

A CLEAN BREAK FROM BUSINESS AS USUAL

Labour's Principles for Bank Reform & Recapitalisation

The Government is currently preparing to invest some €7 billion in recapitalising the country's two largest banks. It is vital that the scheme to be announced marks a new departure for Irish banking, in order to restore confidence and credibility at home and abroad.

Labour's Eight Principles

Labour proposes eight key principles for bank reform which must be incorporated in the recapitalisation programme if such a programme is to succeed. They are summarised in the title of this document '*A Clean Break from Business as Usual*'. The eight principles outlined set out the basis on which Labour will judge any proposals from the Government.

- 1. Get credit flowing to business**
- 2. Identify the scale of bad assets**
- 3. Write-down impaired assets**
- 4. Establish an Irish Banking Commission**
- 5. Regime change in the banks & cap executive pay**
- 6. Full investigation of Anglo Irish Bank**
- 7. Place a moratorium on family home repossessions**
- 8. Retain a presence for mutual (building) societies**

Avoiding a Lost Decade

Irish banking is at an impasse and there is a real risk of a Japanese-style scenario taking hold, whereby 'zombie' banks hide bad debts on their balance sheets. Unless the government gets this right, Ireland could be facing a lost decade.

Ensuring that Ireland's major banks are adequately capitalized and able to lend is of paramount importance to the Irish economy.

Reforming the banks is essential to sustaining existing jobs and businesses and supporting the creation of new enterprises and employment.

Allied Irish Banks and Bank of Ireland are key vehicles for channeling much needed credit to the 'real economy'. Ensuring that these institutions can provide this credit will be a key building block in Ireland's economic recovery.

Any recapitalisation programme must have protection for the taxpayer. This means ensuring a fair rate of return for capital injected into the banks, and an up-side to the taxpayer from recovery in the value of the banks. Labour proposes that the taxpayer be given an option to acquire ordinary shares at a future date, when banks are again functioning independently, at the price prevailing before recapitalisation.

Recapitalisation of the banks without a clear-out of bad debts from their balance sheets will only be another stop-gap solution.

Labour's Eight Principles

1. Get Credit Flowing to Business

Any rescue package must include mechanisms that will ensure a flow of credit to business. This can potentially take a number of forms. Labour has already proposed that European Investment Bank funds could be drawn down through a state vehicle which has good structures for engaging in lending to business. Similarly, dedicated pools of funds could be ring-fenced for lending to small business. Consideration should also be given to a working capital guarantee scheme for viable businesses. Such schemes exist in a wide range of countries and can have a positive impact if properly designed.

2. Identify the scale of bad debts

A key impediment to the success of recapitalisation is the on-going uncertainty about the scale of bad-debts in the Irish banks. Having mooted a series of recapitalisation schemes, the international financial markets must be assured that the amounts the Government proposes to invest in the banks are sufficient to deal with the bad debt problem. As matters stand, however, there is very little information concerning the scale of losses. The Government must present the markets with a realistic and credible statement of the scale of bad debts, and how the recapitalisation scheme is adequate to meet them.

The Government has never published PriceWaterhouseCooper's recent report on asset quality in the Irish banks. Current write-downs by Irish banks owned by foreign parents appear to be far in excess of the stress-test measures understood to have been adopted in this report.

3. Write-down impaired assets

Irish banking is at an impasse and there is a real risk of a Japanese scenario taking hold, whereby 'zombie' banks hide bad debts on their balance sheets.

If banks try to avoid writing down their bad debts, their capacity to lend will be significantly reduced and they may even stop lending to new and existing businesses, causing the flow of credit to the 'real economy' to dry up completely.

A rigorous clean-up of balance sheets is required. This clean-out must be supervised to ensure that decisions are made on a clearly commercial basis.

There is a strong focus in the international debate on bank reform on ideas such as a 'bad bank' or 'clean banks'. Both of these are variations on the same theme i.e. that the bad assets in the banking system should be quarantined in some manner, so as to ensure that 'clean' banks can lend effectively into the real economy. A number of models are emerging on how this can be achieved, including a state-led 'bad bank' that would buy up the bad assets, or the separation of banks into privately owned 'bad banks' and 'clean banks'.

These ideas have strong merit, and they should be examined by the Government, for a number of reasons. Firstly, they provide a means of signaling to the international financial markets that a proper quantification of the scale of the problem has taken place. Secondly, many of the bad loans in Irish banks are linked into more than one institution.

International markets, at present, are assuming the worst. By dealing with the impaired loans on the banks' balance sheets and putting them into a special vehicle, this would draw a line under the banks' exposure; and the banks would then be assisted in getting back to realistic lending practices.

Any special vehicle should have a limited mandate of 7-12 years to manage and eventually eliminate the portfolio of impaired assets.

4. Establish an Irish Banking Commission

As part of the process of regime change, the Government should appoint an Irish Banking Commission. This would be an independent body, composed of people of the highest international reputation and competence, with a mixture of Irish and non-Irish Commission members.

The Commission's functions would include the approval of appointments to the Boards of Irish Banks, the approval of the appointment of senior executives, the vetting and monitoring of both business plans and the overall debt situation.

The Commission could also oversee the setting of Board Remuneration and executive pay.

Such a body would lend credibility to the changes that are needed for Irish banks. It would be time-limited in duration, pending reform of the role of the Financial Regulator and the Central Bank.

5. Regime Change in the Banks & Cap Executive Pay

The crisis in Ireland's banks has resulted in enormous damage to the reputation of the Irish financial system and to individual banks. As part of the process of restoring confidence, it must be clear that there has been 'Regime Change' in the Irish Banks. The Government must insist on the removal of top level executives. The Boards should be replaced. The people who got us into this mess are not the people to get us out of it.

As institutions that are reliant on state support, it is not acceptable that executive remuneration would continue at existing levels. The 25% cut suggested by Government is not adequate. An upper limit should be set on executive and director pay, which does not exceed the salary of the Minister for Finance (the remuneration package of the Minister for Finance is a gross of approximately €250k).

6. Full Investigation of Anglo Irish Bank

Restoring confidence also means sending a signal that wrong-doing will not be tolerated by the Irish authorities, and that the highest legal and ethical standards will be applied. This means that the events leading up to the nationalisation of Anglo Irish Bank must be fully investigated, including the warehousing of directors loans.

The issues surrounding share dealings in Anglo are also of public concern and should be fully investigated. Labour has been calling for the appointment of a High Court Inspector to Anglo Irish Bank.

7. Place a Moratorium on Family Home Repossessions

Labour was the first party to argue for a moratorium on family home repossessions. This would apply to family homes under a defined threshold in value, for at least two years.

We do not believe that it makes sense for banks to repossess homes at this stage, which they would be obliged to sell at a loss, when re-scheduling the mortgage, over a long period, would result in them getting their money back.

Such a moratorium would make an important contribution to restoring confidence among consumers in Ireland. It would also be an important statement of social solidarity. Nor would it be acceptable for the taxpayer to bail out the banks, and then have to bear the cost of housing people whose homes had been repossessed.

There a number of models for doing this, including the establishment of a mortgage protection agency, under the aegis, for instance, of the National Treasury Management Agency. It is unlikely that a code of conduct by itself would be sufficient if there are widespread mortgage defaults arising from rising unemployment.

8. Retain a Presence of Mutual (Building) Societies

Two of the institutions covered by the guarantee are mutual societies. While it would appear that mutuality has not necessarily acted as a restraint on lending practices, nonetheless the principle should obtain that a significant community/mutual element be retained in the Irish financial services sector.

It should be an object of Government strategy to ensure that an element of mutuality is retained in the system, with strong governance and management structures.

Labour's Record

Labour opposed the legislation enacting the Bank Guarantee, because we were not prepared to support the commitment of enormous sums of taxpayers money, without adequate information or fundamental reform, including regime change in the Banks. Subsequent revelations about the affairs at Anglo Irish Bank have justified this position.

Labour also questioned the inclusion of 'dated subordinated debt' in the bank guarantee, a form of near-equity capital which has not been included in guarantees in other countries. Labour voted against the Bill nationalising Anglo Irish Bank, noting in particular the refusal of the Government to appoint a High Court Inspector to the Bank.

The Bank Guarantee had enormous implications for the public finances. The interest on Irish Government debt, (as measured by the 'Bund spread'), has soared since September 2008, and now stands at approximately 200 basis points more than is being paid by Germany. This means that Ireland could be paying an interest rate 2% higher than Germany on national debt. Already, the interest charges on Irish sovereign debt for 2009 has spiraled upwards by €544m since October's budget.

The blanket bank guarantee was hastily conceived and executed on September 29th, 2008. It carried no incentive for the banks to address their flawed business models, insufficient capital adequacy, or mounting but hidden bad debts. This guarantee would have cost upwards of €10bn on the open market, yet the government demanded only €500m in return.

Put simply, the banking recapitalisation must work. The Irish economy and the exchequer cannot afford another false start. It is vital, in all our interests that the Government package succeeds.