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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The ECB and Financial Assistance Programmes: Has ECB Acted Beyond its Mandate?

IN-DEPTH ANALYSIS

Abstract

This paper discusses the ECB's role in Ireland's EU-IMF programme and briefly raises some issues regarding its decisions relating to the Greek banks during this year's crisis. The absence of clear procedures for lender of last resort led to a number of key decisions being taken by the ECB in a way that fell short of the relatively transparent and accountable standards that it has set in the monetary policy area. I recommend that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes. Some institutional changes have occurred that make some of the negative aspects of the ECB's involvement in Ireland's programme less likely to occur again. However, this year's events in Greece show that as long as the ECB's lender of last resort role remains confused, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

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CONTENTS

EXECUTIVE SUMMARY **4**

1. INTRODUCTION **5**

2. THE ECB AND IRELAND **6**

2.1 Prior to the Programme 6

2.2 The ECB and Ireland's Application for Programme Funds 9

2.3 The ECB and Programme Negotiations 12

3. THE ECB AND IRELAND: AN ASSESSMENT AND SOME QUESTIONS **14**

3.1 An Assessment 14

3.2 Some Questions 17

4. THE ECB AND GREECE'S 2015 CRISIS **18**

REFERENCES **20**

EXECUTIVE SUMMARY

- The ECB has played a key role in determining the timing of financial assistance programmes, in setting the conditions for these programmes and in programme monitoring.
- In this paper, I discuss the ECB's role in Ireland's EU-IMF programme and briefly raise some issues regarding its decisions relating to the Greek banks during this year's crisis.
- Despite the welcome release of two letters sent by Jean-Claude Trichet to the Irish government in 2010, the circumstances surrounding the ECB's involvement in the instigation and negotiation of Ireland's programme are still unclear.
- There is now substantial circumstantial evidence that former U.S. Treasury Secretary Timothy Geithner was involved in both the ECB's decision to insist that Ireland enter an EU-IMF programme and the subsequent decision to see that all senior bondholders of Irish banks be repaid in full. The ECB should explain how these decisions were taken.
- I conclude that the absence of clear procedures in the Eurosystem for lending of last resort to banks has led to a number of key decisions being taken by the ECB in a way that fell well short of the relatively transparent and accountable standards that it has set in the monetary policy area.
- It is unclear whether the ECB's role in designing and monitoring programme conditionality relating to fiscal policy and structural reforms is consistent with its legal mandate. The ECB should explain why it was necessary for it to be a formal member of the "Troika" group.
- I recommend that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes.
- Some institutional changes have occurred since 2010 (new state aid rules, the Bank Recovery and Resolution Directive and the appointment of the ECB as a single supervisor for the euro area's banks) that make some of the negative aspects of the ECB's involvement in Ireland's programme less likely to occur again.
- However, this year's events in Greece show that as long as the ECB's lender of last resort role remains as confused as it currently is, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

1. INTRODUCTION

The multiple crises that have affected euro area member states over the past few years exposed a significant number of gaps in the policy architecture underlying the euro as a common currency area. In its early years, the ECB focused almost solely on its monetary policy responsibilities and had relatively little role to play in banking-related financial stability areas. Indeed, responsibility for financial stability issues still lay largely with national governments and national central banks and the ECB did little to articulate how the lender of last resort function was supposed to work in the euro area.

On the fiscal policy side, the Stability and Growth Pact was supposed to prevent countries from getting into trouble but, if they did, the plan was that there would no financial assistance from other member states. The subsequent reality of ongoing fiscal and banking crisis has resulted in a huge change in the institutional structures underlying the euro. Fiscal rules have been reformed, a permanent euro area bailout fund has been put in place and the ECB has been assigned as the regulator of the euro area's largest banks.

The events of recent years have particularly highlighted the absence of a clear approach within the Eurosystem to last resort lending to banks. As a result, many of the decisions related to such lending (most notably in relation to Emergency Liquidity Assistance or ELA) were made in an ad hoc and secretive manner. A key area of uncertainty in recent years has been the role played by the ECB in the so-called "troika" of institutions that oversaw financial assistance programmes in Greece, Ireland, Spain and Portugal and the interactions between last resort lending and these programmes.

In this paper, I will mainly discuss the role the ECB played in Ireland's financial assistance programme because it is the case that I am most familiar with. Section 2 discusses the role the ECB played in the timing of the Irish programme and its role in designing the terms of the programme. Section 3 assesses the ECB's role in the Irish programme and raises some questions. Overall, I conclude that the absence of clear procedures for lender of last resort led to a number of key decisions being taken by the ECB in a way that fell well short of the relatively transparent and accountable standards that it has set in the monetary policy area. I also recommend that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes.

A number of years have now passed since the negotiations for the Irish programme and there have been some improvements in institutional design. The ECB is no longer quite so secretive about ELA (though decisions in the area are still pretty murky). In addition, the advocate general of the European Court of Justice has argued that the ECB must not be involved in the monitoring of any European Stabilisation Mechanism financial assistance programme that would be required under an Outright Monetary Transactions (OMT) programme. The ECB is now also the official supervisor for the euro area's largest banks and has a clear mandate to deal with these banks when they are failing, a task made easier by the passing of the Bank Recovery and Resolution Directive. All of these elements are helpful in keeping the ECB's role in relation to crisis countries as transparent as possible.

That said, as I discuss in Section 4, the ECB's role in this year's Greek crisis shows that the Governing Council is still making highly politicised decisions on lending of last resort and continuing to link financial stability decisions to fiscal conditionality set by official lenders. This shows the ECB is still falling some way short of the role that it should be playing in maintaining financial stability in the euro area.

2. THE ECB AND IRELAND

2.1 Prior to the Programme

Prior to the global financial crisis, Ireland appeared to many to be a model for success among European economies. Though there has since been plenty of revisionism by international organisations, prior to the crisis Ireland was hailed as a model of fiscal and financial stability by the IMF and the European Commission.[1]

By mid-2008, it became clear that much of the economic growth Ireland had achieved in the final years of its expansion had been built on shaky grounds. A gigantic property boom had seen per capita housing completions running at four times the rate seen in the US during the peak of its housing boom and house prices quadrupling between 1996 and 2007. As the global economy began to slow down, house prices in Ireland began to slide and construction activity collapsed.

The construction bust had severe implications for Ireland's public finances. The tax base had become increasingly reliant on what turned out to be temporary revenues from the construction sector and the large increase in unemployment due to the sector's contraction put huge pressure on public spending for(?) welfare benefits. Ireland moved swiftly from running a small budget surplus to deficits that were double-digit shares of GDP.[2]

That said, Ireland should have been well positioned to cope with a large fiscal shock. It had a gross debt-GDP ratio in 2007 of 25% and a sovereign wealth fund worth close to this amount. On its own, the large fiscal shock could possibly have been coped with without requiring official financial assistance. The aspect of Ireland's crash that pushed it over the edge was the effect of the construction bust on the banking sector.

By mid-2008, it was clear to international bond markets that Irish banks had made enormous loans to the construction sector for speculative development projects and that the losses on these loans would be substantial. These banks had relied on issuing bonds to international capital markets to finance their rapid growth and suddenly found they were unable to roll over this funding. The banks began to borrow from the Eurosystem to pay off maturing bonds. When Anglo Irish Bank ran out of Eurosystem-eligible collateral in September 2008, the Irish government choose to offer a guarantee to all depositors and the vast majority of bondholders of the domestic Irish banks.

While this guarantee temporarily stabilised the condition of the Irish banks, it became clear from late 2008 onwards that Anglo Irish Bank, which had specialised in commercial property lending, was in serious trouble. The bank was nationalised in early 2009 and was suffering from substantial deposit withdrawals when the Central Bank of Ireland agreed in March 2009 to provide it with €11.5 billion in Emergency Liquidity Assistance (ELA), i.e. loans from the Central Bank of Ireland against collateral that is not eligible for standard Eurosystem operations. While the risk associated with ELA is borne by the issuing central bank, these loans must still be approved by the ECB's Governing Council.

As the sovereign debt crisis intensified through 2010, the pace of deposit withdrawals from Anglo Irish Bank intensified and its ELA borrowings moved up sharply. Over the course of 2010, the other main Irish banks also came under pressure from deposit outflows. By mid-

[1] For example, the IMF (2007) reported that "Economic performance remains very strong, supported by sound policies" that "Fiscal policy has been prudent … In the past couple years, windfall property-related revenues were saved and the fiscal stance was not procyclical, in line with Fund advice" and that "Banks have large exposures to the property market, but stress tests suggest that cushions are adequate to cover a range of shocks."

[2] See Whelan (2014) for a detailed discussion of Ireland's economic boom and bust and its impact on the banking sector.

2010, the severity of Ireland's recession and growing international realisation of the huge size of recapitalisation costs of the banking sector (which reached 40 percent of GDP by the time the full scale of the crisis had become apparent) raised doubts about the solvency of the Irish state. These doubts then meant that the state guarantee became essentially useless to the Irish banks during 2010.

The September 2008 guarantee had been put in place for two years and the covered banks had issued a large amount of bonds that matured prior to September 2010. As September 2010 came and went, they failed to find new sources of private sector funding. Thus, these banks further increased their reliance on ECB funding and each of the banks eventually applied for ELA.[3]

As the enormous scale of the losses at Anglo Irish Bank and Irish Nationwide began to emerge during 2010, it became clear that Irish government could not borrow from financial markets to recapitalise these banks. Instead, the government issued the banks with so-called promissory notes that pay principal and interest gradually over time. In turn, these notes were used by the banks as collateral to obtain ELA from the Central Bank of Ireland.

By the end of 2010, the Irish government had issued €31 billion in promissory notes to the Irish Bank Resolution Corporation (IBRC), the institution created by merging Anglo and Irish Nationwide. The schedule for the promissory notes required the Irish government pay €3.1 billion per year, about two percent of GDP, into the IBRC, which in turn would use the money to repay ELA, which would then see the Central Bank of Ireland retire the money created to provide the ELA from money supply. While the promissory notes have since been replaced by a new series of bonds, the burden of these debts on the Irish people in the coming years will be considerable.

Figure 1 below illustrates the evolution of Eurosystem borrowing by the guaranteed Irish banks while Figure 2 shows trends in resident and non-resident deposits at these banks. By the end of October 2010, the guaranteed Irish banks were taking up €76 billion of the total €557 billion of Eurosystem refinancing credit. In addition, ELA had risen to €33 billion. Measured against Irish nominal GDP at this time of about €160 billion, these were extraordinary statistics, indicating a systemic banking crisis.

[3] See Whelan (2014) for a more detailed discussion of Ireland's banking crisis.

Figure 1: Borrowings from the Eurosystem of Guaranteed Irish Banks (Billions of Euros) Source: Central Bank of Ireland, Monthly Money and Banking Statistics

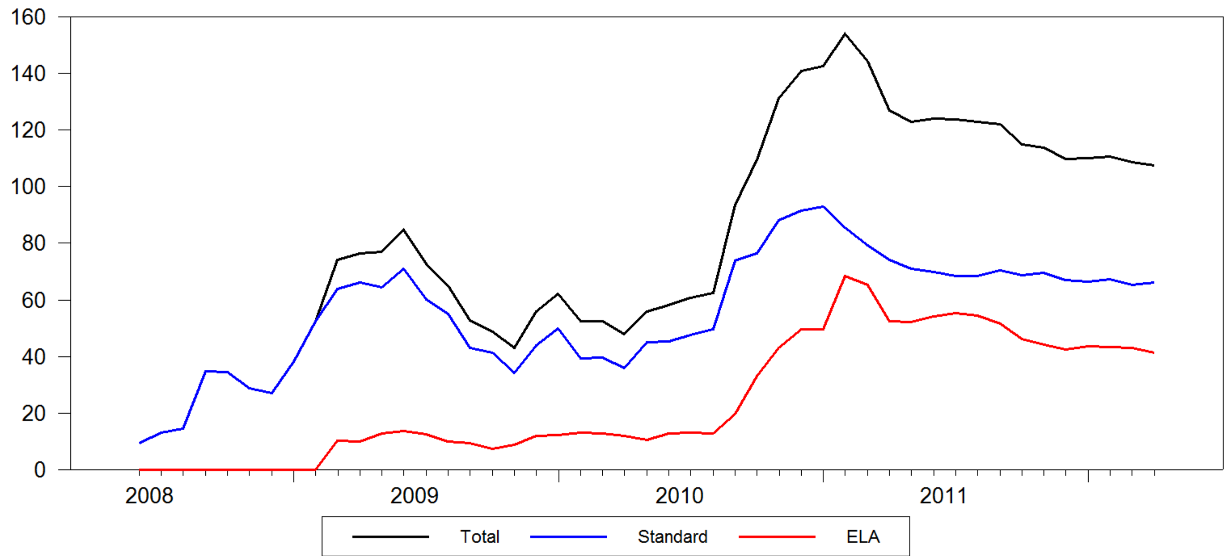

Figure 2: Resident and Non-Resident Deposits in Guaranteed Irish Banks (Billions of Euros) Source: Central Bank of Ireland, Monthly Money and Banking Statistics

2.2 The ECB and Ireland's Application for Programme Funds

The circumstances surrounding Ireland's application for an EU-IMF programme were, for a number of years, shrouded in secrecy. We know more now than we did a few years ago, However, it is worth explaining that the actual circumstances surrounding the decision to apply for a programme are still a bit murky. What is clear, however, is that the ECB played the decisive role in the timing of the Irish government's decision to request funds from the EFSF and the IMF.

In the months leading up to Ireland's application for funds, the ECB appears/appeared to have become increasingly concerned about the extent of borrowing from Irish banks. Senior ECB officials apparently believed the financial crisis was largely over and were giving speeches about their plans for an "exit strategy" from non-standard measures (something which still has not happened). The reliance of the Irish banks on Eurosystem funding did not fit with the ECB's plans to revert to auctioning off fixed amounts of credit. ECB officials began briefing widely about their concerns about "addict banks" that were overly reliant on ECB funding.[4]

In addition to their concerns about Ireland representing a problem for executing an exit strategy from non-standard measures, it also appears that the ECB had growing fears that losses on loans to Irish banks could have an impact on the balance sheet of Eurosystem central banks: Operating procedures see losses on regular refinancing operations shared among member national central banks according to their capital key.

A more official indication that the ECB was intending to intervene in Ireland came on October 9, 2010 when they issued a statement tightening the Eurosystem's "Risk Control Framework".[5] These guidelines had already stated that "*the Eurosystem may suspend or exclude counterparties' access to monetary policy instruments on the grounds of prudence*" and had previously contained the line "*The Eurosystem may exclude certain assets from use in its monetary policy operations*." This latter statement was augmented to include "*Such exclusion may also be applied to specific counterparties, in particular if the credit quality of the counterparties appears to exhibit a high correlation with the credit quality of the collateral submitted by the counterparty*." Since the Irish banks had substantial assets either guaranteed or issued by the Irish government, this clause could be used to limit their access to ECB funding, which would have led to an inability to meet requests for deposit withdrawals or pay off maturing bonds.

The Official Story

In November 2014, after years of refusing to disclose correspondence from 2010 between the ECB and the Irish government, the ECB finally released two letters sent in 2010 by Jean-Claude Trichet to Brian Lenihan, Ireland's Minister for Finance at the time. The first, dated October 19 warns Mr. Lenihan about the "*extraordinarily large provision of liquidity by the Eurosystem to the Irish banks*" and explains that "*the Governing Council cannot commit to maintaining the size of its funding to these institutions on a permanent basis*." The letter warned that because Irish banks were using Irish government bonds and government-guaranteed bonds as collateral, the Governing Council would need to see progress on "*fiscal consolidation, structural reforms and financial sector restructuring*" if it was going to maintain the supply of liquidity.

[4] See, for instance, this story by Ralph Atkins of the Financial Times from September 13, 2010: http://www.ft.com/intl/cms/s/0/580109dc-bf43-11df-a789-00144feab49a.html

[5] Statement here: http://www.ecb.int/press/pr/date/2010/html/pr101009.en.html

The situation in Ireland worsened in the subsequent weeks, partly as a result of the "Deauville declaration" of Merkel and Sarkozy suggesting the need for creditors to share losses as a condition for countries to access the European Financial Stability Fund (EFSF). Irish sovereign yields rose sharply and the deposit run intensified.

The ECB has also released a second letter from Jean-Claude Trichet to Brian Lenihan, dated November 19. This letter explicitly required the Irish government to apply to the Eurogroup for financial support as a condition for the continued provision of Eurosystem liquidity to the banks. The ECB also released a letter from Brian Lenihan to Trichet, dated November 21, indicating that Ireland intended to apply for external support.

The November 19 letter is dated one day after the Governor of the Central Bank of Ireland, Patrick Honohan, stated on Irish radio that he expected Ireland to enter a financial assistance programme. This has led some to conclude that the ECB's intervention was not a crucial one in determining the timing of the programme application because by November 19 it was clear that Ireland would already be entering a programme. The truth, however, appears to be a little different.

What Actually Happened

On Friday November 12, 2010, Reuters reported that Ireland was in talks with the EU to receive emergency funding.[6] In response, the Irish government denied that any official talks were taking place and stressed that the government could meet its budgetary needs through until the summer of 2011. My interpretation is that the ECB had briefed Reuters and other news organisations that programme negotiations were underway.

There is substantial evidence that some form of communication from the ECB to the Irish government occurred on Friday November 12. A number of Irish government officials have confirmed to me that communication of some sort from ECB occurred that day and the implication of this communication was that Ireland would be applying for a programme.

Brian Lenihan discussed the events of this period in a BBC radio documentary that is available online.[7] He described communication with the ECB as follows

> *Trichet wrote to me. He raised the question about whether Ireland would be participating in a programme at that stage. I rang Mr Trichet after receipt of the letter. [...]*
>
> *But it was clear to me at that stage that there was a serious issue for Ireland, and I said it was important that we discuss his concerns. And we agreed that on the following Sunday there would be an official level discussion about these issues, in Brussels.*

The discussion in the documentary of the various events that occurred the weekend after this communication (including ministers denying a bailout negotiation was underway) make it clear that Lenihan was talking about getting a letter either on or prior to November 12, 2010. In the documentary, Lenihan was also clear that "*the major force of pressure for a bailout came from the ECB*."

Another source of evidence that the letter arrived on November 12 came from an interview that Lenihan's economic adviser, Alan Ahearne, gave to the Irish Independent.[8] Here is an extract from the Irish Independent article:

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[6] Here is a link to the Reuters story here http://uk.reuters.com/article/2010/11/12/uk-g20-ireland-idUKTRE6AB0NV20101112

[7] Bailout Boys Go to Dublin. https://www.youtube.com/watch?v=AAj7Sob3cxg

"Yeah, the letter came in on the Friday from Trichet. The ECB were getting very hostile about the amount of money that it was having to lend to Ireland's banks. The ECB demanded something be done about it and it mentioned Ireland going into the bailout. They were keen to get Ireland into the programme."

He added: "Lenihan rang Trichet that day, and they agreed officials would meet the following day in Brussels. When they met, the ECB put huge pressure on Ireland to go into the programme."

Ahearne said Lenihan was now at the centre of international chaos and Ireland's future hung in the balance.

"The following Tuesday, Lenihan went to the eurozone meeting …"

The Irish Independent story does not state the date of arrival of Trichet's letter but the reference to a Eurozone meeting on the following Tuesday seems to confirm November 12 as the date.

Another piece of evidence on this issue comes from the testimony of Governor Patrick Honohan at the Irish parliament's banking inquiry.[9]

Deputy Eoghan Murphy: It seems clear that the ECB was in favour of Ireland entering a programme from September of 2010. But, was that ever communicated to you from Mr. Trichet or the board, that we think, the ECB, that Ireland should apply for a programme?

Professor Patrick Honohan: The first time it was communicated in any, sort of, formal way was in ... what date are we talking about, I guess it was 11 November when ... no, it's Friday, 12 November, after the famous discussion in Seoul.

The reference here to Seoul refers to a side meeting that occurred at a G20 meeting. Irish journalist Sean Whelan summarised what occurred as follows:[10]

Olli Rehn recently confirmed on the Marian Finucane show that Timothy Geithner, the then US treasury secretary and former head of the New York Fed had raised his worries that Anglo could trigger an international banking crisis at the G20 summit in Seoul on November 11 2010.

Rehn said he met Geithner, Trichet and German finance minister Wolfgang Schauble in Seoul, and they had agreed that Ireland had to enter a bailout programme to stop the threat of a wider banking crisis.

The following day – November 12 – Trichet reportedly phoned Lenihan and apparently told him then that the ECB could not go on funding Irish banks if the state did not enter a bailout programme.

My interpretation of these events is that after meeting with Geithner at the G20 meeting, there was some form of communication between Jean-Claude Trichet on November 12, 2010. This was perhaps a communication that a letter like the one subsequently dated November 19 would be sent if programme negotiations did not commence. Overall, the balance of evidence points to November 12 as being the crucial date for when the ECB insisted Ireland joined a programme and the November 19 letter that was kept secret for

[8] See http://www.independent.ie/opinion/analysis/we-were-a-war-cabinet-and-lenihan-was-leader-26779992.html
[9] A transcript of Honohan's testimony is available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2015/06/25062015_Honohan_vol3.pdf
[10] See http://analysis.rte.ie/business/2014/11/06/the-ecb-letters/

years was merely a formal restating of a message that had already been communicated a week earlier.

2.3 The ECB and Programme Negotiations

The ECB played a central role in both the negotiation and subsequent monitoring of Ireland's programme. Here, I want to flag two areas: Fiscal policy and the treatment of senior bond debts of certain Irish banks.

Fiscal Policy

The ECB did not play any role in providing money to the Irish government as part of its EU-IMF programme. Despite this, it is my understanding that the ECB still played a very active role in designing the fiscal policy conditionality associated with the programme.

The programme featured a substantially front-loaded fiscal adjustment: Fiscal adjustment of €6 billion was required in 2011 with a further €3.6 billion required in 2012 and €3.1 billion required in 2013.[11] Given the depth of the recession being experienced by Ireland at this time and factoring in that Ireland had access to non-market funding for three years, this substantial front-loading was highly questionable from a macroeconomic perspective.

This extreme front loading was, as I understand it, partly due to the ECB's insistence. Indeed, I believe the ECB's initial position in programme negotiations was that the adjustment should be even more front loaded than was required in the agreed version of the programme.

It is legitimate to ask why the ECB, rather than solely the European Commission, was involved in setting fiscal policy conditionality and whether this role meant the ECB was acting beyond its legal mandate.

One theme that emerged during the programme was that the involvement of the ECB in the programme was partly due to technocratic consideration. The European Commission did not appear to have sufficient numbers of suitably qualified staff to play the intense role required for designing and monitoring a large financial assistance programme. The ECB, on the other hand, has a large number of well-qualified economists. Whether this disparity led to ECB staff playing a larger role in the programme than perhaps they should have is an issue worth exploring.

Senior Bank Bonds

By November 2010, Ireland's original near-blanket guarantee had been replaced by a less sweeping guarantee that only covered new issues. This left outstanding a number of unguaranteed senior and subordinated bank bonds that had been issued by institutions such as Anglo Irish Bank and Irish Nationwide which were grossly insolvent and wholly reliant on Irish state assistance to pay off their liabilities.

During the negotiations of the programme, the Irish government and the IMF were in favour of putting Anglo and Irish Nationwide through bank resolution regimes that would see large haircuts on the senior bonds of these institutions. The widespread expectation that this might happen was reflected in the low prices of the bonds and their downgrades by ratings agencies. These downgrades meant that the bonds had to be off-loaded by many investment funds and banks who were not allowed to hold low-grade bonds as part of their investment portfolio. Indeed, it seems likely that by late 2010, a significant fraction of the bonds were owned by hedge funds and distressed-debt specialists.

[11] See http://www.finance.gov.ie/sites/default/files/euimfrevised.pdf

The ECB, however, was adamant that all unguaranteed senior bonds should be paid back in full with the funds provided by the Irish state. There is now evidence that they were supported in this position by then U.S. Treasury Secretary, Timothy Geithner, but the ECB's opinion in this area was likely to be hold sway even without any intervention from Mr. Geithner.

The requirement to repay senior bond holders does not feature as an official part of the EU-IMF programme and it was not mentioned in any of the various Memoranda of Understanding relating to the programme. However, it is generally understood that the ECB argued that it would react to senior bank bond haircuts by withdrawing liquidity support for Irish banks. At the time, some commentators and politicians in Ireland argued that the ECB would never carry through on such a threat as it would lead to restrictions on deposit withdrawals and capital controls. Subsequent experience in Cyprus and Greece show there was every reason to believe the ECB's position in 2010 was a credible one. Certainly, the ECB's position on this issue was sufficient to deter any unilateral action on this front by the Irish government.

The ECB's interactions with the Irish government on this issue continued into 2011, after the election of a new government. The new Minister for Finance, Michael Noonan, has testified before the Irish parliament's banking inquiry that he had planned in March 2011 to announce write-offs for certain bonds issued by Anglo and Irish Nationwide but did not do so after an intervention from Jean-Claude Trichet. According to Mister Noonan, Trichet argued that such a default would have negative implications for the Irish financial sector and, more darkly, warned of "a bomb going off in Dublin" if any of these bonds were defaulted on.[12]

At this point, it is worth putting some context on these particular events. Given the role the banking crisis played in triggering Ireland's EU-IMF programme and given the colourful nature of some of the stories that have emerged, a tendency has emerged for people to believe that the ECB's interventions in late 2010 and early 2011 in relation to senior bank bonds played a very important role in raising the financial burden of the programme on Irish taxpayers. This is not the case.

The vast majority of the bank debts that had been covered by the September 2008 guarantee had matured prior to the ending of this guarantee in September 2010. Of the unguaranteed bonds that remained, some were secured and could not be simply defaulted on. Economist Seamus Coffey has calculated the amount that defaulting on bonds issued by Anglo Irish Bank and Irish Nationwide in late 2010 would have saved the Irish taxpayer: He puts this figure at about €4 billion.[13]

In a country with a population of about 4.5 million, the figure of €4 billion represents a substantial amount of money. In this sense, the controversy about the role played in this area by the ECB is legitimate. However, this is only a very small proportion of the total costs of the banking crisis incurred by the Irish people. The September 2008 guarantee, passed by the Irish government without threats from the ECB, should be seen as far more important in raising the costs of the crisis to Irish taxpayers than the ECB's actions of 2010 and 2011.

[12] The transcript of Michael Noonan's appearance before this inquiry is available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2015/09/10092015_Noonan_vol1.pdf

[13] See http://www.independent.ie/opinion/comment/seamus-coffey-so-how-much-has-been-paid-out-to-unsecured-unguaranteed-bondholders-in-the-irish-banks-26889017.html

3. THE ECB AND IRELAND: AN ASSESSMENT AND SOME QUESTIONS

In this section, I summarise the role of the ECB in the Irish programme and suggest a number of questions worth asking.

3.1 An Assessment

A Positive: A Necessary Banking Sector Restructuring

I will start with the most positive aspect. Despite the controversy over the ECB's role in Ireland's application for official funds, there is little doubt that the ECB officials were correct in their diagnosis of the health of the Irish banking sector in November 2010.

The Irish banks had lost the confidence of international investors and depositors and there was nothing in the mix of prevailing Irish government policies that was likely to undo this trend. The ECB's hope that the announcement of the availability of a large quantity of funds to recapitalise the banking system would quickly stabilise the situation did not turn out as well as might have been expected. As Figures 1 and 2 above show, even after the announcement of the EU-IMF agreement, deposits continued to flow out of the Irish banks and reliance on Eurosystem funding increased for a number of months. However, once the Financial Measures Programme was announced at the end of March 2011, combining a realistic assessment of potential loan losses with a commitment to over-capitalise the banks, the funding situation stabilised. The EU-IMF programme deserves credit for stabilising a situation that was out of control and which could have ended up inflicting even more damage on the Irish and European economies than actually occurred.

The fact that Ireland was unable to regain market access once it had stabilised its banking sector shows that claims the ECB was fully responsible for Ireland entering a programme are largely unfair. The underlying fundamentals in late 2010 were moving Ireland towards a bailout programme and while one can raise legitimate issues about the ECB's behaviour in late 2010, their advice that accessing such a programme was required turned out to be correct.

A Negative: Conditionality and Confusion of Mandates

The "Troika" as the combination of European Commission, ECB and IMF came to be known, was born during the negotiations for the Irish deal. While everyone became used to the idea of this Troika being involved in monitoring financial assistance programmes, it is worth noting that the involvement of the ECB in negotiating and monitoring of such a deal is actually something of an anomaly.

Ireland's EU-IMF programme involved borrowing of €45 billion from the EU (in the form of two different programmes, the EFSF and EFSM) and €22.5 billion from the IMF. For these reasons, it was clear the programme needed to be monitored by the IMF and also by the EU, in the form of the European Commission.

What was less clear was why the ECB is involved in programme design and monitoring. The ECB did not lend money to the Irish government as part of the programme, as such loans would be illegal. Instead, the Eurosystem was lending money to Irish banks and the terms and conditions for such loan are set by the Eurosystem's common monetary policy guidelines.

In theory, the Eurosystem monetary policy since 2007 has allowed banks to borrow as much as they wish in refinancing operations provided they have sufficient eligible collateral. In practice, however, the ECB used its risk control measures to determine which banks it was willing to lend to and how much it was willing to lend. Still, it is unclear why the ECB's

risk control framework should have extended to involving them in designing and monitoring a package of fiscal measures rather than assessing each bank that it loans money to on its own merits.

As an indication of how various lines became blurred due to the ECB's involvement in programme design and monitoring, consider the following quote from Klaus Masuch, former head of the European Central Bank mission to Ireland, as spoken to the BBC:[14]

> *People in Ireland were not aware of the enormous support that they get from the Eurosystem. This is a privilege, of course. The partners in the Eurozone also expect that every partner – every government in the Eurozone – is doing its own homework. This means keeping public finances stable and, of course, keeping the banking sector stable.*

It is hard to imagine a representative of the Federal Reserve telling the citizens of Texas they should realise that it is a privilege that their banks can borrow from the Fed so one might ask why ECB officials believed it was a good idea to lecture Irish citizens in this manner. Moreover, the enormous "support" that was referred to in this quote (and this phrase was also repeatedly used by Jean-Claude Trichet) was largely channelled towards seeing that non-Irish bondholders and depositors were able to pull their money out of Irish banks. In linking the performance of the public finances with the privilege of "receiving support" from the Eurosystem, these kinds of statements suggested a role for the ECB in monitoring the fiscal policies of member states that I do not believe exists in the European treaties.

The ECB's approach to senior bank bonds also led to confusion in Ireland and elsewhere about the conditionality associated with the EU-IMF programme. The programme made no reference to the requirement that private unguaranteed bondholders be repaid. Indeed, such a clause would be unprecedented in an IMF programme document. However, the involvement of the ECB in the Troika monitoring of the programme and its insistence that these bonds be repaid meant that most Irish citizens believed that repayment of unguaranteed bonds was a condition of the programme. This perception undermined the popularity and legitimacy of the adjustment programme.

My conclusion is that the ECB should not be involved in designing the fiscal policy conditionality for future programmes. The ECB's role should be limited to an advisory capacity and it should focus on the role that it plays as bank supervisor and lender of last resort to banking sectors in crises. In particular, there should be no implicit linking of financial assistance programmes with requirements to repay private bank creditors.

A Negative: Confused Decision Making on Lender of Last Resort

Since the early days of banking, it is understood that a lender of last resort is required if the banking system is to avoid periodic systemic crises. Ireland's crisis is just one example of how the ECB has not yet learned to function as lender of last resort in an efficient manner.

The ECB's normal refinancing operations require collateral that is on a specified list of eligible assets. However, in recent years, banks in Ireland, Greece, Cyprus and elsewhere have all been able to borrow via Emergency Liquidity Assistance. In late 2013, the ECB published a short document outlining the procedures the Governing Council follows when approving ELA programmes.[15] However, these guidelines make clear that there is

[14] See http://www.thejournal.ie/the-bbc-bailout-documentary-some-choice-quotes-126048-Apr2011/

[15] See https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf

enormous room for arbitrary discretionary decisions on the part of the Council when deciding whether to start or continue ELA progammes.

In Ireland in 2010, there was a lot of secrecy about the procedures underling ELA and more uncertainty about how the ECB would behave. In particular, it is unclear on what basis the ECB Governing Council approved the extension of ever-increasing amounts of ELA to Anglo Irish Bank, which was becoming more and more insolvent per month. The ECB was most likely receiving assurances from the Central Bank of Ireland and the Irish government that the losses incurred by this bank would be manageable.

The months of briefing from the ECB prior to November 2010 about the temporary nature of the liquidity being provided to the Irish banking sector did the exact opposite of what we would expect a lender of last resort to do. It signalled to the market that liquidity may be pulled soon, leading to a crisis in which creditors could lose a lot of money. The secretive and ad hoc nature of the ECB's decision making process further contributed to give the market the impression that the ECB was at best a very reluctant lender of last resort. These factors further fuelled the ongoing bank run that was already underway in Ireland in late 2010.

I believe that now is a good time to develop a completely new approach for the ECB as lender of last resort. The ECB has taken over as the supervisor of the euro area's banks. This removes most of the previous arguments that were in place for the current system of ELA provision. Previously, banks were overseen by national supervisors. As such, it could be argued that those banks that got into trouble and required ELA were the responsibility of national central banks and that the risk associated with lending to these banks should be borne at a national level.

This point no longer holds. The euro area's banks have been given an official diagnosis of good health from the ECB via its comprehensive assessment proecss. If further problems arise, they should be considered the joint responsibility of all central banks in the Eurosystem.

For this reasons, I believe it is time to change the system in which lending against eligible collateral is a Eurosystem concern while ELA is a national concern. The ECB should be required to initiate and run every ELA programme and have the risk shared among the Eurosystem. As an independent regulator, the ECB should also be a position to assess whether the liquidity problems for a bank applying for ELA reflect temporary problems or else reflect deeper structural issues. This should help with speeding up the process of restructuring problem banks, via recapitalisation or bail-in. A speedier response of this sort would help to avoid a repeat of long-term ELA programmes in which Eurosystem funding is used to allow private creditors to gradually get their money safely out of insolvent banks.

A Negative: Confused Decision Making on Systemic Risk

In late 2010, the ECB made a decision that the senior bonds of highly insolvent Irish banks should be honoured on the grounds that a default on these bonds would have threatened European financial stability.

Over time, of course, the ECB's attitude to bank creditors has evolved. Events in Ireland and elsewhere contributed to the perception that there was a "vicious circle" between banks and sovereigns and the euro area's leaders committed to breaking this link in their statement of June 2012. By the time the Cyprus crisis of 2013 came around, the ECB was comfortable proposing the idea of recapitalising banks via a large haircut on deposits.

Overall, the events of recent years demonstrate that the absence of a coherent European approach to financial stability issues has left the ECB to fill the vacuum in an ad hoc manner that may or may not be consistent with its mandate. One can point to Article 3.3 of

the ECB statue which says that "*the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system*." However, in many cases, it has been the ECB rather than any other "competent authorities" that has taken the key decisions and it has generally not been held accountable for the decisions it has taken.

Again, there are questions about whether the ECB's mandate stretches to making the protection of certain private creditors (or the absence of protection of others) to be a condition of the provision of financial assistance to countries by the EU. In my opinion, it would be better if the Eurogroup of finance ministers and\or the European Council took these decisions, albeit with the advice of the ECB. Of course, if decisions about certain creditors being protected are taken at a European political level to protect Europe-wide financial stability, then this would raise the question of whether the costs of protecting these creditors should also be shared at European level.

3.2 Some Questions

The disclosure of Jean-Claude Trichet's letters to Brian Lenihan in 2010 and the appearance of various figures involved in Ireland's programme before a banking inquiry have helped to clarify many of the questions that had lingered over Ireland's bailout programme. However, a number of questions are still worth asking.

1. Given the size of the emerging solvency problem at Anglo Irish Bank in Spring 2010, why did the Governing Council approve such a large ELA programme for the bank?
2. If the ECB were relying on the Irish state's backing for Anglo as reassurance that the bank's solvency would be maintained, at what point did doubts emerge about the state's ability to provide this assistance?
3. Was it wise for ECB staff to brief journalists from September 2010 onwards about their concerns about "addict banks"?
4. Is it correct that a meeting with Timothy Geithner at the G20 meeting in Seoul on November 11, 2010 triggered the ECB's decision to tell the Irish authorities that they should enter an EU-IMF programme?
5. What was the nature of the communication between the ECB and the Irish government on November 12, 2010?
6. Did ECB staff brief Reuters and other news agencies on November 12, 2010 that Ireland was negotiating a bailout programme?
7. What was the decision making process underlying the ECB's objections in November 2010 to haircuts being applied to bonds issued by Anglo Irish Bank and Irish Nationwide Building Society? What role did Timothy Geithner play in these decisions?
8. Given the subsequent experience with haircuts in Cyprus, does the ECB now accept that haircuts for Irish bank bonds in 2010 were unlikely to have triggered a systemic financial crisis?
9. Did Jean-Claude Trichet tell Michael Noonan in March 2011 that "a bomb would go off" in Dublin if bank bonds were defaulted on? If so, what did he mean by this?
10. Now that the ECB has taken over as regulator of the euro area's largest banks, is it time to reform its approach to the provision of Emergency Liquidity Assistance?

4. THE ECB AND GREECE'S 2015 CRISIS

While the main focus of this paper is on events in Ireland in the years up to 2011, it is worth reflecting on developments since 2011 to assess how relevant the issues raised remain today.

Some institutional changes have occurred that make some aspects of the situation in Ireland in 2010 less likely to occur again.

- State aid rules for the banking sector have been tightened in a way that would make it difficult for a government to issue the kind of blanket guarantee for banks that the Irish government introduced in September 2008.
- The ECB is now the supervisor for Europe's largest banks, so if lack of access to accurate information about the health of the Irish banks was one of the problems during 2010, this is less likely to the case in future.
- The Bank Recovery and Resolution Directive now means there are better tools available to governments and regulators to wind down failing banks and there is less concern about bail-in causing financial instability.

In addition, there are strong legal arguments against the ECB taking part in designing and monitoring financial assistance programmes that will be a condition for the ECB being willing to provide Outright Monetary Transactions. In particular, the advocate general of the European Court of Justice has argued as follows:[16]

> *"if exceptional circumstances were to arise which were grounds for activating the OMT programme, it would, for that programme to retain its function as a monetary policy measure, be essential for the ECB to detach itself thenceforth from all direct involvement in the monitoring of the financial assistance programme applied to the State concerned. Nothing would prevent the ECB from being kept informed and even from being heard, but under no circumstances would it be possible for the ECB, in a situation in which a programme such as OMT is under way, to continue to take part in the monitoring of the financial assistance programme to which the Member State is subject when, at the same time, that State is the recipient of substantial assistance from the ECB on the secondary government bond market."*

All of these developments are positive. However, this year's events in Greece show that the ECB still believe it is appropriate to use its lender of last resort powers to pressurise countries into signing bailout agreements with the EU and IMF.

Central to this year's crisis was the ECB's insistence that Greece needed to be signed up for an EU-IMF programme if it was to continue provide full liquidity support to Greek banks. This insistence meant the Greek government knew that a failure to agree on a new programme with the EU meant the ECB would cap liquidity support, thus leading to the imposition of capital controls. Discussions of "Grexit" were given credibility by the fact that an extended period of capital controls would possibly lead the Greek government to decide to introduce its own currency. Members of the ECB Governing Council, including Executive

[16] See http://curia.europa.eu/juris/document/document_print.jsf;jsessionid=9ea7d2dc30dd3d2fa1b9e18943c7a196a6fa90afb753.e34KaxiLc3qMb40Rch0SaxuPahz0?doclang=EN&text=&pageIndex=0&part=1&mode=DOC&docid=161370&occ=first&dir=&cid=377680

Board member Benoit Coeure, encouraged the perception that this process could end with Greece leaving the euro by freely admitting this was a possibility.[17]

Throughout the Greek crisis of earlier this year, ECB officials insisted that they were being forced by their own rules to cut off liquidity support for Greek banks. This is simply untrue.

The ECB was the supervisor of the large Greek banks and had declared them to be solvent in late 2014. Arguments about certain assets such as Greek government bonds (of which very little were held by the Greek banks) or Greek-government guaranteed bonds (which were more important) being deemed riskier in the absence of a renewed agreement with the EU may have been correct. However, these arguments did not amount to clear evidence that the Greek banks were suddenly insolvent. Moreover, the precedent set from the provision of ELA in both Ireland and Greece meant that the Eurosystem could insist on the use of a so-called "floating charge" over a bank's assets, which allowed loans to be secured without itemising specific assets as collateral.[18] In other words, the ECB could approve an ELA programme based on its overall assessment of bank solvency rather than focusing on the eligibility of specific assets to serve as collateral.

With a focus on the solvency of the Greek banks and the need to encourage financial stability, the ECB and European governments could have handled the situation in Greece in a very different manner. For example, an alternative scenario in Greece that could have played out is as follows.

- As tension builds up in Greece prior to the Greek election in early 2015, Mario Draghi assures depositors in Greece that the ECB has fully tested the Greek banks and they do not have capital shortfalls. For this reason, their money is safe.
- Draghi announces that the ECB will thus provide full support to the Greek banks even if the government defaults on its debts, subject to those banks remaining solvent.
- Eurozone governments agree that, should Greek banks require recapitalisation to maintain solvency, the European Stabilisation Mechanism (ESM) will provide the capital in return for an ownership stake in the banks,
- Provided with assurances of liquidity and solvency support, there is no bank run because Greek citizens believe there banking system is safe even if the government's negotiations with creditors go badly.
- The ECB stays out of the negotiations for a new creditor deal for Greece and its officials assure everyone that the integrity of the common currency is in no way at stake.

There are no legal impediments to this scenario. Supporting banks that you have deemed solvent is pretty standard central banking practice. So the ECB could have provided full and unequivocal support to the Greek banks if they wished. They just chose not to. Similarly, procedures are in place for the ESM to invest directly in banks so a credible assurance of maintaining solvency could have been offered by European governments interested in maintaining financial stability.

[17] See Coeure's comments here http://www.reuters.com/article/2015/06/29/us-eurozone-greece-coeure-idUSKCN0P92P820150629

[18] Of course, we know now that Greece's banks require an additional €14 billion to meet capital requirements under an adverse stress scenario. However, this additional capital requirement has largely been the result of the crisis triggered by capital controls and uncertainty about euro membership, a crisis that was avoidable on the part of both the ECB and the Greek government.

Why did this not happen? Ultimately, I believe these decisions reflected political realities. European governments did not want to provide assurances to Greek citizens about their banking system at the same time as their government was openly discussing the possibility of not paying back existing loans they had received from euro area states. Indeed, the fact that the ECB had the ability to restrict liquidity and required the imposition of capital controls was perhaps the key bargaining chip that European governments had when negotiating with Greece.

Already under political pressure from Germany and other Northern European countries because of objections to their existing monetary policy programmes (such as OMT and the new Quantitative Easing programme) Mario Draghi and the ECB Governing Council decided it was better for them to play along with the creditor country squeeze on Greece than to stabilise the Greek banking system.

As long as the ECB's lender of last resort role remains as confused as it currently is, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

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