The IBRC, ELA, Promissory Notes and All That …

Karl Whelan
University College Dublin
Institute for International and European Affairs
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Plan for this Talk

- Well known that Irish state is carrying a large debt burden due to decisions taken to bail out banks, particularly Anglo\INBS (now IBRC).
- But lots of confusion about the form of the debt and what can be done about it.
- Today, I will discuss
  - The IBRC's balance sheet
  - Exceptional liquidity assistance
  - Promissory notes and their potential restructuring

The IBRC’s Balance Sheet

Anglo's Liabilities at End-2007

Components	Amounts
Total Liabilities	€92.6 billion
Deposits	€58.4 billion
Debt Securities	€23.6 billion
Subordinated Debt	€5.3 billion
Other Liabilities	€5.3 billion
Debts to Central Banks	Zero

Anglo's Liabilities at End-2010

Components	Amounts
Total Liabilities	€68.6 billion
Deposits	€12.1 billion
Debt Securities	€6.9 billion
Subordinated Debt	€0.5 billion
Other Liabilities	€3.6 billion
Debts to ECB	€16.9 billion
ELA Debts to Central Bank	€28.1 billion

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Anglo’s Liabilities at 2011:H2

Components	Amounts
Total Liabilities	€50.7 billion
Deposits	€1.2 billion
Debt Securities	€5.7 billion
Subordinated Debt	€0.5 billion
Other Liabilities	€2.6 billion
Debts to ECB	€2.4 billion
ELA Debts to Central Bank	€38.4 billion

INBS's Liabilities at End-2007

Components	Amounts
Total Liabilities	€14.6 billion
Deposits	€7.3 billion
Debt Securities	€6.7 billion
Subordinated Debt	€0.4 billion
Other Liabilities	€0.1 billion
Debts to Central Banks	Zero

INBS’s Liabilities at End-2010

Components	Amounts
Total Liabilities	€12.2 billion
Deposits	€3.7 billion
Debt Securities	€0.6 billion
Subordinated Debt	€0.4 billion
Other Liabilities	€0.2 billion
Debts to ECB	€7.4 billion
ELA Debts to Central Bank	Zero

IBRC Liabilities at End-2007

Components	Amounts
Total Liabilities	€107.2 billion
Deposits	€65.8 billion
Debt Securities	$\boxed{\text{€30.3 billion}}$
Subordinated Debt	€5.6 billion
Other Liabilities	€5.4 billion
Debts to Central Banks	Zero

Guess at IBRC's Balance Sheet: July 2011
Billions of Euros

Assets		Liabilities	
Promissory Notes	28.1	Deposits	1.1
Loans	27.5	Debt Securities	6.3
Other	3.0	Subordinated Debt	0.7
		Other Liabilities	2.3
		Debts to ECB	6.0
		ELA Debts to Central Bank	42.2
Total	58.6	**Total**	58.6

Recent Senior Debt Developments

- IBRC Senior Debt in June 2011 was €6.3 billion. Only €2.9 billion was unguaranteed by the government.
- Since then, various repayments:
  - $1 billion in October 2011
  - €1.25 billion in January 2012.
- So down to less than €1 billion in senior unsecured unguaranteed senior bonds.
- Could decide to default on guaranteed bonds but this probably would impact AIB and BoI.

ELA

What is ELA?

- **Exceptional Liquidity Assistance** provided by the Central Bank of Ireland.
- Legal basis: Section 5B(d) of Central Bank Act of 1942. Provides power to lend against security to credit institutions in pursuit of financial stability objective
- Not part of usual Eurosystem monetary operations.
- ELA loans accepted in return for collateral not accepted in Eurosystem operations.
- Risk falls on CBI, not shared with Eurosystem.

Where Did the ELA Come From?

- Not from borrowing it from the ECB.
- From thin air: This is textbook money creation.
- Money creation is decentralised in the Eurosystem. It is done by national central banks, not the ECB.
- The Central Bank simply credited the reserve accounts of the IBRC banks and this money was then used to pay off depositors and bondholders.

Interest on ELA

- The interest the CB charges the IBRC is top secret.
  - But CB has reported €510 million in ELA interest in 2010.
  - "Other assets" averaged €21.3 billion in 2010 and was €1.6 billion before Anglo ELA.
  - Gives 2.58%. ECB rate was 1% throughout this period. So, my guess: ECB Refinancing Rate Plus 150bp.
- Is this pure profit for CBI? Not quite.
  - CBI compensates IBRC for its reserve balances.
  - When IBRC bondholders and depositors moved money out of Ireland, this increased CB's "Target2" liability which it pays the refinancing rate on to Target2 creditors.

Central Bank Balance Sheets

Assets	"Liabilities"
Assets acquired by making loans and buying securities	Money created by making loans and buying securities
Some other stuff	"Central Bank Capital"

- Central Bank capital is the "residual item" – if the value of assets acquired in the process of making loans falls below the value of the money created, then this item will fall in value.

CBI Balance Sheet: Feb 2011 Billions of Euros

Assets		"Liabilities"	
Eurosystem Lending	117	Bank notes	12
Securities, gold, other claims	21	Reserve accounts	9
Other assets (ELA!!)	70	Other Liabilities	185
		Capital and Reserves	2
Total	208	Total	208

CBI Balance Sheet: Dec 2011
Billions of Euros

Assets		"Liabilities"	
Eurosystem Lending	107	Bank notes	13
Securities, gold, other claims	25	Reserve accounts	6
Other assets (ELA!!)	44	Other Liabilities	155
		Capital and Reserves	2
Total	158	Total	176

- Repayment of ELA by Irish banks has largely lead to a reduction in "*other liabilities*" (i.e. a reduction in the amount of money that has been created by the Central Bank of Ireland) rather than a big increase in holdings of securities, gold etc.

Why Not Just Write Off the ELA?

- Wrong answer: “Because the Central Bank of Ireland will be broke, we’re only burning ourselves.”
- Central bank capital isn’t like private bank capital. The liabilities are notional and central bank insolvency is a meaningless idea.
- Nothing bad happens if central bank capital is negative (insolvency isn’t a useful word in this case) provided people accept the currency they print.

The Real Reason

- Printing money to bail out insolvent banks and then telling them they don’t have to pay back could be considered
  - An abuse of the power to print euros (in a common currency area).
  - Very poor precedent (if everyone did it, we’d have higher inflation ….)

Monetary Financing?

- 2008 ECB Convergence Report:
  - *"National legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is incompatible with the monetary financing prohibition."*

Euro-Wide Monetary Implications?

- ECB's February 2007 Monthly Bulletin:
  - *"the Eurosystem also has procedures in place regarding the provision of ELA … aimed at ensuring an adequate flow of information within the Eurosystem to the decision-making bodies of the ECB. In this way, the impact of an ELA intervention on aggregate liquidity conditions in the euro area can be managed in a manner consistent with the maintenance of the appropriate single monetary policy stance*.

The Role of the Governing Council

- So CBI is not free to do as it wishes in relation to ELA.
- Article 14.4 of ECB statute
  - *National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB.*
- Does a rescheduling of ELA repayment "interfere with the objectives of ESCB"? Some may think so.
- To avoid the two-thirds vote, CBI has to co-ordinate its ELA policies with the ECB Governing Council.

How Will IBRC Repay the ELA?

- IBRC's legacy assets can cover its debts to the ECB, bondholders and others but cannot cover ELA debt.
- So how is the ELA debt to be repaid?
  - **Promissory notes**. The payment structure on these notes indicates an implicit repayment schedule for ELA that has been agreed with ECB.
  - **Letters of comfort** assuring CBI that the ELA will be repaid.
- "Restructuring promissory notes" to slow payments into IBRC doesn't matter if ECB insists on ELA being repaid according to current implicit schedule.

Promissory Notes

Promissory Note Schedule

	Total Interest	Repayments	Total Capital Reduction	Total Amount Outstanding
31/3/2011	0.6	3.1	2.5	28.1
31/3/2012	-	3.1	3.1	25.0
31/3/2013	0.5	3.1	2.6	22.4
31/3/2014	1.8	3.1	1.2	21.2
31/3/2015	1.7	3.1	1.3	19.9
31/3/2016	1.7	3.1	1.4	18.5
31/3/2017	1.5	3.1	1.5	17.0
31/3/2018	1.4	3.1	1.6	15.4
31/3/2019	1.3	3.1	1.7	13.7
31/3/2020	1.2	3.1	1.9	11.8
31/3/2021	1.1	3.1	2.0	9.8
31/3/2022	0.9	3.1	2.2	7.6
31/3/2023	0.7	3.1	2.3	5.3
31/3/2024	0.6	2.1	1.5	3.8
31/3/2025	0.4	0.9	0.5	3.3
31/3/2026	0.4	0.9	0.5	2.8
31/3/2027	0.3	0.9	0.6	2.2
31/3/2028	0.3	0.9	0.6	1.6
31/3/2029	0.2	0.9	0.7	0.9
31/3/2030	0.1	0.9	0.8	0.1
31/3/2031	0.0	0.1	0.0	0.0
TOTALS	16.8	47.9	30.6	

Where Does the Money Go?

Irish Government

Provides Promissory Notes to

IBRC

Which Then Owes ELA debts to

Central Bank of Ireland

who accept repayment of ELA and reduce their stock of money created (effectively burning it)

Promissory Note Interest: An Intra-Governmental Transaction

- Interest on the promissory notes goes from one part of the state (central exchequer) to another (IBRC).
- Interest over and above interest on IBRC’s liabilities provides income that can be retained inside IBRC and handed back to the state at a later date.
- Payment schedule actually implies ELA will be paid off by approx. 2022 and IBRC wound up rather than let accumulate pointless profits from state payments.

A Schedule for ELA Repayment

	ELA Interest Rate	Repayments	Interest Payments	Total Amount Outstanding
31/3/2011	0.025	3.1	0.78	28.1
31/3/2012	0.025	3.1	0.70	25.7
31/3/2013	0.025	3.1	0.64	23.3
31/3/2014	0.030	3.1	0.70	20.7
31/3/2015	0.035	3.1	0.73	18.3
31/3/2016	0.045	3.1	0.82	15.8
31/3/2017	0.045	3.1	0.71	13.4
31/3/2018	0.045	3.1	0.60	10.9
31/3/2019	0.045	3.1	0.49	8.3
31/3/2020	0.045	3.1	0.37	5.6
31/3/2021	0.045	3.1	0.25	2.7
31/3/2022	0.045	2.8	0.12	0.0

So What's the Right Interest Rate?

- Interest rate on promissory notes or on ELA charged to IBRC by CBI are both intra-state transfers and don't capture the ultimate cost.
- Currently CBI pays 1% rate on intra-Eurosystem (Target2) liabilities.
- The state borrows from EU-IMF at about 3% but long-term market rates currently about 7%.
- Think of the current plan as paying off a €31 billion low interest rate (1%) loan by borrowing €3.1 billion a year at higher interest rates (3% or 7%).

One Reason the Promissory Note Interest Rate Does Matter

- Eurostat, however, book the payments on the national debt as
  - €31 billion in 2010, hence deficit of 32% of GDP.
  - Interest on notes added to GGB deficit later.
- Irish\IBRC agreed “holiday” on interest over 2011-2013, reducing its impact on headline GGD deficit.
- Holiday ends in 2013: €1.8 billion interest in 2014.
- Relative to this year, an extra €1.8 billion in cuts and tax hikes required just to keep 2014 GGB on track.

Alternatives to the Current Arrangement

A Concrete Proposal

1. Leave IBRC to use its existing resources to pay off bondholders, ECB, other creditors and as much ELA as it can, including the interest payments.
2. Restructure promissory notes to begin slowly repaying remaining ELA debts either
   - When the country recovers from crisis according to some quantitative criteria
   - Or when IBRC no longer has assets to repay ELA.
3. CBI tables this proposal to ECB Governing Council.

Objections

- **The Moral Hazard/Slippery Slope Argument**: Other countries may also seek to use ELA and the consequences may be inflationary.
- **The Legalistic Argument**: Some may believe current ELA programme for the IBRC comes close to violating their understanding of the monetary financing prohibition article in the Treaty.
- **The "What's Your Problem?" Argument**: Your programme's on track, why do you say it needs to be altered?

Counter-Arguments

- ELA needs Governing Council approval. They have a price stability mandate but restructuring collateral on €28 billion is small beer compared with €1 trillion LTRO just offered.
- Repayment schedule could be subject to Euro area M3 growth.
- Legalistic: IBRC solvent provided ELA is paid back and payments can be deferred while still repaying ELA.
- What's Our Problem? Ireland likely to need a lightening of debt burden if it is to return to markets.

An EFSF Loan to Replace ELA?

- A long-term loan from EFSF could be used to provide funds to IBRC to pay off its ELA.
- Not my favourite proposal
  - EFSF not giving out very long-term loans. A ten-year loan would shorter average duration but by less than desirable.
  - Would require political approval across Europe. Seen as a second bailout for Ireland.
  - Probably not possible in current environment with uncertainty about Treaty referendum.
- But better than current arrangement.