

# Irish banks: a long convalescence ahead

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Irish banks were slammed by the financial crisis in 2009. National responses and above all the roll out of the €85bn EU-IMF bailout plan helped prevent the Irish banking system from collapsing. This enormous rescue package (55% of GDP) was largely devoted to the recapitalisation of banks (€35bn) and helped ease the country's liquidity crunch. We estimate Ireland's 2011 GDP growth at 1.7%, which places the country in a relatively less uncomfortable situation than Greece and Portugal, the two other eurozone members benefiting from international aid.

Although efforts to consolidate public finances and restructure the banking system seem to be well underway, especially since plans were completed ahead of schedule, Ireland is still at risk: extremely open to world trade, the country is not sheltered from a slowdown in world demand or another correction in house prices. Such events could undermine credit quality and increase the cost of risk, thwarting the recovery of Irish banks.

Last spring, the government published the results of stress tests conducted by the private company BlackRock under the central bank's supervision. These tests revealed the need for an additional €24bn in capital. Over two thirds of this amount was covered by the injection of public funds into banks, resulting in the quasi-nationalisation of the banking sector. The publication of the banking section of the Financial Measures Programme was supposed to reassure investors, but they continued to worry about the sustainability of public debt. In contrast, the banking sector's exposure to sovereign debt is not a major subject of concern, as revealed by the latest EBA stress tests in December.

In exchange for EU-IMF international aid, in spring 2011 the Irish government announced a new recapitalisation and restructuring plan for the banking system. Although the series of measures are designed to restore the financial health of banks in

the medium to long term, in the very short term, the banks are finding it hard to recover from past excesses, as illustrated by their H1 2011 results. Persistent sources of risk could eventually slow medium-term improvements in their financial situation.

## New restructuring measures in spring 2011

In spring 2011, the Irish government revealed a new restructuring plan for the banking system, as demanded by the European Union and the IMF when they agreed on providing international aid. The plan hinges on bank recapitalisation, based on the results of new stress tests, and deleveraging, the corner stone of which is a new focus on core business. Since Irish companies are highly dependent on bank financing, it is vital for the Irish economy to have a healthy and solid banking system, capable of continuing to finance productive, non-speculative activities.

### Second round of recapitalisation of the banking system

Victims of major domestic economic imbalances, Irish banks began reporting heavy losses right from the beginning of the financial crisis. With the banking system risking collapse, the public authorities rolled out large-scale measures. Without going into detail on the scope or nature of these measures<sup>1</sup>, these national and European responses helped ease the banks' financing constraints. National measures included raising the ceiling on deposit guarantees from €20,000 to €100,000 per depositor and per

establishment; granting public guarantees on new issues of bank debt instruments; and the creation of the asset relief scheme NAMA (National Asset Management Agency). European responses included the introduction of non-conventional measures by the ECB and the rollout of a €85bn EU-IMF bailout plan in fall 2010. The EU-IMF rescue package also gave Ireland's public finances a shot in the arm, but failed to fully reassure private non-financial agents (households and non-financial companies) and even less so international investors.

The stress tests performed in March 2011 by Blackrock Solutions on behalf of the Central Bank of Ireland were designed to ease the financial markets' lack of confidence in Irish banks. These tests led to the publication of the Prudential Capital Assessment Review (PCAR) and Prudential Liquidity Assessment Review (PLAR). They provided a robust, transparent estimate of the banks' additional capital needs, which were evaluated at €24bn under a more restrictive stress scenario than the one conducted by the European Banking Authority (EBA) in July 2011<sup>2</sup>. After a restructuring plan was presented to the European Commission for each entity receiving assistance<sup>3</sup>, public funds were injected into the banks, resulting in the quasi-nationalisation of the banking sector. The banks were recapitalised through capital injections by the Irish government in exchange for equity stakes via the National Pensions Reserve Fund (NPRF). For all the banks in our selection, the impact of capital injections on the capital/asset ratio was offset in 2008 by the strong growth in assets (see chart 1). Yet the average Tier 1 ratio picked up significantly, due to the decrease in risk-weighted assets (see chart 2)<sup>4</sup>. The stress tests conducted by the EBA in July 2011 showed that the banks did not have any additional capital needs with regard to the 2011 PCAR requirements, a clear sign that the

banking sector recapitalisation and restructuring measures had strengthened the financial base of these establishments.

More recently, in October and December 2011<sup>5</sup>, the EBA conducted new stress tests to evaluate any additional capital needs based on a stress scenario that valued sovereign debt at market prices. The tests calculated weighted assets according to Basel 2.5<sup>6</sup> and removed the prudential filters applicable under Basel 2<sup>7</sup>. The 71 European establishments that had already undergone stress tests in July 2011 – including the three Irish banks Allied Irish Bank, Bank of Ireland and Irish Life & Permanent – were asked to report a core Tier 1 ratio of 9% by June 2012, based on the market value of sovereign debt at 30 September 2011. The EBA concluded that the banking sector could apply the new regulatory framework beyond Basel 2.5 and cover its sovereign exposure without raising additional capital<sup>8</sup>.

The Irish banking sector benefited from more public funds than any of the other OECD countries as expressed as a percentage of GDP (see chart 3). Irish banks also received the highest share of public aid not subject to repurchases or repayment (see chart 4). Since the beginning of the crisis through the end of November 2011, Irish banks have been recapitalised by €23.6bn<sup>9</sup>, virtually all of which has come from public funds (€21.2bn) (see chart 5). Government intervention was almost equally split between capital injections in the form of subscriptions to subordinated debt securities (€7.5bn, 35% of capital injections), preferred shares (€7bn, 33% of the total) and ordinary shares (€6.7bn, 32% of the total). As a result, and unlike their UK counterparts, the three Irish banks benefited from a smaller share of capital injections in the form of ordinary shares, the only category that is eligible as common equity under Basel 3.

### Equity as a share of total assets %

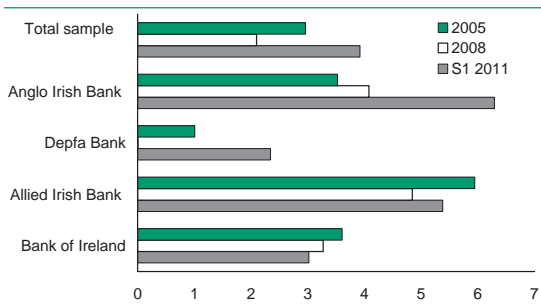


Chart 1 Source: Bankscope

### Public aid measures in the OECD countries, outstanding in % of GDP

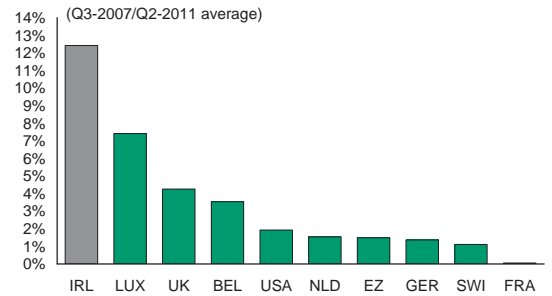


Chart 4 Sources: Bloomberg, Datastream

### Tier 1 ratio (% of weighted average assets)

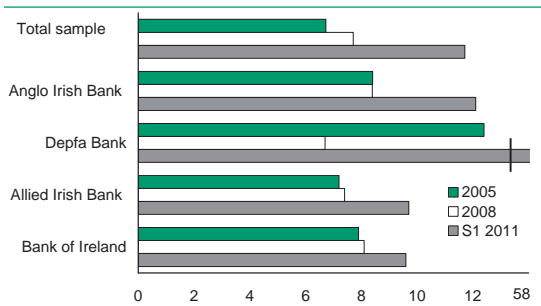


Chart 2 Source: Bankscope

### Capital injected in Irish banks

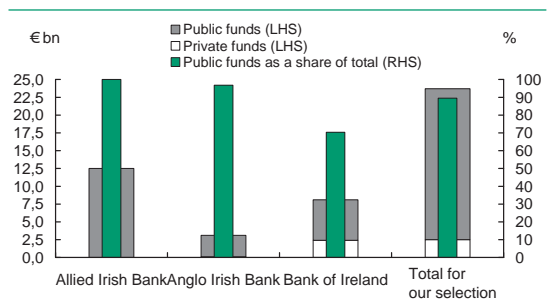


Chart 5 Source: Bloomberg

### Public aid measures in the OECD countries, capital injections as % of GDP

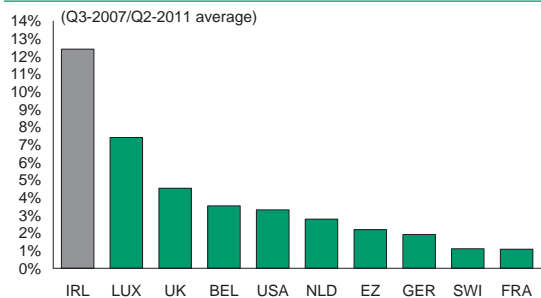


Chart 3 Sources: Bloomberg, Datastream

### Cumulative banking sector losses in the OECD countries (% of GDP)

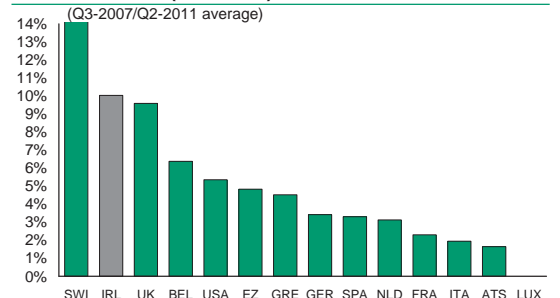


Chart 6 Sources: Bloomberg, Datastream

Yet with respect to the new solvency requirements, the upcoming switch to Basel 3 should not result in any major new efforts because common equity as a percentage of weighted assets, after regulatory deductions, was already high according to the latest EBA estimates (13.3% for AIB, 10.3% for BOI and 23.9% for ILP). Moreover, Irish banks, like their European counterparts, will benefit from a grandfather clause under which hybrid shares not eligible as common equity in the Basel 3 sense of the term, but issued before the adoption of CRD4 on 20 July 2011<sup>10</sup>, can be gradually withdrawn from capital requirements during a 10-year transition period. This clause is particularly pertinent in Ireland's case since such a big share of the capital injections were hybrid instruments underwritten by the government. A bank-by-bank analysis (see chart 5) highlights the preponderance of public funds, which range between 70% for the BOI to 100% for Allied Irish Bank.

In addition to direct capital injections, junior private creditors also participated in the recapitalisation effort. Most of the Irish banks largely benefited from gains following the early repayment of heavily discounted subordinated debt. These operations enabled them to improve their solvency and to generate capital. In May 2011, after the High Court of Justice gave its approval the previous month, AIB imposed discounts on its subordinated debt ranging from 75% to 90%. Following in its wake, in June 2011, BOI, ILP and EBS issued separate press releases expressing their intentions to proceed with buybacks of €2.6bn, €840m and €260m, respectively, at discounts similar to AIB's range. In early December, after energetically supporting the Irish banks' initiatives, the government indicated that it was renouncing, at least for the moment, the project to share BOI losses more amply with its junior creditors, based on the bank's successful recapitalisation (€4.2bn).

When the joint recapitalisation efforts of various countries are superimposed on losses and expressed as a share of GDP (see chart 6), Ireland (10% of GDP) ranks second behind Switzerland (13.8%) and is virtually the same as the UK (9.5%), but far ahead of the eurozone (4.8%), Germany (3.4%) and France (2.3%). In general, in addition to recapitalisation measures, the public authorities have expanded and consolidated bank restructuring plans by adding measures such as deleveraging of the banking sector or repositioning banks within the domestic market.

## Deleveraging of Irish banks and a new focus on core business

Under the terms of the EU-IMF international bailout plan, Irish banks must sell off €73bn in assets by 2013. For Ireland's public decision makers, restructuring the banking system should benefit the real economy above all, by maintaining financing for the domestic economy. Starting from the observation that there was room to scale back activities that did not contribute directly to the real economy and given the dependence on Eurosystem refinancing, quantified deleveraging targets were set for each Irish bank. Banking lending had clearly swelled to excessive levels in Ireland during the period prior to the financial crisis. Between December 2003 and December 2009, there was a major increase in the total assets of monetary financial institutions (IFM), which rose from 514% of GDP to a peak of 1018% before easing slightly to 885% in H1 2011 (compared to a eurozone average of 341% of GDP). Fuelled by access to very low or even negative real interest rates<sup>11</sup>, the strong increase in loans kindled the formation of a real estate bubble (see below). The loan to deposit ratio rose very sharply, from 136% in January 2003 to a peak of more than 193% in October 2008 (see chart 7). The resulting excessive debt loads of private agents certainly contributed to the economic boom for some time, but the tightening of monetary policy in early 2006 and the deterioration of credit conditions (due to the preponderance of variable rate loans) sparked a downturn in the real estate market and a banking sector crisis that gradually asphyxiated the financing of the Irish economy.

**Loan-to-deposit ratio for non-financial agents  
Ireland vs. Eurozone**

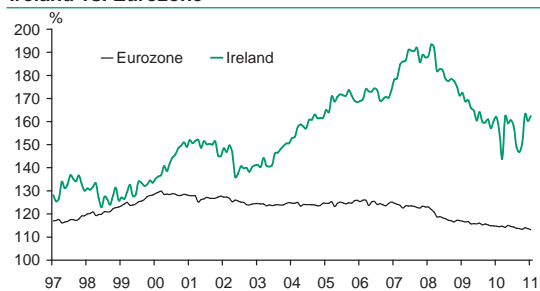


Chart 7

Source: ECB

The loan to deposit ratio (LDR) gradually declined after the crisis broke out as loan portfolios were transferred to NAMA (estimated at €71bn at the end of December 2010). But this indicator suggests that debt leverage is still very high, with LDR at 164% in Q3 2011, compared to a eurozone average of 113%. Aware of the need to reduce the banking system's LDR, the public authorities decided to roll out a deleveraging plan last spring. The plan sets LDR targets for each bank, which must be reached within the next three years: AIB (122.5%), BOI (119.2%), EBS (121.8%) and ILP (121.7%). For all the banks in our selection, LDR would level off at 122.3% in 2013, a decline of 57.5 percentage points from the 2010 level.

Since it is crucial for the banking system to continue providing intermediated financing<sup>12</sup>, deleveraging will occur by focusing on core business and reducing the portfolio of non-strategic assets. By core activities, the government means financing activities in the retail banking segment and granting loans to SME and major corporations. Investment banking activities (M&A and syndication), investor services (asset management) and insurance must be delimited from core needs, i.e. those that ultimately serve the domestic market. As it pursues its goal of providing the country with a healthier banking sector, the government will mainly rely on two universal banks, the Bank of Ireland (BOI) and the entity arising from the merger of AIB and EBS<sup>13</sup>, as well as on ILP to finance the economy. Last July, after the European Commission gave its approval, the High Court of Dublin approved the merger of Anglo Irish Bank and INBS. The new entity was renamed the Irish Bank Resolution Corporation and its mission is to gradually sell off the assets of the two banks over a period of about ten years.

With the shake up of Ireland's banking landscape, international activities will continue to be sold off. AIB has already made major disposals in Poland and in the retail banking sector in the UK. Similarly, BOI spun off its asset management business in October 2010 and began actively deleveraging by selling its international corporate activities. In October 2011, BOI, which is 15% state owned, unwound non-strategic mortgage loans held abroad (in the US, UK, Europe and the Middle East) for €5bn at a discount of about 9% on their nominal value. By refocusing on the domestic market, these banks could strain their margins and their capacity to

generate income in the future. Reducing their geographic diversification could also increase the banking sector's sensitivity to fluctuations in the domestic economic cycle, where growth is not expected to pick up before 2013 (to 2% vs. -0.4% in 2010).

## H1 2011 results remain in a slump

After benefiting from support measures in 2010 and more recently in spring 2011, the Irish banking sector is still extremely weak, mainly due to an unparalleled contraction in the economy. Although our selection of banks reported overall earnings of €1.7bn in H1 2011, swinging back into positive territory for the first time since 2008, this timid rally was due solely to exceptional items at Allied Irish Bank, which reported gains on the discounted repayment of subordinated debt securities for €3.3bn and on €1.5bn in asset disposals.

The other big Irish banks either reported another loss (€0.5bn for the Bank of Ireland and €0.1bn for Anglo Irish Bank) or barely broke even (Depfa Bank). In the end, pretax income before exceptionals was still largely negative (excluding non-recurring items and minority interests), dragged down by another decline in net banking income and the deterioration in operating conditions.

### Net banking income continues to decline

Net banking income, over 80% of which is comprised of net interest income (see chart 8), declined by 29.7% in 2010 compared to the previous year and by another 7.8% in H1 2011 (compared to the first six months of 2010). This can be attributed to the decline in the net margin, which dropped from 0.8% in 2009 to 0.6% in 2010 and to 0.5% in H1 2011.

Unlike their UK counterparts, Irish banks did not benefit from the normalisation of the structure of net banking income in H1 2011 (net interest income accounted for 64% of NBI in the pre-crisis period). Commissions and other operating income had declined slightly in 2007 and 2008 followed by a severe contraction in 2009<sup>14</sup>.

### Structure of net banking income Five largest banks of our sample

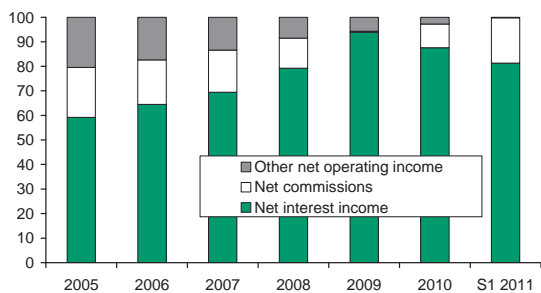


Chart 8

Source: Bankscope

This structural deformation of NBI must be seen in the light of the high volatility of revenues pertaining to market activities, where commissions, which are largely *ad valorem*, contracted sharply due to the sell off in the equity markets. The drop in equity prices triggered a decline in transactions and assets under management as investors fled towards less risky investments. As a result, commissions and other operating income received by the banks declined in 2009 and 2010. Starting in 2011, this movement can also be attributed to the new focus on core banking business encouraged by the government (see above) and the abandon of higher yielding but more risky activities.

### Margins are expected to narrow again in 2011

Irish banks have seen their net margins deteriorate, dropping by half from 1% before the crisis to 0.5% in H1 2011. Margins have eroded since the crisis due to a faster reduction in the apparent margin on lending (1.6% in H1 2011, down from an average of 3.3% in the pre-crisis period) than the apparent margin on funding (1.1% in H1 2011, down from a 2005-2007 average of 2.4%). The margins of Irish banks are relatively low compared to their eurozone counterparts (see chart 9) largely because of their unfavourable balance sheet structure.

The share of deposits by non-financial agents from the eurozone (non-financial companies, households and public administrations) accounted for 14.7% of total assets in Q4 2005, compared to an average of 31.2% for the banking systems of the eurozone as a whole. Although this factor provides an instantaneous explanation<sup>15</sup> of the low level of Irish bank margins compared to their European

### Net interest margin in 2010 : net interest income as share of productive assets

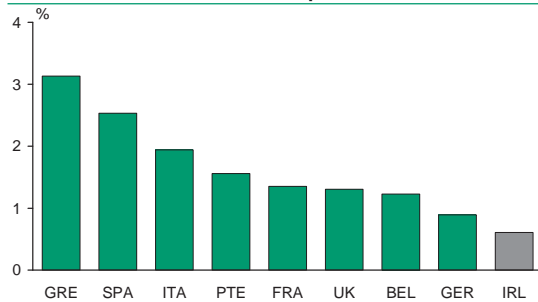


Chart 9

Source: Bankscope

counterparts, it does not justify the dynamics of this decline over time, because deposits as a share of the total assets of monetary financial institutions (IFM) has not changed much since 2005.

To understand the erosion of margins, we must look instead at the interest rate environment (see chart 10). Relatively low long-term rates through spring 2010 tended to hold down asset returns. Due to the preponderance of variable rate loans, the decline in money market rates (following a series of key rate cuts) triggered a reduction in lending rates and thus in the interest received by Irish banks. At the same time, fiercer competition in deposit collection made it harder for Irish banks to generate margins in the domestic market. Lastly, with wholesale funding accounting for more than 40% of liabilities, banks saw the cost of funding rise, as shown by the sharp increase in premiums on Credit Default Swaps (CDS) (see below) in the wake of growing mistrust for Irish banks.

### Interest rates by maturity

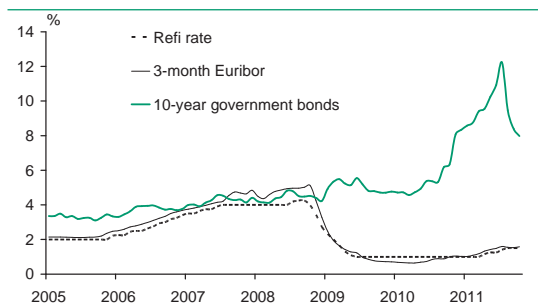


Chart 10

Source: Datastream

Although the monetary policy *status quo* is likely to be maintained, net margins will probably continue to narrow in 2011 for several reasons: 1) increasingly fierce competition in deposit collection, 2) another increase in the cost of financial resources (due to the adoption of the new Basel 3 capital requirements) and 3) a slowdown in loan demand. Irish banks will need to increase the share of stable and/or long-term financing (i.e. more than one year) for two main reasons. First, they are currently overly dependent on short-term sources of refinancing, notably from the ECB (see below). Sooner or later they will have to reduce this short-term financing by strengthening their deposit base. Second, to comply with the new liquidity requirements introduced with Basel 3 (i.e. the net stable funding ratio, or NSFR, applicable as of 1 January 2018), Irish banks, like their European counterparts, will have much less manoeuvring room for transforming maturities than they have today, since long-term assets will have to be financed using long-term or stable funding. Lastly, loan volumes are bound to decline during the current phase of private sector debt reduction, limiting the potential for Irish banks to rebuild margins.

Between 2001 and 2009, the debt ratio of private non-financial agents increased significantly, from 44.2% to 105.1% for non-financial companies and from 49.6% to 123.3% for households<sup>16</sup>. In 2010 the debt ratio of private non-financial agents declined for the first time since the beginning of the decade, by 9 points for non-financial companies and by 4.4 points for households. This illustrates that deleveraging is underway in Ireland (see above) (see chart 11).

#### Debt ratio of non-financial agents

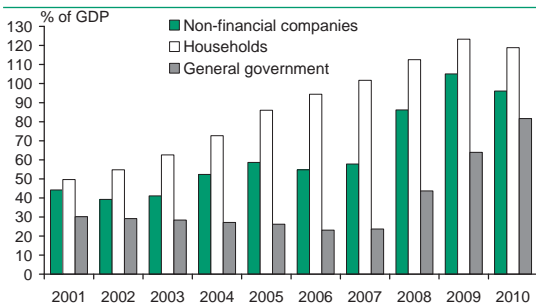


Chart 11

Source: Eurostat

The crisis was accompanied by a cyclical downturn that abruptly eroded the confidence of private agents, including the banking sector, which in

late 2008 cut short the massive supply of credit. For households, this credit crunch and tighter solvency requirements were accompanied by a drop in the value of real estate assets, which triggered another contraction in lending and a downward spiral in loan allocations (see chart 12). With the sharp slowdown in bank lending (see chart 13), the financial health of companies deteriorated as sources of financing dried up. Non-financial companies had to resort to deleveraging, which partially explains the sharp decline in the investment rate, to 8.6% in 2010 from 16.8% in 2007.

#### Growth of household bank lending Ireland vs. Eurozone

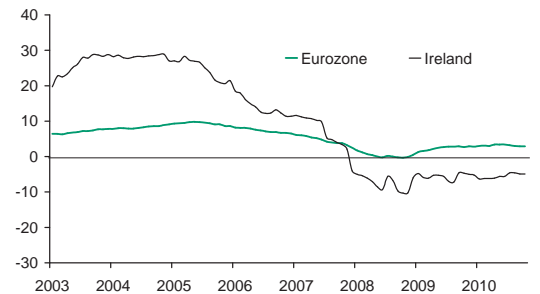


Chart 12

Source: ECB

#### Growth of bank lending to non-financial companies Ireland vs. Eurozone

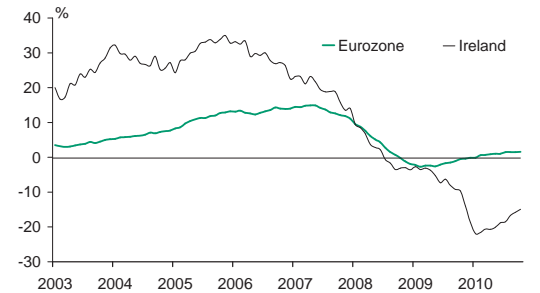


Chart 13

Source: ECB

In contrast, public debt swelled dramatically just after the financial crisis as the recession cut into fiscal revenues and the Irish government launched a series of rescue plans for the banking sector (quasi-nationalisation of the sector and transfer of toxic assets to a public "bad" bank). Public debt continued to swell in 2010, despite the launch of several austerity plans as early as fall 2008<sup>17</sup>. Even so, the government still plans to reduce the deficit to 7.5% of GDP in 2013 and to less than 3% of GDP in 2015.

## Aggregated income statement for the five largest Irish banks\*

Amounts in € bn Variations in %	2005	2006	2007	2008	2009	2010	H1 2010	H1 2011	Variation H1 2010/ H1 2011
Net banking income	10.0	10.9	12.4	12.9	7.9	6.0	2.7	2.5	-7.8
of which; net interest income	5.9	7.0	8.6	10.2	7.4	5.2	2.6	2.0	-21.8
of which: net fees and commissions	2.0	2.0	2.1	1.6	0.0	0.6	0.2	0.5	99.6
of which: other net operating income	2.0	1.9	1.7	1.1	0.4	0.2	-0.1	0.0	n.s.
Operating expenses	5.0	5.5	6.0	6.8	4.4	5.0	2.0	1.9	-3.2
of which: staff expenses	3.0	3.5	3.6	3.4	2.3	2.4	1.1	1.0	-11.5
of which: other operating expenses	2.0	2.0	2.3	3.4	2.2	2.6	0.8	0.9	8.0
Gross operating income	4.9	5.4	6.5	6.1	3.5	1.0	0.7	0.6	-19.7
Cost of risk	0.2	0.3	0.4	4.0	23.2	14.2	5.7	4.5	-21.2
Profit before exceptional items and taxes	4.8	5.1	6.1	2.1	-19.7	-13.3	-5.0	-3.9	n.s.
Non recurring income and exceptional items	0.1	1.0	0.6	0.1	1.7	-18.3	-5.6	5.3	n.s.
Tax expenses	0.9	1.0	1.1	0.6	-0.8	-2.0	-0.4	-0.4	n.s.
Minority interests	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	n.s.
Net income attributable to equity holders	3.9	5.0	5.4	1.5	-17.2	-29.7	-10.2	1.7	n.s.

(\*) Our sample encompasses the five largest banks in terms of capital tier one, so in 2010 : Bank of Ireland, Allied Irish Banks, Merrill Lynch Int. Bank, Anglo Irish Bank Corp., DEPFA Bank. This sample was covering 58% of the Irish MFIs balance sheet in December 2010.

Table

Source: Bankscope – Banks Press Releases

The debt servicing charge will continue to weigh heavily on the budget deficit, especially since Ireland's credit rating has deteriorated sharply, increasing the cost of market financing.

### Operating conditions are unlikely to return quickly to the pre-crisis situation

Although Irish banks sharply reduced staff size in 2009 to adapt to the economic slump<sup>18</sup>, the sharp contraction in NBI since the crisis combined with the upturn in operating expenses in 2010 has driven up the cost-income ratio (from 56.1% in 2009 to 84.1% in 2010 and 76.1% in H1 2011) (see chart 14). In 2009, Irish banks had one of the lowest cost-income ratios in Europe. In 2010 and H1 2011, however, they moved ahead of their counterparts in Germany (67%), the UK (64.9%), Italy (63.9%), France (61.3%), Portugal (58.7%) and Spain (47.6%). Operating income continued to contract in 2010 to €1bn from €3.5bn in 2009 and a pre-crisis average of nearly €6bn. In H1 2011, operating income was down

### Cost-income ratio (operating expenses/NBI)

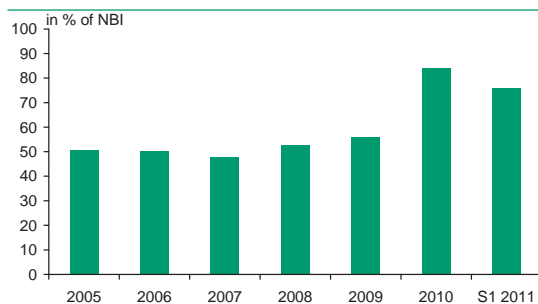


Chart 14

Source: Bankscope

19.7% compared to the cumulative figure for the first six months of 2010.

At the same time, the cost of risk remained very high in 2010 and in H1 2011, although slightly lower than in 2009 (at 238.4% and 179.6% of GDP, respectively, compared to less than 3% before the crisis). To cope with earlier troubles in the real estate sector and ongoing price adjustments, the Irish banks reported major provisions and heavy losses. The cost

of risk surged in 2009 to €23.2bn. Although it slowed down thereafter (-38% in 2010 and -21.2% in H1 2011 compared to the first six months of 2010), the cost of risk remained very high in 2010 and in H1 2011 at €14.2bn and €4.5bn, respectively. To clean up bank balance sheets, the public authorities set up a defeasance structure to pool together toxic assets within an ad-hoc legal entity called the National Asset Management Agency (NAMA). Using a classic defeasance mechanism, assets were transferred to this ad-hoc entity to give Irish banks more time to sell off assets, which had become illiquid at the height of the crisis after demand contracted<sup>19</sup>. Since its creation, NAMA has purchased €72.3bn from participating banks at an average discount of 58%. The quality of banking assets (see below) is still a big problem for the Irish banking system, especially since NAMA has less room to act since its asset purchasing capacity is capped at €80bn. In the future, the cost of risk ratio (see chart 15) could hold at high levels under the combined impact of further real estate price corrections and persistently sluggish GDP, which is expected to hold well below pre-crisis levels.

our selection was a negative €3.9bn in H1 2011. Losses before exceptional items were not as heavy in H1 2011 as in the first six months of 2010. Nonetheless, banking income will continue to be strained by the uncertainties surrounding the economic recovery in 2012 and the need to adapt to a new regulatory environment with the implementation of Basel 3 (higher cost of funding).

Moreover, although the Irish banks in our selection managed to swing back into positive economic results and financial returns (0.4% and 8.5%, respectively, in H1 2011), profitability was only restored through exceptional items that temporarily shored up their financial positions. Irish banks will need to see a real improvement in operating conditions before they can get back on the road to sustainable profitability.

## Credit and liquidity risks are still significant

Unlike the UK banking groups HSBC and Standard Chartered, Irish banks are mainly focused on the domestic market, which makes them much more vulnerable to national cyclical trends. A more in depth analysis of the situation of Irish banks shows that there are still substantial credit and liquidity risks. Credit risks are unlikely to be absorbed rapidly for several reasons (concentration of risks in the home mortgage segment and another correction in the housing market). The conditions for accessing liquidity have not returned to normal yet, suggesting that the Irish banking sector could continue to have trouble financing assets in the medium to longer term.

### Credit quality: short-term risks are still present

The cyclical downturn and the correction in the housing market, a segment in which Irish banks were massively active, have sharply eroded the quality of banking assets, as illustrated by the big increase in non-performing loans as a share of gross loans outstanding (see chart 16). Accounting for less than 0.8% of total bank loans outstanding before the crisis, the share of non-performing loans increased significantly to 2.6% of total loans outstanding in 2008 and to about 9% since 2009. The share of non-

**Cost of risk ratio and GDP growth rate**

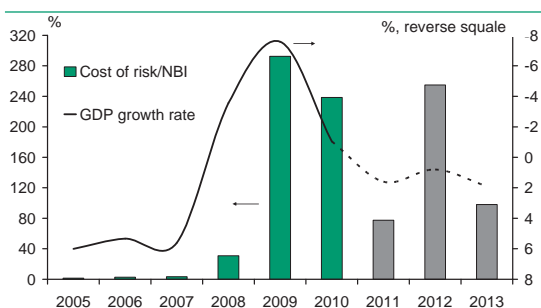


Chart 15 Sources: Bankscope, Datastream, BNP Paribas estimates

The limited increase in operating expenses and the persistently high cost of risk, despite a sharp decline in 2010, once again strained pretax income before exceptional items, which was a negative €13.3bn in 2010 (after -€19.7bn in 2009). Although operating expenses and the cost of risk declined in H1 2011 (by 3.2% and 21.2%, respectively, compared to H1 2010), they were still high at €1.9bn and €4.5bn, respectively. Net banking income was also relatively weak. As a result, the aggregate pretax income before exceptional items for the Irish banks in

### Non-performing loans as a share of total loans outstanding

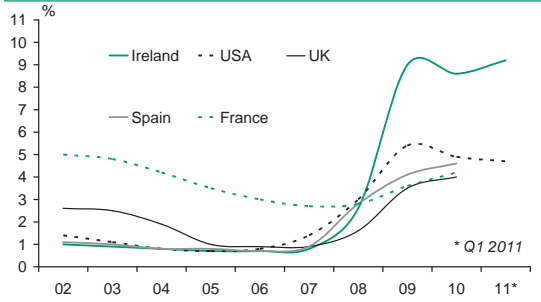


Chart 16 Source: IMF - Financial Soundness Indicators

### Real house price trends

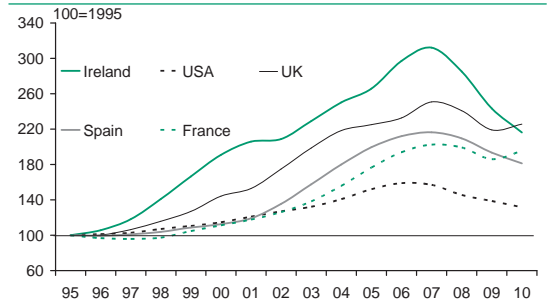


Chart 19 Source: OECD

### Breakdown of the loan portfolio at 31.Dec.2010 (as share of total loans)

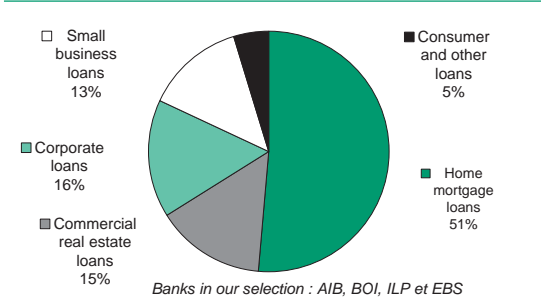


Chart 17 Source: Central Bank of Ireland

### Housing market: price to rent ratio

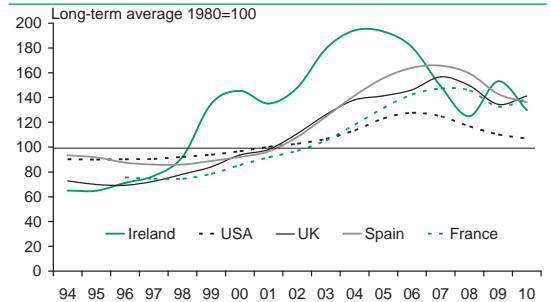


Chart 20 Source: OECD

### Provisions to non-performing loans

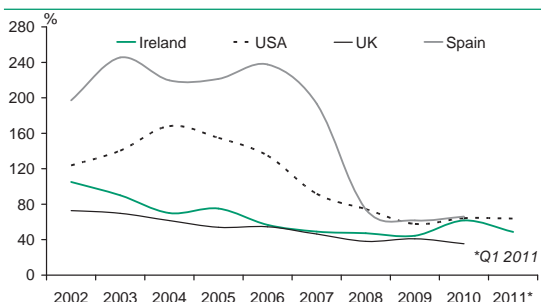


Chart 18 Sources: IMF-Financial Soundness Indicators

### Housing market: price-to-income ratio

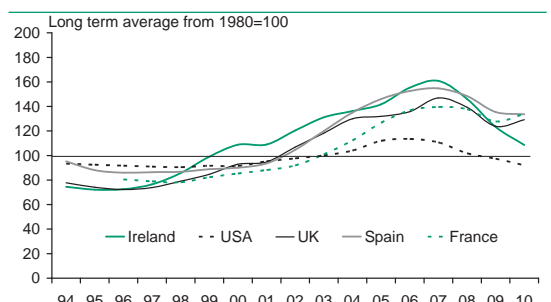


Chart 21 Source: OECD

performing loans is expected to remain high in 2011 and 2012 due to the ongoing macroeconomic slump and decline in real estate prices. We estimate the unemployment rate in Ireland at 14.2% in 2011 and 14.3% in 2012. Moreover, companies will not benefit from a rebound in activity before 2013. Under these conditions, Irish banks could be hit by another increase in the default rate.

The loan portfolios of Irish banks are highly concentrated (see chart 17), which largely explains the troubles they are now facing; they are extremely vulnerable to another correction in the real estate market. At 31 December 2010, nearly 80% of household loan portfolios were comprised of home loans, which accounted for more than half of the loan portfolios of Irish banks. A large share of corporate loans is also concentrated in the real estate sector in the broad sense of the term, including construction and real estate activities and services. Since a large number of rescue operations were geared towards mortgage loans, the ratio of provisions to doubtful loans actually declined through 2009 (see chart 18): Irish banks were still counting on reselling assets in an environment of rising property prices. In 2010, the cyclical downturn in the housing market also reversed the banking sector's expectations, and encouraged by the Central Bank of Ireland, they made greater provisions for doubtful loans.

House prices have already entered a sharp correction, declining 43% in real terms from the peak in 2007 to July 2011 (see chart 19). Yet the price-to-rent ratio (see chart 20) and the price-to-income ratio (see chart 21) have both held at high levels, suggesting that valuations are still too high and that prices could still fall further. As a result, the quality of bank assets continued to erode. Irish banks are hit on two levels, *via* 1) a higher default rate and 2) losses reselling assets held as collateral<sup>20</sup>. Faced with this environment, Irish banks are finding it very hard to return to pre-crisis earnings, especially since they are not very diversified geographically, and thus cannot benefit from new sources of international growth. Uncertainty over cyclical trends has naturally led them to expect their credit quality to deteriorate further.

### Bank funding: access conditions will remain tough for a long time to come

The series of rescue plans failed to restore investor confidence in the Irish banking system.

### 5-year Credit Default Swaps (CDS)

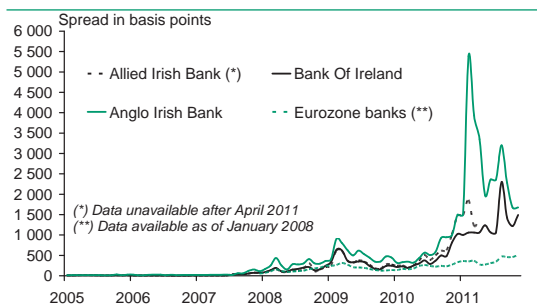


Chart 22

Source: Datastream

Although premiums on Credit Default Swaps (CDS) have declined sharply since the beginning of the year, they are still very high and the situation is far from normal: the CDS spreads of the main Irish banks are much higher on average than those of their counterparts in the eurozone (see chart 22). From a more general perspective, and looking beyond the quality of assets, the balance sheet risks that emerged during the financial crisis are still disturbing. First, Irish banks are still receiving a big share of their financing via the market, notably via short-term funding on the interbank market, while the customer deposit base, which is known as a stable source of funding, remains relatively narrow. Second, in a persistently mistrustful environment, Irish banks remain highly dependent on ECB refinancing.

### Preponderance of market financing and interbank loans

As we have pointed out previously<sup>21</sup>, with the deregulation of the financial sphere in the 1980s, there was a general decline in customer deposits in favour of interest-bearing financial instruments, mainly long-term bonds, which made banks more dependent on changes in market conditions and the cost of marketing financing, which was more volatile. Although long-term bond issues have declined since 2006 (27.6%), they still made up a significant share of financing in H1 2011. They accounted for about a fifth of the assets of Ireland's five biggest banks, the same percentage as in Portugal, compared to 16% in Spain, 10.5% in the UK and 4.7% in Greece. A large number of these secured bonds are guaranteed by public securities, which increases the banks' sensitivity to sovereign risk. Even today, tensions in

the Irish sovereign debt market continue to strain financing conditions and/or to exacerbate liquidity problems.

The situation has not yet returned to normal, as illustrated by the ECB's very active policy, and Irish banks are still highly dependent on short-term refinancing on the interbank market. They are thus particularly exposed to tensions in the international banking markets, which makes them all the more vulnerable to liquidity risk. From this perspective, Irish debt with eurozone credit institutions is still extremely high, accounting for nearly 63% of total deposits, vs. a eurozone average of about 36%, and nearly 26% of total liabilities, vs. 18% for the eurozone (see charts 23 and 24). Inversely, the share of deposits of non-financial agents held at a low level in Ireland in Q3 2011 (accounting for 15.2% of total assets, vs. a eurozone average of 32.7%), limiting the banks' access to a more stable and less costly source of funds. Irish banks were also relatively dependent on international credit institutions located outside of the eurozone in Q3 2011. Although deposits by non-resident monetary financial institutions located outside the eurozone have declined as a share of total assets since the outbreak of the financial crisis (by about 6 points), they are still significantly high. They account for more than a tenth of total financing, down from an average of 17.2% in the pre-crisis period (see chart 25). The contraction in interbank loans provides another illustration of the mistrust of foreign banks for their Irish counterparts. Already handicapped when accessing liquidity on the international markets, Irish banks will remain prone to trouble in the near future unless confidence is restored quickly.

Due to the low level of stable short-term funding (deposits by non-financial agents are relatively small as a share of total assets) and the size of long-term commitments to non-financial customers (long-term loans are concentrated in the residential and commercial real estate markets), Irish banks face a particularly high transformation risk. An analysis of the structure of assets and liabilities of Irish monetary financial institutions in Q3 2011 continues to suggest very asymmetrical maturities and high transformation risk. Long-term resources, in the strict sense of the term (debt issues of more than a year, capital and reserves), only accounted for 15.2% of the assets of Irish monetary financial institutions, compared to a eurozone average of 25.2%. The government's plan

**Deposits of monetary financial institutions in the Eurozone as share of total deposits: Ireland vs. Eurozone**

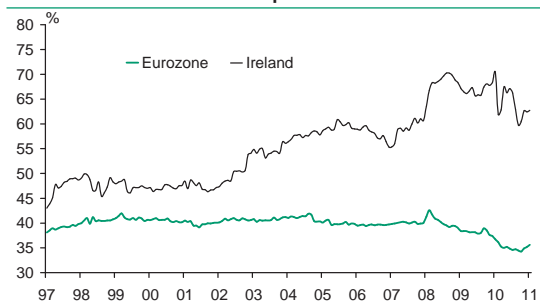


Chart 23

Source: ECB

**Deposits of monetary financial institutions in the Eurozone as share of total assets: Ireland vs. Eurozone**

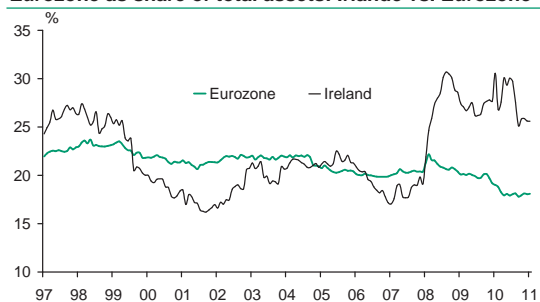


Chart 24

Source: ECB

**Deposits of non-residents outside of the Eurozone as share of total assets of credit institutions**

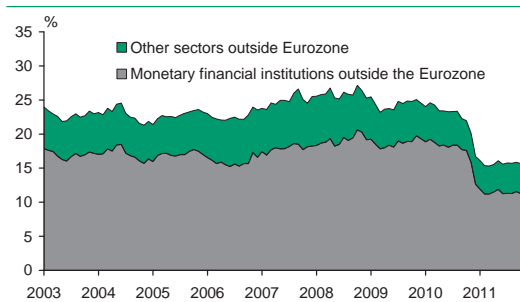


Chart 25

Source: Central Bank of Ireland

to encourage deleveraging (see above) by shifting the focus of lending toward the economy's core needs should reduce transformation risk in the years ahead by limiting the distribution of home loans, which have the longest maturities.

*Still highly dependent on the ECB and the Central Bank of Ireland for refinancing*

With the financial crisis and the widespread mistrust between credit institutions that ensued, market financing dried up and it became harder to access the interbank market. Since the outbreak of the crisis, the ECB and the Central Bank of Ireland have partially stepped in to replace the markets, providing the necessary funding for Irish banks and easing the liquidity crunch (see chart 26). In spring 2011, the ECB also eased the conditions for Irish banks to access its liquidity facilities by suspending the minimum eligibility requirements for collateral used in Eurosystem credit operations, for negotiable debt instruments issued or guaranteed by the Irish government. This decision applies until revoked to all credit instruments in circulation as well as to new issues. This emergency measure allows banks to benefit from unlimited refinancing at little cost, and indicates that access conditions to bank funding are still tough.

**Structure of liabilities of Irish credit institutions**

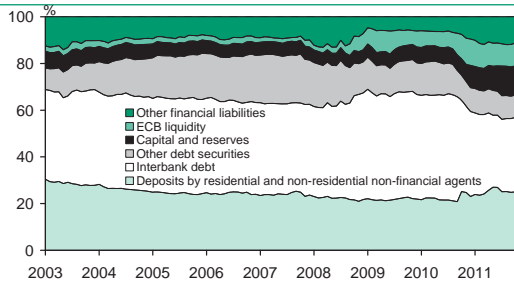


Chart 26 Source: Central Bank of Ireland

At the end of October 2011, liquidity provided as part of all ECB refinancing operations was still very high at nearly €101bn, even though it had declined over the past 12 months, compared to an average of €23bn in the pre-crisis period 2005-2007. It accounts for nearly 20% of all financing provided by the ECB for a country that contributes only about 2% of eurozone GDP. Irish banks also continue to receive refinancing as part of the Emergency Liquidity Assistance (ELA), which provides liquidity to banks that no longer have collateral that meet ECB eligibility requirements. These loans amounted to nearly €48bn in October 2011, compared to an average of €3.6bn before the crisis (see chart 27).

**Dependence on liquidity from the Eurosystem and the Central Bank of Ireland**

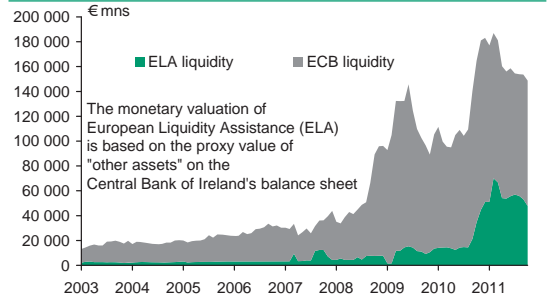


Chart 27 Source: Central Bank of Ireland

**Eurosystem liquidities as a share of the total assets of monetary financial institutions (\*) in the peripheral countries**

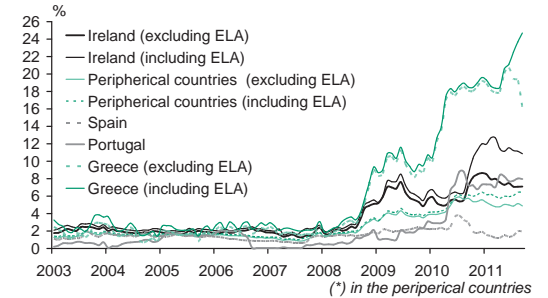


Chart 28 Sources: ECB, national central banks, Datastream

**Eurosystem liquidities as a share of total GDP in the peripheral countries**

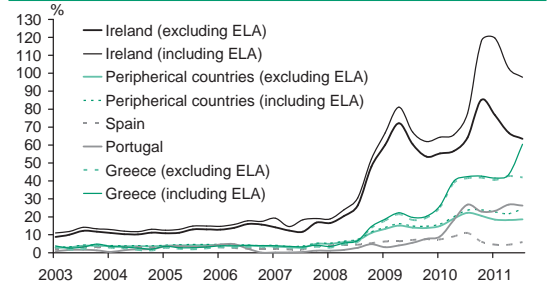


Chart 29 Sources: ECB, central national banks, Datastream

In terms of the total assets of monetary financial institutions (see chart 28), liquidity support measures accounted for 10.9% of their total assets (including ELA) at September 2011, which places Ireland behind Greece (24.7%, including ELA) but ahead of Portugal (8%) and far ahead of Spain (1.9%). Moreover, Irish credit institutions are still extremely dependent on the monetary authorities compared to their counterparts in other peripheral countries. ECB

loans accounted for about two thirds of Irish GDP in Q3 2011 (97.8% including ELA), compared to less than half for Greece (though 60.4% including ELA liquidity), a quarter for Portugal and 4.4% for Spain (see chart 29).

## A very dark horizon that is unlikely to clear up anytime soon

Ireland now has a two-speed economy in which national companies, severely handicapped by fiscal austerity measures and the severe correction in the real estate market, co-exist with multinational export companies that were drawn to the country by its attractive fiscal policy (corporate tax rate of 12.54%, the lowest in the eurozone). It will take years before economic output returns to pre-crisis levels: we are forecasting growth of 2% in 2013 after 0.2% in 2012. Economic fundamentals are still fragile because, in addition to the uncertainties weighing on domestic demand (ongoing real estate market correction, high unemployment, fiscal consolidation plans, etc.), Ireland is dependent on exports and is not sheltered from a slowdown in the growth of its trading partners. Given this environment of sluggish growth, non-performing loans are likely to remain high. Coupled with a sharp slowdown in credit demand, these factors could strain the results and profitability of Irish banks, whose low geographic diversification makes them highly dependent on the domestic economy.

Despite persistent concerns about their financial health, the government's successful €1.1bn disposal of a 37% stake in the Bank of Ireland to private investors last summer can be interpreted as a sign that the private sector is gradually regaining confidence in Irish banks. Even so, private investors still do not seem to have much of an appetite for Irish bank stocks, as illustrated by the price to book ratio at the end of December 2011 (0.66 for the Bank of Ireland and 0.20 for Allied Irish Bank). Moreover, the government's gradual pull out from the sector is due less to the success of last spring's restructuring efforts than to tighter budget constraints following the banking crisis. The pressure is all the stronger since

the markets, the European Union and the IMF seem to see the clean up of public finances as the sign of Ireland's credibility.

The latest government plan announced last spring continues to strive towards a thorough consolidation of the Irish banking system. Yet the clean up of Irish banks is far from over. First, non-performing loans still account for a substantial share of total assets, raising doubts about the banking system's capacity to strengthen solvency in a sustainable manner. Second, Irish banks continue to have a hard time mobilising new sources of funding. Even so, they probably benefited from the ECB's new exceptional lending measures announced on 21 December (€489bn for the eurozone), which provides access to 3-year credit lines at a rate of 1%.

### Share price trends

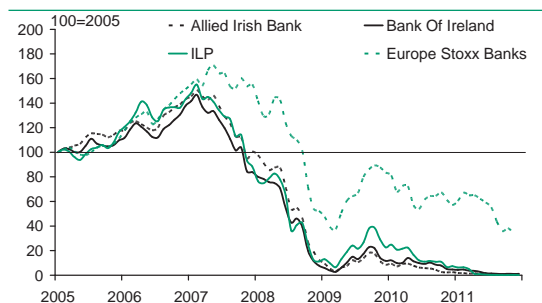


Chart 30

Source: Datastream

The market is not very optimistic about the sector's future prospects, resulting in very low valuations for Irish bank stocks, well below their pre-crisis levels and those of their European counterparts (see chart 30). No doubt the Irish banking system will remain under tight surveillance in the quarters ahead, both by private investors and by the public authorities, who are still worried about financing a national economy highly dependent on banking financing.

Completed, 4 January 2012  
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## NOTES

- <sup>1</sup> See Philippe Sabuco: "Irish banks: another look at the Celtic mirage" in the December 2010 issue of *Conjoncture*, BNP Paribas.
- <sup>2</sup> For a detailed review of stress test results, see Céline Choulet: "Irish banks: public support is a double-edged sword" in *Ecoweek* 11-14, BNP Paribas.
- <sup>3</sup> The European Commission provides that "1) assisted banks must set up a restructuring plan ensuring that they will be viable in the long term without benefiting from additional public aid, 2) these banks and their owners must assume an equitable part of the cost of restructuring, and 3) measures must be taken to limit the distortion of competition in the single market".
- <sup>4</sup> Defpa Bank, an Irish subsidiary 100% controlled by the German bank Hypo Real Estate, reported a very big increase in its Tier 1 ratio in 2010 (50.8%) and in H1 2011 (58.7%). This trend can be attributed to the seven-fold reduction in risk-weighted assets, which was due in turn to the transfer of €131bn in loan and securities portfolios (excluding derivatives) in October 2010 to a German wind-down entity, FMS Wertmanagement.
- <sup>5</sup> To address concerns about exposure to sovereign debt and to highlight any needs for equity capital, the EBA conducted a preliminary test published on 27 October based on sovereign exposure at 30 June 2011 and a second, definitive test presented on 7 December based on data at 30 September.
- <sup>6</sup> Basel 2.5 aims to tighten capital requirements in the face of the market risk of trading books. Its principles were set forth in European Directive CRD3, transposed into French law in November 2010 and applicable for equity capital at 31 December 2011. The text specifically stipulates:
- 1) an additional capital requirement in terms of "stressed Value at Risk (VaR)", introduced to correct the pro-cyclical nature of VaR and which requires credit institutions to deploy scenarios calibrated to a stress period and not solely to observations of the past 12 months;
  - 2) an incremental risk charge designed to cover a default or a deterioration in the credit ratings of issuers (credit, underlying instrument of derivatives and securitisation support);
  - 3) a comprehensive risk charge based on stress tests designed to better account for the risk of correlation between banking establishments;
  - 4) application of banking book capital requirements for securitised assets on the trading book, to avoid any regulatory hedging between the trading book and banking book.
- <sup>7</sup> Prudential filters were specified to offset the shortcomings of IFRS standards by allowing for the restatement of book amounts before integrating them in prudential capital.
- <sup>8</sup> The EBA review was based on: i) an evaluation of capital requirements following the application of CRD3, and ii) the assessment of additional capital following the stress of marking sovereign exposure to market prices. As for Irish banks, the additional safety mattress to cover their sovereign exposure would require a limited capital increase of €815m (0.5% of weighted assets), which is largely offset by the surplus capital position arising from the simple application of CDR3.
- <sup>9</sup> Recapitalisation measures were designed to strengthen book equity.
- <sup>10</sup> CRD 4 corresponds to the transposition of Basel 3 regulations into European law.
- <sup>11</sup> When Ireland joined EMU, non-financial agents benefited from much more attractive credit conditions resulting from a lower credit spread in the financial sector.
- <sup>12</sup> The majority of the financing of Irish companies is through bank loans and the ratio of loans to total debt was 93% in December 2010. Based on Central Bank of Ireland figures, the government estimates the financing needs for small business loans and home mortgages at between €11bn and €16.5bn from a 3-year horizon. According to government estimates, the financing capacity of the newly restructured banking system will be €30bn over the same time frame, of which €16bn to €20bn will be dedicated to small business loans and mortgage loans.
- <sup>13</sup> This merger should enable a larger scale amortisation of fixed costs and generate synergies from the complementary strategies of each bank.
- <sup>14</sup> Other operating income comprises income from insurance activities and hedging instruments.
- <sup>15</sup> By instantaneous, we mean the observation of a phenomenon at a given moment.
- <sup>16</sup> In 2001, Ireland's household debt ratio was 49.6% of GDP, similar to the eurozone average of 48.5% and the Spanish ratio of 48%, but ahead of France (34.6%) and far behind the UK (71.8%) and the United States (94.7%). Over the span of a few years, Ireland's household debt ratio (as a share of GDP) rapidly converged with that of its UK and American counterparts. This debt dynamic can be attributed to a credit bubble in which households borrowed mainly to purchase homes. Since economic agents had excessively optimistic expectations, credit risks were undervalued: the appreciation of real estate assets, fed by the credit boom, gave an erroneous impression of relative security. Since real estate assets could be used as collateral, the banks assumed they could use these guarantees if their debtors encountered difficulties. Yet what seemed supportable from a microeconomic perspective was much less so at the macroeconomic level, notably when there was a sudden, widespread decline in real estate prices.

<sup>17</sup> For a presentation of these austerity measures, see Caroline Newhouse: "Ireland: a recovery still in need of confirmation" in the November 2011 issue of *Conjoncture*, BNP Paribas.

<sup>18</sup> See Philippe Sabuco: "Irish banks: another look at the Celtic mirage" in the December 2010 issue of *Conjoncture*, BNP Paribas.

<sup>19</sup> This facility was not easy to deploy since it was necessary to determine the price of so-called toxic assets, which generated a loss on the income statement. Nonetheless, by having an agency, generally publically owned, purchase these assets at prices above market value, the banks could remove them from their balance sheets at a disposal price that, while lower than book value, nonetheless generated fewer losses than if the assets had been sold at rock bottom prices. It also limited the impact of the lack of liquidity in some markets on bank balance sheets and income statements.

<sup>20</sup> By reselling real estate assets held as collateral when a borrower defaults, banks exacerbated the downward pressure on house prices, which further deteriorated the quality of their assets.

<sup>21</sup> See Philippe Sabuco: "Irish banks: another look at the Celtic mirage" in the December 2010 issue of *Conjoncture*, BNP Paribas.

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