Ireland’s Banking Crisis and Fiscal Crisis Are Intertwined

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The market is putting Ireland’s proposed rescue of its banking sector at risk. In a fashion similar to the way that the market finally forced the hands of the EU and the IMF to put together a solution to Greece’s effective loss of access to the capital markets, Ireland appears to be on the brink of a similar situation. In just the past two weeks, yields on Ireland’s government bonds have risen nearly 2% at all maturities, and more at the three year maturity **(Figure 1).** Three observations of note: (1) Ireland’s credit yield trajectory toward than of Greece, (2) the big moves up in the yield curves of Greece, Ireland, and Portugal over the last two weeks, and (3) the smaller relative move upward in that of Spain.



With very thin trading activity evident, there appears to be a buyers’ strike on Irish debt, with the ECB the only recent significant bidder in the market. Although the country has funded itself through the middle of next year, it has ongoing commitments to its banking system, and those appear to be spooking the market. Both three- and ten-year government bond spreads over Bunds as of Monday equated to median credit spreads of B1-rated entities. LCH Clearnet has new required more margin for trading in Irish securities. As this goes to press, yields continue to rise.

According to Moody’s Investors Service, the total bank recapitalization costs for 2009 and 2010 will end up amounting to nearly €60 billion[[1]](#footnote-2), but the government is also, as of now, guaranteeing €12.3 billion of NAMA debt, in addition to bank deposits. The issue of senior debt remains in the balance, with the government still publicly stating that it expects senior bondholders to be made whole—except for noises to the contrary on Anglo Irish. Market participants are clearly concerned about the ability to finance all these explicit and contingent liabilities.

Ireland’s cost of default protection has risen as least as fast as its government bond yields as seen by its five-year CDS spread **(Figure 2).** This has led to a falling CDS-implied rating **(Figure 3)** with Ireland now reaching into the Caa1 range. Statistically, the one through three year probabilities of default rise exponentially as entities move down the rating scale. Although there are back up facilities available in the forms of the EFSF[[2]](#footnote-3) and the IMF (the ECB has already been a large purchaser through its Securities Market Programme (SMP)), it is increasingly likely that Ireland, and potentially Greece and Portugal, will have to access these facilities. The Irish have already put in place such stringent austerity measures that IMF conditions would hardly be much more onerous.





Because Anglo Irish and INBS are subject to uncertain resolutions, investors are being forced into discussions surrounding loss sharing among senior bondholders. The Government of Ireland’s implied cost of funding (based on secondary trading levels) is causing the market to call the viability of Allied Irish, and even Bank of Ireland, into question. Current Irish sovereign funding rates in the capital markets (around 4% in the secondary market for 1 year maturity debt) would make the banks’ ability to earn an incremental positive net spread on government provided funding difficult if not impossible. Current rates may not be achievable if Ireland actually comes to market.

The banks’ cash needs near term are significant. According to Bloomberg, Allied Irish has €6.3 billion in principal and interest due in 2011, while Bank of Ireland has €6.7 billion due . This liquidity conundrum points to a classic jump to default scenario, which is arguably unnecessary given that the banks are still solvent, and in our view have a positive asset value on a going concern basis. Senior creditors will likely twist in the wind as the politics and practical issues play out over the next several months.



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1. For full detail on Ireland’s bank recapitalization costs, see Moody’s Special Comment, “Key Drivers of Decision to Review Ireland’s Aa2 Rating for Possible Downgrade”, October 5, 2010 at <http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_128037>. [↑](#footnote-ref-2)
2. European Financial Stability Fund. For more information on the fund, please refer to <http://www.efsf.europa.eu/attachment/faq_en.pdf>. [↑](#footnote-ref-3)