Bank of Ireland, we have concluded that a different response is required for Anglo Irish Bank. Intensified oversight of this bank in recent months has brought to light unacceptable practices by the former chairman and some of his former staff. The concealment of loans to directors and the scale of those loans have done serious damage to the reputation of Anglo Irish Bank and to Irish banking at a difficult time in the markets.* ” (Lenihan, 2009)

## **Government dealing with a bank failure**

A prime example of a government dealing with a failing bank can be seen through the study of the Financial Crisis of 2008 in Ireland. Ireland’s banking sector, unfortunately, was hit hard as a result of the property bubble experienced in the country at that time. “ During the bubble, the balance sheets of Irish domestic banks had grown through property lending to four times Irish GDP, and the scale of the Irish banking crisis was correspondingly larger than in other countries.” (European Commission, 2017). As a result, the Irish government had to come to the Irish Banking Sector’s rescue as

many banks were on the brink of failing. Before deciding to assist or liquidate the failing banks, the government needed to examine the impact the closure of the bank would have on the national economy. Despite the fact a bank may not be fundamental to the stability of the economy as a whole, it may be vital to the health of the local economies. Closure of banks in rural regions would result in reduced ease to access of credit. The reduced competition within the banking sector would result in the remaining banks being able to charge higher rates than previous. " The objective of these decisions is to ensure that the financial system in Ireland meets the everyday financial needs of individuals, businesses and the overall economy." (RTÉ, 2008). A large proportion of the Irish citizens blame the government for all the hardship in which they encountered.

In September 2008, after realising Anglo Irish bank could not be saved, the government issued a guarantee of liabilities to the value of almost 2.5 times the GNP. At that time, the government's main goal was to try recover economic growth, this could not happen without the recovery of the Irish Banking system. Therefore, the government was forced to make the following decisions; Blanket guarantee, early recapitalisation and nationalisation of Anglo and INBS.

The blanket guarantee scheme was issued in September 2008 by the Irish government, for two years, to cover almost all of the Irish banks liabilities. The banking guarantee ensured that " 97% of all customer deposits in the Irish banking system were fully guaranteed" (Brennan, 2013). In recent years, Economists have argued that this was a drastic move. However, the

Irish government were faced with a huge problem and their hands were somewhat 'tied'. Anglo Irish bank was considered a failed bank and the government needed to avoid the same thing happening Bank of Ireland and AIB.

While the blanket guarantee was introduced to solve the liquidity problems the banks were facing, the early recapitalisation was there to solve the underlying solvency problem. The recapitalisation of the Bank System occurred from late 2008 to 2011. A sum of €80 billion was injected by the Irish government throughout the 2-year period. (Honohan, 2012).

While, all Irish banks were involved in property lending, Anglo Irish and Irish Nationwide Building Society (INBS) were unarguably the most invasive, both in growth and riskiness of their portfolio. From my understanding, both these banks lacked corporate governance and as a result, in January 2009 the government nationalised Anglo and INBS. Anglo Irish deposits were moved to AIB, and INBS deposits were moved to Irish Life and Permanent.

### **Evolution of the European financial stability policy in relation to bank failure:**

Following the 2008 financial crisis, many changes were made to the European financial stability policy. An example of an instrument introduced to during the crisis was the European Financial Stability Facility (EFSF). The EFSF was formed in June 2010. Its role was to help all Eurozone countries recover from the hit of the financial crisis. EFSF issued bonds and other debt instruments on capital markets, which helped the struggling economies. The

EFSF mainly helped economies in countries such as Ireland, Portugal and Greece.

Despite the introduction of the EFSF, a lot of economists would argue that the EU did not make a significant effort in providing mechanisms that helped such struggling economies. There are also arguments that the introduction of EFSF was too late. Economists have suggested that if the EU supervised the financial institutions better, maybe the crisis would not have happened or hit countries like Ireland so hard.

## **Conclusion**

We can conclude from above that dealing with failing financial institutions on a case-by-case basis while taking different factors into consideration, results in a thought-out process. Once this process is finished, the government can justify why they opted to follow a particular outcome. While this procedure has not been standardised, in 2014 the EU implemented the Bank Recovery and Resolution Directive (BRRD). BRRD requires a bank to prepare recovery plans in case they experience financial distress in the future. It includes rules which set up a national resolution fund in each EU country, which all financial institutions must contribute to. This is to prevent the need for a large scale publicly funded bail-out, which was seen following the financial crash in 2008. While the Global Financial Crisis had a major impact on Ireland and Europe, the road to recovery has commenced. Like every major financial crisis, lessons were learnt and such steps have been put in place to prevent a similar banking crisis going forward.



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