

The US subprime crisis has hit our shores with a vengeance. The rejection by the US House of Representatives of the Bush administration's \$700bn rescue plan on Monday evening was the nail in the coffin for any hopes that Irish banks would be spared from financial turmoil. The bill voted down by the House was not perfect. In particular, it did not deal clearly with the problem of the shortage of capital in the US banking sector. Nonetheless, rejecting the bill was utter madness as it pushed an already highly vulnerable US financial system to the brink of collapse. Unless a modified plan is accepted very soon, an unthinkable number of banks around the world are likely to be forced over the edge of the credit crisis cliff. As someone said yesterday, in the current environment the definition of optimism is a banker ironing 5 shirts on a Sunday night.

The Irish government's response to events this week was dramatic. Tuesday morning saw the introduction of an unlimited State guarantee of all the deposits and most of the borrowings of the six main Irish-owned financial institutions. By borrowings, I mean the funds that the Irish banks and building societies have borrowed from other financial institutions. Irish banks owe large amounts of money to foreign banks, for instance. These borrowings are part of the Irish banks' liabilities, as are customer deposits at the banks. The guarantees will last for two years. The government has not guaranteed the loans made by Irish banks to businesses, property developers, and households.

These moves by the Government leave this country with a model for banking that you wouldn't wish on your worst enemy. What we now have is a dangerous combination of private financial institutions and public government guarantees. This means that these institutions face an array of poor incentives. Gone is the market discipline that creditors usually exert on banks. When making loans and investments, banks are normally mindful that bad lending and investment decisions will probably be punished by other banks refusing to lend to them at a reasonable cost. But with government guarantees in place, banks are often less careful about their lending decisions. Absent market discipline, greater responsibility now rests with the Financial Regulator to police the banks.

Consider what happened in the cases of Fannie Mae and Freddie Mac in the United States. These private financial companies took advantage of their government guarantees to pad their profits by making investments that were too risky. Public protection for private banks elsewhere has also had undesirable consequences. Such guarantees benefit shareholders (hence the rebound in Irish bank shares on Tuesday) and the management of the protected institutions, but they tend to promote poor banking practices.

A major concern for this country is that the Government's new scheme may encourage Irish banks to avoid dealing with the underlying problem in our banking system. Irish banks have outstanding loans to the construction industry of more than €100 billion. With residential and commercial property prices tumbling here and in the UK, a significant chunk of these loans will turn sour. Banks need to face the reality of these bad debts; otherwise we face the risk of a Japanese-style prolonged economic depression. Best practice is for the banks to recognise the losses on these loans and dispose of the properties that are collateral for these loans. If a bank does not have sufficient capital to take the hit, then it should be forced to raise new capital to plug the hole or shut down.

The worry is that the banks will use the unlimited guarantees to borrow funds and pump more money into zombie construction companies. The restructuring of bank loans that is critical for recovery in our property market may be delayed. Government guarantees have bought time for the banks, but possibly at the expense of inaction and excessive forbearance.

This does not mean that the Government's actions were wrong. No one would want to start from here, but the alternatives may have been worse. It does mean that we should try to get away from the current model as soon as possible. In this regard, the Government has yet to explain why its guarantees cover a period of two years, as opposed to, say, six months.

What were the alternatives? Newspapers yesterday reported that the option to allow one particular financial institution to fail and then moving to nationalise it was seriously considered. This suggests that on Monday evening one (or perhaps more) institution was threatened by a "bank run" in the form of a run on customer deposits or an inability to access funds on wholesale money markets.

Banks in other European countries have faced similar problems this week. The UK government on Monday nationalised building society Bradford & Bingley. The Benelux governments part-nationalised Fortis Bank by taking a 49 per cent equity stake. Hypo Real Estate, Europe's largest mortgage bank, received a last-minute emergency financing package with central bank backing.

What explains the different approach here? The answer may have to do with the Government's fear of contagion from one Irish bank to another. This contagion could work through two channels. First, the stronger Irish banks have probably lent large amounts of money to some of the weaker Irish banks. Had the Government allowed a weak financial institution to fail, these loans might not have been repaid. Of course this suggests that the weak institution may in reality be insolvent (that is, the value of its liabilities exceeds its assets), though the accounts may disguise this fact by using inflated values for assets. Second, had one Irish bank failed, foreign lenders may have tarred all our banks with the same brush and withdrawn funding. The point is that the Government may not have seen any way to ringfence the better Irish banks from the bad apples.

When a bank is nationalised, equity holders are usually wiped out and the chief executive is replaced. This is considered best practice in dealing with troubled banks. This raises three questions for the Government. Will they make public the name of the particular financial institution that was about to fail? Why should equity holders in that institution have benefited from the Government's actions? And when will that institution's chief executive be replaced?

Alan Ahearne lectures in economics at NUI Galway and is a research fellow at Bruegel, the Brussels-based think tank. He is a former senior economist at the Federal Reserve Board in Washington DC.

