

AN EASY SOLUTION IN IRELAND?

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[Banking on Economics Blog](#)

November 27, 2008

## BACKGROUND

REUTERS: An Irish-led consortium has entered into preliminary due diligence with Bank of Ireland (BKIR.I: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) and could buy a 60 percent stake if a deal is struck, the Irish Independent reported on Wednesday. The Irish Independent, which did not cite any sources, said the consortium called Mallabraca had a 5 bn euro (\$6.5bn) fund. Mallabraca, headed by Irish investment company *Cardinal Asset Management* and including U.S. *private equity groups*, had met with Bank of Ireland's management team, the report said. Cardinal Asset Management was not immediately available for comment. The Irish Independent said the consortium had told the Irish government during separate talks it was looking at a five to 10 year potential investment.

## COMMENT

Given the relative cost-less-ness of guaranteeing bank deposits the Irish Government should be unlikely to allow the sale of the core banking system to US equity funds or any other buyer that may not "pass muster" with the regulator never mind the Government - political suicide or otherwise! Next year the regulator will effectively be European anyway with the headmaster in New York at the IMF. One would think that 'logically' the IE government in a context of ever intensifying supervision and transparency in financial services worldwide, would not consider facilitating the wholesale transfer of Irish Banking assets to a Private Equity fund which in its terms of reference is by definition opaque. One would think! The problem is Capital, in other words cash! The sale of Bank of Ireland has been on the blocks as a current publicly revealed prospect. [http://www.bankofireland.com/includes/investor/pdfs/interim\\_nov08.pdf](http://www.bankofireland.com/includes/investor/pdfs/interim_nov08.pdf), this probably applies to the others. The point is that there is a windmill here which David McWilliams has been tilting at. <http://www.davidmcwilliams.ie/2008/11/26/nationalise-the-banks-but-dont-feed-them-to-vultures>

## AN EASY SOLUTION IN IRELAND?

### **KARL MARX AND REYKJAVIK**

It does seem ontological; currently conceptual or not!

The Irish government doesn't have cash to "nationalize them"; from Mr. McWilliams' unusually Marxist/Leninist Tub-Thump, they just do not have the cash to own all of the Irish Financial system and they cannot easily borrow it.

So, its Bostonian, Midwest and Pacific IE-Diaspora capital (with a Wall Street badge on!) or "nuthin!"; if the plan expedited now doesn't work now then you may as well tow Ireland to Reykjavik, its closer to the IMF!

Hence while McWilliams is not totally correct is he not tilting at windmills or knocking over straw men! The Problem is capital! But as always in Ireland how much? The Bank of Ireland has set final terms on a planned €2bn (\$2.6 bn) bond backed by a government guarantee, Final guidance on the two-year bond was set at mid-swaps plus 65 bp, and demand topped €3.5 bn (\$4.5 bn), Any investor could probably make all the capital the bank needs and redeem purchase price by selling BoI Life. Would that be allowed? The question is analogous in Edinburgh for Lloyds.





## EASY SOLUTION

On top of €20bn replenishment funding the bank needs €7bn in more capital reserve. The valuation question is what to pay for the €25bn liquid bonds that are €0.6bn m2m down?

The easy solution is for Government to provide surety for say €60bn of retail assets for €2bn in stock warrants and buy €7bn in preferred stock (replenishing the capital reserve) and giving it 70-80% ownership until the ordinary shares rebound by say 400% when Government will own half only or less. With this infusion finding €20bn new funding should be no problem.

## ISSUES

The issues today are about Cardinal Asset Management (CAM). Irish business may not have learned the Private Equity route yet despite ample evidence. CAM has a €6.5bn fund. Can it borrow €15.5bn? And would you let a medium term profit-making equity fund buy a major bank or even let it buy a Life Company? Has CAM got that to invest to acquire the bank for its "fair value"; say a €9bn price, of which shareholders get €2bn?

## BANK OF IRELAND ANALYTICS

Prev Close €1.30 Open €1.30 Day's High €1.41 Day's Low €1.27 52-wk High  
 €1,393.00 52-wk Low €0.81  
 Beta 1.37 Volume 1,566,405 Avg. Vol 7,865,415 Mkt Cap. €1.326 bn Shares Out  
 1,004.21M EPS (TTM) €1.42  
 Div & Yield 0.39 (29.4)



Balance sheet	30 Sept2008	31 March 2008	
Stockholders' equity (€ billion)	6.4	7.2	-11% (now 1.3+Gov)
Total assets (€ billion)	204	200	2% (bad or good?)
Total loans & advances (€ billion)	145	136	7%
Total customer deposits (€ billion)	91	76	19% (good performance)
Wholesale funding (€ billion)	78	85	-8% (good)
W/s funds / total assets (excl. BoLife)	41%	46%	(good?)
Loans & advances / deposits	159%	174%	(bad!)
Funds >1yr deposits/loans & advances	79%	80%	(bad!)
Funds >1yr, sub.debt + deposits/loans &advances	84%	86%	(bad!)

### CAPITAL

	30 September2008	31 March 2008
Core Tier 1 ratio	6.3%	5.7%
Tier 1 ratio	8.7%	8.1%
Total capital ratio €14.15bn	12.2%	11.1%
RWA(€ bn)	116	117
Implies collateral/surety cover =	88 (43%)	83 (41.5%)

Impairment charge €0.267bn (up €0.188bn) or 38bp incl. WAMU €0.04bn.

This 38bp equates to €70bn (less than RWA), but assets are €204bn or €144bn loans & advances. Where does this 38bp est. come from? - must be for the half year x half the loan assets therefore. But anyway by any comparison it seems very small! Only 60-90bp is forecast for year. Let's say a realistic 300bp (amount past due) = €4.3bn loss against underlying profit of €1.3bn and €14bn reserve capital. All impaired loans are €2bn already:

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**MODEL: BoI needs 20% of loans refunding = say €30bn.**

In last 2Qs deposits grew by €15bn, and assuming getting €15bn renewed is harder and they get €10bn then they need €20bn, and assume after first €5bn gets pricey, then bank needs €15bn (just over its total cap reserve but only half of what it can draw down from CBI) in the next 2 quarters say or it has to liquidate 10% of its loan book against a 2% trends i.e. 12% of loans/advances to be called in = €18bn, and/or liquidate some of the remaining €60bn assets (e.g. sell BoI Life?) on top of €5.7bn raised in >1yr funds and at Sept.08 c.€47bn eligible collateral, of which c.€39 bn immediate access to central bank if required.

This bank has €53.4 + 38bn loans to mortgages and property with rest of loans being €5+bn unsecured consumer lending i.e. credit cards etc. It has €34bn bonds, €34.6bn SMEs +Corps.

Assuming half the bonds are corp. bonds, then the bank is only 1/3 diversified into non-property business, except I bet a lot of the corp. bonds are also property junk. Trading book for sale assets are €29.5bn down from €33.5bn of which €25bn is AAA and AA- liquid so €8.5bn is ABS etc.

*"The group expects to retain its AFS assets until maturity and, under IFRS, they are marked to market through to reserves."*

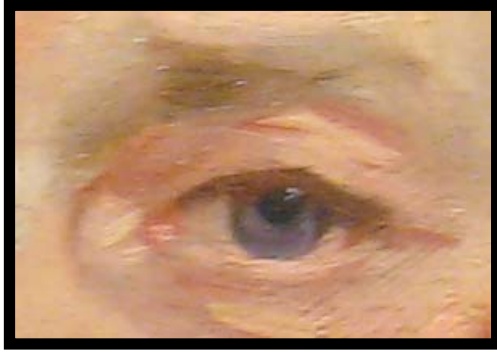
So, let's assume that the €8.5bn of bought in illiquid ABS etc. is worth 25% today, then bang goes half of the bank's capital reserve!

*So what we got here?*

€204bn assets less €5bn lost equity, less €160bn deposits and w/s funds, less €15bn subordinated cap. debt = €24bn  
Less €4.5bn defaults, less €7bn ABS writedown, less €0.6bn liquid bonds  
= €11.9bn + €2bn share value = €14bn  
+ cost of purchasing bank (€1bn M&A fees) + €7bn reserve capital to invest in the bank = €22bn

In one sentence: €233bn maximum exposure versus €204bn assets = €29bn!

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### Afterthought

Read the Financial Stability Review published by the Irish Central Bank at anytime since 2004 and you will see examples of world leading thought in monetary economics which subtly explains and evidences the "funding deficit" of the Irish Banking system. Put crudely, this means that neither the Irish personal nor corporate banking sector has maintained a financial surplus for many years. This has a consequence for the Irish Banking system in that to provide the cash when we demand another mortgage or loan, the Banks do not have deposits to rely upon. They thus have no choice but to close this "funding gap" by recycling our outstanding credits in aggregate vehicles called structured products or securitizations. Irish legislation has facilitated leading the world in this activity and, much to the chagrin of some competing banks one Irish bank in particular has made this process a conveyor belt of enviable ease and quiet efficacy. In doing this, expertise for other jurisdictions becomes clustered in Dublin.

These Structured Products are of course instruments of Credit Risk Transfer, the emphasis here on risk. We have witnessed financial wizardry in the US going too far in a low interest rate context occluding the pricing of Irish instruments and

thereby spoiling the party for Ireland for a time. The secondary impact may be that the ECB has lost control of interest rates as a lever of monetary policy also "for a time". However, this does not mean that the Central Bank of Ireland is failing to police financial product issuance in Ireland. The Irish Financial Regulator and the Irish banks have worked hard together over the past years to implement the "Basel II" accords, a European initiative to strengthen global financial stability, deeply intertwined with structured product challenge.

The implication of the recent issues in Ireland is that the Irish Banks, prompted by the Irish regulator, will now accelerate and deepen their efforts at Basel II compliance because it now makes clear business sense to demonstrate and report that there is no dodgy aspect to a complex structured instrument issued by or via an Irish company. But these are complex instruments and the calculus of risk quantification in them can require one to place the proverbial wet towel on the head. An important way to accelerate and reinforce this process of maintaining the image of Ireland Inc is for the Irish software industry and the multinational software companies located in Ireland to step up to the plate and partner the Irish Banking industry and regulator. That partnership could traction the world leading econometric thinking in Ireland to develop software analytics and data management which can ensure that Irish financial technology can develop in the future as world leading as it is today.

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### UNION LEGEND

Union Legend (UL) is a specialist Consulting Partner in Solution Architecture Design for Risk Management and IT-Project Resourcing. UL takes an agile, smart and hybrid (multidisciplinary) approach to IT Solution Design and Resourcing. In the Risk Management space we are focused upon Financial Predictive Analytics which we understand cannot be delivered without Solution Partnerships and the integration of expert resource from distinct domains. UL therefore works alongside experts throughout the engagement to optimise the implementation of client requirements, to ensure that they are fully understood and met at the lowest possible cost, in the shortest timescale without losing sight of requirement scope.

### UL Methodology

The UL methodology is to combine expert consulting with experienced resourcing. Our Consultants partner with your staff and industry experts so that your project is fully equipped with optimized human capital, providing the highest level of business and technical knowledge. This focused perspective brings project resource to our clients, which has been rigorously validated as appropriate to the specific requirement. UL can through this philosophy bring optimized specialist resource to bear on each complex task

requirement within the overall framework of your project or programme plan.

### UL Partnership

UL can assist our clients in the strategy, solution design and implementation of integrated Data Management and Financial Predictive Analytic (FPA) platforms. In other words, the UL mission in FPA is the integration of 3<sup>rd</sup> generation BI (Predictive) environments with standard BI toolsets and the data management platforms normally implemented to support them. We can further assist with the planning and architecture for High Performance Computing (HPC) environments for Predictive Analytics, where these may be necessary (and in our view they will be). UL has further relevant experience with the integration of General Ledger platforms with Risk Management data warehouses or marts and we have the specialist knowledge to integrate FPA tools into the GL environment. In short we can provide the support necessary to assist management to move towards Target Operating Models predicated upon the integration of FPA with the GL and operational BI for Credit, Market and Liquidity Risk analytics, necessary post CC.

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