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POLICY PAPER

ELA, Promissory Notes and All That: The Fiscal Costs of Anglo Irish Bank

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Abstract: This paper describes the cost to the Irish state of its bailout of the Irish Bank Resolution Corporation (IBRC). The paper discusses the IBRC's balance sheet, its ELA debts to the Central Bank of Ireland and the promissory notes provided to it by the Irish government to pay off its liabilities. Options for reducing these costs are discussed.

I INTRODUCTION

The Irish state has committed an extraordinary €64 billion – about 40 per cent of GDP – towards bailing out its banking sector. €30 billion of this commitment has gone towards acquiring almost complete ownership of Allied Irish Banks and Irish Life and Permanent and partial ownership of Bank of Ireland.[1] It is possible that some fraction of this outlay may be recouped at some point in the future via sales of these shares to the private sector. In contrast, the remaining €35 billion that relates to Irish Bank Resolution Corporation (IBRC), the entity that has merged Anglo Irish Bank and Irish Nationwide Building Society, is almost all "dead money" that will never be returned to the state.

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[1] The source of the figures on the cost of the bank bailout is a written parliamentary answer from Minister for Finance, Michael Noonan (available at http://debates.oireachtas.ie/dail/2012/04/18/00157.asp) updated to take into account the €1.3 billion spent in June 2012 on acquiring Irish Life from what had been Irish Life and Permanent.

Much of the commentary on Ireland's bank bailout has focused on the idea that the Irish government should change its policy in relation to payment of unsecured IBRC bondholders. However, the amount of IBRC bondholders remaining is small when compared with the total cost of bailing out these institutions. Instead, the major debt burden due to the IBRC relates to promissory notes provided to it by the Irish government, which in turn are largely being used to pay off so-called Exceptional Liquidity Assistance (ELA) loans that have been provided by the Central Bank of Ireland.

This paper discusses the fiscal costs of the IBRC bailout focusing in particular on the institution's ELA debts and the promissory notes being used to repay them. The paper explains how a number of aspects of the IBRC bailout differ somewhat from how they have been described by the media. Despite a lot of media focus on the interest rate on the promissory notes, I explain how the interest rate on these notes has no long-run impact on Irish public debt. In addition, the official promissory note schedule is unlikely to be stuck to as the IBRC will likely be wound up once its ELA is paid off. Finally, in light of the Eurosummit statement of June 29, 2012 suggesting the potential for a restructuring of Ireland's bank-related debt, I discuss the range of policy options available for reducing the cost of the IBRC bailout.

The paper is organised as follows. Section II discusses the balance sheet of the IBRC and the crucial role played by its ELA debts. Section III describes the process of granting and repayment of ELA and the role of the ECB in this process. Section IV discusses the IBRC's promissory notes and their effect on official debt and deficits. Section V then examines some potential policy options and Section VI concludes.

II THE IBRC'S BALANCE SHEET

The IBRC was formed on 1 July 2011 by a merger of Anglo Irish Bank and Irish Nationwide Building Society (INBS) both of which were being wound down after huge losses on property loans. Table 1 illustrates how the liability side of the combined IBRC balance sheet evolved over the past few years.

At the end of 2007, Anglo had €58 billion in deposits and €24 billion in funding from debt securities while INBS had €7 billion in deposits as well as €7 billion in debt securities. The subsequent years, amid financial crisis and nationalisation of the banks, saw the vast majority of these deposits pulled and moved out of Ireland while the institutions were unable to issue any new debt securities. Combined funding from deposits and debt securities fell from €96 billion at the end of 2007 to €23 billion at the end of 2010.

Table 1: *The IBRC's Liabilities (Billions of Euros)*

	End-2007	*End-2010*	*End-2011*
Total Liabilities	107.2	80.8	52.3
Of Which:			
Deposits	65.8	15.9	1.0
Debt Securities	30.3	7.5	6.3
Subordinated Debt	5.6	0.7	0.5
Other Liabilities	5.4	4.3	3.2
Eurosystem Borrowings	0.0	24.3	2.1
ELA Debts to CBI	0.0	28.1	40.1

Some of the funds to pay off depositors and bondholders over this period came from selling assets and from loan repayments but most came from borrowing from central banks. At first, most of this borrowing took the form of standard Eurosystem refinancing operations. However, these opera-tions require counterparties to pledge particular types of collateral and Anglo began to run out of eligible collateral as the Irish banking crisis began in late 2008.

In March 2009, the Central Bank of Ireland agreed to provide Anglo with €11.5 billion in so-called "Exceptional Liquidity Assistance" (ELA) loans against collateral that did not qualify for standard Eurosystem monetary operations. As the crisis intensified through 2010, ELA borrowings ramped up significantly. By the end of 2010, the IBRC institutions owed €24.3 billion in Eurosystem borrowings and had €28.1 billion in ELA debts to the Central Bank of Ireland.

During the first half of 2011, the IBRC institutions transferred almost all of their remaining deposits to other Irish banks along with their holdings of about €16 billion in senior bonds that had been issued to them by NAMA. Because the NAMA bonds had been used as collateral for Eurosystem borrowings, the IBRC had to pay off most of its ECB loans, which further increased its dependence on ELA from the Central Bank of Ireland. By the end of 2011, Anglo owed €40 billion in ELA and had Eurosystem borrowings of only €2 billion.

Table 2 shows the IBRC's balance sheet as of the end of 2011. By this point, deposits were a tiny part of the organisation's liabilities, while debt securities outstanding were down to €6.3 billion, about 12 per cent of total liabilities. The vast majority of the IBRC's debts – €42.2 billion of a total of €52.3 billion – are owed to central banks and the vast majority of these take the form of ELA.

There has been a considerable focus on payments to unguaranteed senior IBRC bondholders. However, by the end of 2011, most of the IBRC's €6.3

billion in outstanding debt securities were guaranteed by the Irish government. There have also been some repayments during 2012 on unguaranteed bonds, including a €1.25 billion Anglo bond that was paid out in January 2012. As a result of these payments, unguaranteed unsecured senior bonds now account for less than €1 billion of the IBRC's debts.

The left-hand-side of Table 2 explains where the IBRC is to get the resources to pay off its liabilities as it winds down. It has two principal types of assets. First, there are loans to customers. Second, there are a series of promissory notes from the Irish government that were provided to Anglo and INBS during 2010. These promissory notes were valued on the IBRC's balance sheet at end-2011 at €29.9 billion and (as will be discussed later) are currently scheduled to provide a series of payments over the next 20 years.

A key message from the balance sheet is that, without the promissory notes, the IBRC would still have sufficient assets to pay off all of its deposits, its bondholders, its Eurosystem borrowings and all of its other debts apart from ELA. But only €10 billion of the €40 billion ELA debts could be paid off if the bank did not have the promissory notes. So, effectively, the promissory notes exist to pay off the ELA debts to the Central Bank of Ireland.

Table 2: *IBRC Balance Sheet at End-2011 (Billions of Euros)*

Assets		*Liabilities and Equity*	
Promissory Notes	29.9	Deposits	0.6
Loans	20.0	Debt Securities	5.4
Other	5.6	Subordinated Debt	0.5
		Other Liabilities	3.6
		Eurosystem borrowings	2.1
		ELA Debts to Central Bank	40.1
		Equity	3.2
Total	55.5	Total	55.5

III THE ABCS OF EXCEPTIONAL LIQUIDITY ASSISTANCE (ELA)

This section discusses the process by which Exceptional Liquidity Assistance is issued and moves on to the various legal and accounting issues related to the issuance and repayment of ELA and the cost of this repayment to the Irish state.

3.1 *Central Bank Balance Sheets and Collateral Frameworks*

The national central banks (NCBs) in the Euro area each report a monthly balance sheet. A stylised central bank balance sheet is produced below. On the

left-hand-side, it describes the current value of the assets the central bank has acquired via money creation. The right-hand-side shows the amount of money the central bank has created over time as well as the residual value by which the value of the bank's assets exceeds the money created, which is termed the central bank's capital.

The right-hand-side of the balance sheet is often described as illustrating the central bank's liabilities. However, it is worth stressing that a central bank's liabilities are quite different from those of any private entity. A central bank that prints a fiat currency that people wish to use for transactions can never go out of business. A central bank with negative capital could be labelled as "insolvent" in some technical sense. However, this is not an insolvency that corresponds to any private sector version of this concept. As long as the bank can create money that people wish to use, it can pay off any debts that fall due and honour all of its obligations.

That said, the ability to create money is an extremely powerful tool and should be carefully monitored. In particular, within a common currency area, it is particularly important that each participating member state is not seen to be particularly responsible for fuelling inflation by abusing its power to create money. An example of such an abuse is making loans to insolvent banks. To prevent such abuses, the Eurosystem's refinancing operations take the form of repurchase agreements designed to prevent losses on money creating operations.

Table 3: *A Stylised Eurosystem Central Bank Balance Sheet*

Assets	*Liabilities*
Assets acquired by making loans and buying securities	Central Bank Capital
Some other assets	Money created by making loans and buying securities
	Of which:
	Reserve Accounts
	Bank Notes
	Intra-Eurosystem Liabilities

The Eurosystem's repurchase agreements involve banks pledging financial assets to their local NCB as collateral in return for loans, with the terms of these loans set by the ECB's Governing Council. Haircuts are applied to the collateral, meaning the amount that is loaned to the borrowing bank is less than the value of the asset, with the amount that can be loaned increasing

with the quality of the collateral.[2] Should a bank default on its loans from an NCB, the collateral framework is intended to see the NCB still left with an asset that has at least the same value as the loan.

That said, no risk-control framework can completely rule out losses on monetary operations. The legal statute governing the Eurosystem is quite vague about the implications for an NCB of losses incurred in monetary operations. However, in practice, the Governing Council of the ECB used the defaults by Lehmans and other banks in 2008 to clarify in a statement in March 2009 that losses should be shared in full by the Eurosystem NCBs in proportion to their ECB capital key shares.[3]

This raises the question of what would happen should a Eurosystem central bank have its capital eliminated by losses on operations. Perhaps surprisingly, as far as I can tell, the legal structures underpinning the Eurosystem do not discuss this eventuality. However, it is generally understood that NCBs would need to be "recapitalised" by fiscal transfers from their national government.

3.2 *ELA and the ECB Governing Council*

The Eurosystem allows for a broad range of assets to be pledged as collateral in its refinancing operations. However, Anglo Irish Bank began to run out of eligible collateral in early 2010 and would have defaulted on bonds or failed to honour deposit withdrawals without access to alternative funding. That funding took the form of ELA loans from the Central Bank of Ireland. These loans are provided against collateral or commitments that are not accepted in standard Eurosystem operations and any losses on these loans fall directly on the ECB, i.e. the usual loss-sharing arrangements are not applied if a bank fails to repay ELA.

The Central Bank's power to issue ELA comes from Irish law. The Central Bank Act provides it with a general power to lend against security to credit institutions and also provides it with an explicit financial stability objective which can justify exceptional loans to prevent banks from failing.

This does not mean, however, that the Central Bank has complete freedom to operate its ELA programmes however it wishes. The Eurosystem has reporting procedures in place for ELA so the ECB can assess the effect of these operations on aggregate liquidity in the Euro Area and the ECB has substantial control over the activities of NCBs.[4] Article 14.3 of Protocol on the

[2] See European Central Bank (2011) for a detailed discussion of the operational framework for monetary policy in the Euro Area.
[3] See press release here www.ecb.int/press/pr/date/2009/html/pr090305_2.en.html
[4] See ECB (2007).

Statute of the European System of Central Banks and of the European Central Bank states that NCBs "shall act in accordance with the guidelines and instructions of the ECB" while Article 14.4 states "… 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."[5]

These rules mean that the ECB must be consulted when ELA is issued and it will assess whether the issuance of ELA interferes with its monetary policy stance. The Governing Council can vote at any time by a two-thirds majority to stop any ELA programme. In addition, the ECB views loans to insolvent credit institutions and non-temporary liquidity support programmes as a violation of the clause prohibiting monetary financing in the European treaty.[6]

For these reasons, the ECB has been heavily involved in the design of Ireland's ELA programme. It is likely that ECB approval was required in relation to the payment structure of the promissory notes which provide the funds with which ELA will be repaid. In addition, the ECB sought various assurances that ELA would be repaid such as "letters of comfort" sent from the Irish Minister for Finance to the Governor of the Central Bank on each occasion a new ELA programme was initiated indicating the intention that the ELA would be repaid and the provision of so-called "facility deeds" which the Central Bank annual reports describe as providing a government guarantee in relation to repayment of ELA.[7]

In practice, it appears that ELA credit is provided to banks over a very short maturity (a couple of weeks) and the ECB's Governing Council regularly considers whether to stop the programme. In addition, the ECB's view on the need for solvency of institutions in receipt of ELA means that most likely they must approve of any restructuring of the assets of such a bank, such as a change in the terms of the IBRC's promissory note.

3.3 *Issuance and Repayment of ELA and Intra-Eurosystem Balances*

In explaining what happens when ELA is issued and subsequently repaid, it is helpful to explain the three subcomponents listed under "money created" in the stylised central bank balance sheet.

3.3.1 Intra-Eurosystem Balances

The first entry is "reserves". Every bank in the Eurosystem maintains a reserve account with its national central bank. When a bank obtains a loan as

[5] See www.ecb.int/ecb/legal/pdf/en_statute_2.pdf

[6] See page 24 of ECB (2008).

[7] Copies of most of the letters of comfort, which were obtained via a Freedom of Information request by RTE, are available at www.rte.ie/news/2011/0718/centralbank-business.htm

part of either a Eurosystem refinancing operations or ELA, it receives a credit to this reserve account. This is textbook money creation in which money is conjured out of thin air. The second entry is "bank notes". When a bank requests cash to use in ATM machines, its reserve account with the central bank is deducted and the "bank notes in circulation" entry on the central bank's balance sheet is adjusted upwards.

The third entry, Intra-Eurosystem liabilities, is more complex. If an Irish bank requests that money be transferred to another Irish bank, then the Central Bank simply debits one reserve account and credits another. Suppose, however, an Irish bank wants to transfer money to a German bank. This leads to a reduction in the Irish bank's reserve account and increase in the receiving bank's account with the Bundesbank. This implies a decline in the Central Bank of Ireland's liabilities and an increase in the Bundesbank's liabilities.

To keep the central bank capital of both central banks unchanged as a result of this transaction, the Eurosystem's Target2 payments system increases the Central Bank of Ireland's Intra-Eurosystem liability (or reduces its equivalent asset if it is in credit with the Eurosystem) and also it increases the Bundesbank's Intra-Eurosystem asset (or reduces its liability). These Intra-Eurosystem balances average to zero. Those countries with Intra-Eurosystem liabilities pay interest on these liabilities at the rate of the Eurosystem's main refinancing rate (currently 1 per cent). This interest is accumulated at the ECB and redistributed to those countries with Intra-Eurosystem credits.

3.3.2 ELA Issuance and Repayment

We can now describe how the Central Bank's balance sheet changes when it issues ELA to Irish banks to allow foreign bondholders and depositors to be repaid. The receiving bank receives a credit to its reserve account and then requests to transfer funds to a foreign deposit account. This leads to an increase in the Central Bank's Intra-Eurosystem liabilities.

What occurs when ELA principal is repaid by the IBRC? There are two potential scenarios. In the first, the Central Bank of Ireland maintains its balance sheet size exactly as before and simply adds to its stock of assets; for example, they could purchase gold or securities. Profits from these investments could eventually be returned to the Irish state.

In the second scenario, the Central Bank does not acquire any new assets but simply reduces the size of its balance sheet, marking down both the value of its ELA asset and the value of its liabilities. This is the scenario that actually occurs. The Central Bank writes down its assets and while its Intra-Eurosystem liabilities increase when ELA is issued, this entry declines when ELA is repaid.

The effect of ELA repayment on the Central Bank's balance sheet can be seen from the repayments made by the non-IBRC banks over the past year, all of whom have repaid their ELA loans. The "Other Assets" category that is nearly completely accounted for by ELA declined from €70 billion in February 2011 to €45 billion in March 2012 and regular Eurosystem lending declined from €117 billion to €85 billion. This led to a €52 billion decline in the size of the Central Bank balance sheet over this period, with €44 billion of this corresponding to a decline in "Other Liabilities", the category that contains intra-Eurosystem liabilities.

I would note, however, that it is hardly correct to say as Minister for Finance Michael Noonan has, that "… ELA is itself funded by the CBI through Intra-Eurosystem liabilities".[8] This suggests that the appearance of an ELA asset on the Central Bank of Ireland's balance sheet is directly accompanied by an increase in Intra-Eurosystem liabilities. However, at the moment of "conception" of the ELA, the corresponding increase in liabilities is a credit to the reserve account of the bank receiving the ELA loans. Only if that bank then uses its ELA funds to transfer money to bank accounts outside Ireland does the Central Bank of Ireland's balance sheet start to show an increase in Intra-Eurosystem liabilities. Suggestions that ELA funds are "… borrowed by the Central Bank of Ireland from the ECB" are even further off the mark.

3.3.3 Interest Payments on ELA and Funding Cost to the State

The Central Bank has not commented publicly on the interest rate it charges on ELA. However, its *2011 Annual Report* shows €1.63 billion in earnings from ELA interest, while its monthly balance sheet figures suggest an average value for ELA of €52 billion. This suggests an average interest rate of slightly over 3 per cent for 2011. Anglo Irish Bank's recent reports have noted that the interest rate on its ELA loans is linked to the ECB marginal lending facility which is 75 basis points higher than the main refinancing rate and averaged 2 per cent in 2011. So my guess is that the formula used to determine the ELA interest rate is something like "… marginal lending facility plus 100 basis points."

The Central Bank currently pays out interest of 0.75 per cent on money held in its reserve accounts and on Intra-Eurosystem liabilities, so this raises the question of what happens to the profits obtained via the spread charged on ELA. Profits relating to Eurosystem monetary policy operations are shared among the various national central banks. However, this is not the case for profits associated with ELA operations. The Central Bank's 2011 income on

[8] See www.kildarestreet.com/wrans/?id=2012-01-31.767.0&s=mathews#g774.0.q

ELA contributed to a €1.2 billion profit, of which €958 million was returned to the Exchequer.

So what is the ultimate cost to the state of the IBRC having to repay its ELA? Because the payment of money by the Irish Exchequer to IBRC and the repayment of ELA to the Central Bank are both transactions involving arms of the Irish state, some have concluded that these transactions are completely circular and thus have no net cost to the state.

The reality is more subtle and less attractive. When the IBRC repays its ELA debts, the money that had been created is simply taken out of circulation. The only benefit to the Irish state is the reduction in interest payments on the Central Bank's intra-Eurosystem liabilities. This can boost its profits which can be returned to the Exchequer. However, the cost to the Central Bank of the intra-Eurosystem liabilities is very low, currently only 0.75 per cent, and there are no requirements that the principal be repaid according to any set timeline. In contrast, the future costs of funding to the state involved in obtaining the money to repay the ELA are likely to be much higher. Effectively, repayment of ELA by the IBRC is equivalent to the state borrowing money at expensive terms to gradually repay a low-cost interest-only perpetual loan.

IV PROMISSORY NOTES

This section discusses a number of issues relating to the promissory notes provided to the IBRC.

4.1 *Payment Structure*

During 2010, it became apparent that Anglo and Irish Nationwide had two serious problems. The first was a liquidity problem; both institutions were losing deposits and had no access to international bond markets. In addition, there was a solvency problem, as it became clear that both institutions had suffered enormous losses on property-related loans.

The liquidity problem was largely solved by issuing the Anglo and INBS larger and larger amounts of ELA. The solvency problem was trickier. If the state was going to see that depositors, bondholders and increasingly large ELA debts were all to be repaid, where was it going to get the money from? As confidence in the Irish state finances waned during 2010, it was clear that there was no way that the government could obtain the enormous sum required to restore the IBRC organisations to solvency by borrowing from financial markets.

Thus, the decision was taken to supply the IBRC institution with assets in the form of promissory notes. These are IOUs from the state to the IBRC that

promise to pay money according to an agreed schedule. Table 4 reports the full schedule of total payments on the notes that have been issued based on a parliamentary answer provided by Michael Noonan in September 2011.[9] The schedule differs from, for example, a fixed-rate mortgage in that the annual payments change over time with payments of €3.1 billion per year every year on March 31 through to 2023 and then smaller payments in subsequent years.

Table 4: *Promissory Note Payment Schedule*

	Total Interest	*Repayments*	*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	

The interest payments are dealt with somewhat like a fixed-rate mortgage. An annual interest charge is applied to the outstanding principal and the reduction in the principal outstanding equals the annual payment minus the calculated interest. An exception is the treatment of interest in the years 2011 and 2012 when no interest was charged. In relation to the annual

[9] The answer is available at http://www.kildarestreet.com/wrans/?id=2011-09-27.896.0&s=promissory+notes#g897.0.q

budgetary figures, promissory note interest has an impact of €0.6 billion in 2011 (this relates to interest charged on the 2010 notes), zero in 2012 and €0.5 billion in 2013 (based on the interest charged over the first three months of the year).

The notes were issued gradually over the course of 2010 and were given interest rates that were similar to the rates then prevailing on Irish government bonds. The deferral of interest over 2011-2012 then meant that for the bonds to still pay out the interest totals originally agreed, the interest rate applied for the remainder of the payment schedule would be approximately 8 per cent. Once interest on the notes is applied at this level, there will be an interest effect of €1.8 billion on the 2014 figures, which will then gradually decline over subsequent years.

4.2 *The Long-Run Irrelevance of the Interest Rate on the Notes*

Much of the media commentary on the promissory notes has focused on their high interest rate and suggested that a reduction in this rate should be the focus of efforts to reduce the burden of IBRC debt on the taxpayer. In particular, it is often noted that the full total of scheduled payments on the notes is €48 billion once interest payments are added to the €31 billion principal.

In practice, however, lowering the interest rate on the notes does nothing to reduce the long-run burden of the IBRC debt on the Irish state. As with the transactions between the IBRC and the Central Bank discussed above, payments from the Exchequer to the IBRC are intra-governmental transactions and so the interest payments on these transactions have no net impact on state's finances. Indeed, only a small fraction of the €17 billion difference between the payments total of €48 billion and the principal of €31 billion represents a net cost to the state.

One way to see this point is to consider how long it will take the promissory note payments to clear the ELA debts they are earmarked to repay (effectively, I am assuming that the IBRC's other assets will be used to pay off all other liabilities and the remaining ELA).[10]

Table 5 provides a schedule for how the IBRC can use the annual payments on its promissory notes to reduce an amount of ELA equal to the face value of the notes at the beginning of 2012. I have assumed that the ELA interest rate, which is ultimately linked to the ECB's main policy rate, will not remain as low as 3.0 per cent forever and have set out a schedule in which it will move up towards 4.5 per cent and then stay there. According to these

[10] Here I am valuing the promissory note debt at the €28.1 billion nominal amount at which it was carried on the government's gross government debt at end-2011 rather than the €29.9 billion "fair value" which was applied to it in the IBRC's annual accounts.

Table 5: *Schedule for Repaying €28.1 Billion in ELA Using Promissory Note Payments (Billions of Euros)*

	ELA Interest Rate	*Repayments*	*Interest Payments*	*Capital Reduction*	*Total Amount Outstanding*
31/3/2012	0.030	3.1	0.84	2.26	25.84
31/3/2013	0.030	3.1	0.78	2.32	23.52
31/3/2014	0.030	3.1	0.71	2.39	21.13
31/3/2015	0.035	3.1	0.74	2.36	18.77
31/3/2016	0.040	3.1	0.75	2.35	16.32
31/3/2017	0.040	3.1	0.65	2.45	13.87
31/3/2018	0.040	3.1	0.55	2.55	11.32
31/3/2019	0.045	3.1	0.50	2.60	8.72
31/3/2020	0.045	3.1	0.39	2.71	6.01
31/3/2021	0.045	3.1	0.26	2.84	3.16
31/3/2022	0.045	3.1	0.14	2.96	0.20

calculations, the current schedule would mean that IBRC will be able to pay off its ELA debts (with presumably all other debts long gone) in early 2023. Indeed, because the IBRC has assets that exceed its liabilities of €3 billion, the current schedule could see the IBRC in a position to pay off all its liabilities by 2021.

At that point, the government could wind up the IBRC and simply cancel the remaining payments. Note that the total amount of promissory note payments in the example in Table 5 would be €37 billion. The additional €11 billion in payments scheduled after 2022 just would not happen. For this reason, the intense focus on the total repayments figure of €48 billion is misplaced.

In addition, most of the €6 billion paid by IBRC over 2012-2022 in excess of the €31 billion in principal on ELA will represent profit for the Central Bank which can be returned to the state. Ultimately, the interest cost to the state is the interest rate on Intra-Eurosystem liabilities and neither the interest rate on the promissory notes nor the interest rate on the ELA are relevant.

4.3 *The Shorter-Term Relevance of the Interest Rate on the Notes*

While the amount of interest paid on the promissory notes has little long-run impact, these interest payments are still set to have an unfortunate impact on the Irish budgetary process over the next few years. This impact relates to Eurostat's accounting treatment of the promissory notes.

Eurostat's accruals-based accounting for budget deficits counted the full €31 billion principal of the promissory notes on Ireland's general government budget deficit in 2010. The interest payments on the promissory notes are then counted on the general government deficit in the years that they occur. However, Eurostat's rules allow for debt instruments to have "interest holidays" in which no interest is charged and the promissory notes were designed with a holiday period in 2011 and 2012.[11]

When this period is scheduled to end, the interest payments on the note will go from having no impact on the GGD this year to a €500 million impact in 2013 and a €1.8 billion impact in 2014. Even though the cash flow impact of the notes will not change during these years, the government still needs to find €1.8 billion in spending cuts and tax increases over these two years to offset the impact of these interest payments on the official measure of the deficit, for which targets have been set by the EU and IMF. Note that if the ELA repayment schedule described in Table 5 occurred, the government could then write off the €7.6 billion of remaining principal from its general government debt in 2022, so most of these interest payments would only have a temporary effect on the official measure of the debt.

4.4 *The March 31, 2012 Repayment*

The first promissory note payment, on March 31, 2011, occurred on a very busy news day as the government also announced recapitalisation requirements of €24 billion for the Irish banks. With an election, a new government and the implementation of the EU-IMF programme all taking the headlines, the promissory note payment received essentially no attention from the public or media.

In contrast, by early 2012, there was a greater public awareness of the key role the promissory notes played in contributing to Ireland's public debt problem and, specifically, of the March 31, 2012 payment. With the Irish government under pressure to change the promissory note arrangements, there appear to have been extensive discussions with the European Central Bank aimed at getting approval for a delay in the IBRC's ELA repayments.

The government were not successful in these negotiations. IBRC made its €3.06 billion ELA repayment as scheduled and as insisted by the ECB. There was an adjustment to how this payment was made. IBRC were provided with a 13-year government bond. It then entered into a repurchase agreement with the state-controlled National Asset Management Agency (NAMA) in which

[11] See this Department of Finance information note released in November 2010: www.finance.gov.ie/documents/publications/reports/2010/noteprommissory2010.pdf

NAMA provided IBRC with €3.06 billion in return for temporary ownership of the 13-year government bond. So the money to make the ELA payment came from the Irish state.

The IBRC subsequently swapped the bond with Bank of Ireland. Specifically, Bank of Ireland purchased the bond for €3.06 billion and is pledging the bond as collateral with the ECB in return for an estimated €2.87 billion. In return, IBRC is loaning Bank of Ireland the ECB "margin" of €190 million and providing them with a fee of €39 million. So, on net, IBRC is receiving €2.83 billion from this operation, to be repaid in one year.[12] After the Bank of Ireland agreement was concluded, IBRC repaid NAMA, adding an additional €229 million from its own funds.

Minister Michael Noonan has claimed this deal helps to "… reduce the economic cost for the State as a whole of refinancing this payment" and that it improves debt sustainability.[13] It is hard to see any solid grounds for these statements. The deal involves a fee to Bank of Ireland that would not have been paid under the pre-existing arrangements. Since Bank of Ireland must be repaid during 2013, the deal does nothing to reduce cash flow demands during the current EU-IMF deal. Because Bank of Ireland will borrow €2.8 billion from the ECB as part of the deal, it does reduce the amount that Ireland will repay in Eurosystem loans in 2012 which can be welcomed. However, the deal does not do anything to reduce the long-run burden imposed by the notes.

V POTENTIAL POLICY OPTIONS

This section discusses the problems posed for Ireland's public finances by the current promissory note arrangements and the potential options for replacing them.

5.1 *Problems with the Promissory Note Arrangement*

Before considering policy options for changing the structure of the promissory notes, it is worth emphasising why such a restructuring is desirable.

Ireland's debt-GDP ratio is currently projected to peak at 119 per cent at the end of 2013, just as the state is set to run out of its EU-IMF funding.[14] This debt ratio is well beyond levels that have traditionally been considered

[12] The prospectus for the repurchase operation is here http://www.bankofireland.com/fs/doc/publications/investor-relations/boi-egm-circular-final.pdf

[13] Statement by Minister Noonan, March 29, 2012. http://finance.gov.ie/viewdoc.asp?DocID=7195

[14] Projections taken from Department of Finance (2012).

dangerous, even prior to the example of private sector sovereign debt restructuring within the Euro area set by Greece. As currently structured, there is little doubt that the IBRC's promissory notes will represent a significant negative factor in relation to financial market's assessment of the sustainability of Ireland's debt burden at that time.

I have projected above that Ireland is set to make its twelfth and last promissory note payment in 2022. Effectively, the notes act like twelve different zero-coupon bonds with maturities from one to twelve years. With ten payments remaining, the effective average maturity of what is left of this debt is about five years. For such a large debt burden, this is a very short average maturity.

Combined with an average maturity on Ireland's regular sovereign debt of about €80 billion of about six and a half years, the promissory note payments mean that Ireland is set to have very significant funding requirements over the next few years, even before one considers any incremental borrowing associated with budget deficits.[15] A reduction in the near-term payments associated with the promissory notes represents a relatively simple way to reduce this funding burden and improve Ireland's chances of exiting from its EU-IMF programme.

5.2 *Payment Deferral*

From Ireland's perspective, the best option for improving the promissory note arrangements is also the simplest one: Deferral of promissory note payments. Ideally, there would be a deferral for a period of twenty or thirty years. However, given the need for agreement from the ECB Governing Council, this is unlikely to be obtained. A weaker approach would be to link the beginning of promissory note payments to quantitative benchmarks in relation to the performance of the economy: For example, there could be an agreement that payments would begin when nominal GDP has recovered its pre-crisis peak and unemployment has fallen below 10 per cent.

A deferral of promissory note payments to IBRC is not the same as deferring repayment of ELA. As noted above, the IBRC would be able to repay approximately €10 billion in ELA over time even if it never received any promissory note payments. This suggests an even weaker proposal which is to suspend promissory note payments until IBRC has liquidated all its non-promissory assets.

This approach could be agreed between the IBRC, the Central Bank and the Irish government, provided it was not opposed by the ECB Governing

[15] Calculations based on information in www.ntma.ie/GovernmentBonds/Daily_Bonds_Outstanding.pdf

Council. The current payment structure of the promissory notes has been tacitly agreed to by the ECB Governing Council, whose members are therefore aware that IBRC will not be able to pay back its ELA in full for many years. Indeed, the promissory note schedule represents an implicit long-term timetable for ELA repayment.

ECB Governing Council members have generally been silent on the question of whether they support or oppose a renegotiation of the promissory notes. However, there are likely to be two principle objections to renegotiating the structure of the notes.

The first objection is legal in nature. It is likely that some on the Governing Council believe the existing ELA programme for the IBRC comes close to violating their understanding of the monetary financing prohibition article in the Treaty. I do not believe this is a strong argument. The IBRC is still a solvent institution provided the promissory note payments are deferred rather than cancelled.

The second objection relates to precedent setting. If Irish banks can be financed by ELA collateralised by long-maturity promissory notes with delayed payments, then other countries may also seek to use the same method to bail out their banks. ECB officials worry that financing bank bailouts with money printing may be inflationary, violating their primary policy objective of price stability.

I believe there are strong counter-arguments to this position. The Irish ELA programme is small relative to the Euro area money supply. Furthermore, it does not necessarily represent a slippery slope to frivolous ELA programmes across the Euro area because the Governing Council can simply choose to reject future requests that have implications for Euro Area inflation. Moreover, inflationary risks are low at present and the Governing Council could make deferred repayment of ELA from Ireland conditional on continued slow growth in the Euro Area money supply.

In addition, the ECB's legal statute obliges it to support the economic policies of the EU provided such support does not endanger price stability. Since the EU has now effectively declared the restoration of the stability of Ireland's public finances as a goal, there is a strong argument that the ECB should act to support this goal.

5.3 *Reduced Interest Rate on Promissory Notes*

If the promissory note structure remains in place in some form, the government should also work to reduce the impact on the general government deficit of the interest rate on the notes. While I noted above that the interest rates have no long-run impact on Ireland's debt, the addition of €1.8 billion to Ireland's general government deficit in 2014 is unhelpful given the

requirements of the EU that there be a steady improvement in this measure of the deficit. When the promissory note plans were put together in early 2010, the interest rate on Irish government bonds was still quite low and it is unlikely that those who put the plan together intended the interest payments to have such a large impact on the budget.

A simple alternative to the current arrangement is to replace the promissory notes with instruments like NAMA bonds. These bonds pay the six-month Euribor interest rate, which at the time of writing are close to 0.5 per cent. They have been considered eligible collateral for ECB refinancing operations and are valued on bank balance sheets at almost face value.[16] A substitution of this sort would not threaten the IBRC's solvency but would reduce the impact of promissory note interest payments in 2014 from €1.8 billion to below €200 billion.

A final possibility that could affect the accounting treatment of the promissory note interest payments is the reclassification of the IBRC as part of the general government. As Cussen and Lucey (2011) discuss, Eurostat have proposed guidelines recommending that publicly-owned institutions that are managing impaired assets and are effectively not performing as banks should be reclassified to the general government sector. IBRC still has a banking licence but one could argue it meets the spirit of these guidelines. Such a reclassification would see the promissory note interest payments removed from the deficit, replaced by a measure of the net loss (or income) of the IBRC. However, this would be accompanied by the inclusion of all non-promissory liabilities of the IBRC in the general government debt, which would add about 15 per cent of GDP to the headline debt figure. On balance, this is perhaps an initiative not worth pursuing by the government.

5.4 *Refinancing with EFSF/ESM*

A less desirable option than deferral of promissory note repayments is the replacement of the notes using funds from the European Financial Stability Facility (EFSF) or European Stabilisation Mechanism (ESM). For example, ESM could issue thirty-year notes to financial markets and loan the funds raised to the Irish government over the same term. In turn, the Irish government could loan these funds to IBRC as a replacement for the promissory note. IBRC could then pay off all of its ELA debts and be quickly wound down.

Such a loan would lock in a low interest rate for a long period and may provide lower cost financing once the ECB's main refinancing rate moves

[16] Page 317 of AIB's *2011 Annual Report* assigns NAMA bonds with nominal face value of €20.311 billion a fair value of €20.061 billion.

upwards again. More importantly, a thirty-year ESM loan would require only an annual interest payment for 29 years followed by a payoff of the principal in year 30.

This deferral of principal payments would reduce Ireland's cash financing requirements over the next decade. It would also provide a substantial reduction in the net present value of the burden of this debt when calculated using realistic discount rates reflecting Ireland's likely cost of funding. For example, using a 7 per cent discount rate, the stream of planned payments described in Table 5 plus the loan repayment to Bank of Ireland in 2013 have a combined net present value almost twice as large as the stream of payments associated with paying 3 per cent interest on a €28.1 billion loan for 29 years and then repaying the principal in year 30.

Those points accepted, there are a number of strong arguments against this approach. The interest rate on bonds sold by EFSF or ESM, likely to be around 3 per cent, would be higher than the effective current cost of ELA, which is the ECB main refinancing rate (0.75 per cent at the time of writing).

Another complication is that the size of such a loan would be large: €28.1 billion would be required to pay off the remaining ELA and the IBRC's one-year loan from Bank of Ireland. The existing European debt issuance agencies such as EFSF and EFSM have not yet placed a thirty-year bond of anywhere close to this size and this may make it difficult to achieve the desired low interest rate.

An alternative approach could see EFSF directly place low-interest rate bonds with the IBRC, which could pledged the bonds as collateral to the ECB. The government would provide the funds for the interest payments to EFSF (which are then passed to IBRC) and would also agree to provide the principal to EFSF at maturity. This could allow the IBRC to clear its ELA loans immediately and the government to retire the promissory notes. The government could then have a long period of time to accumulate the funds for the final principal payment associated with the EFSF bonds, effectively spreading out the burden associated with the IBRC over a much longer period than currently scheduled.

Of course, this "direct placement" approach would require a change of heart from the ECB in relation to allowing the Eurosystem to maintain a large exposure to the Eurosystem for longer than currently planned, which would beg the question as to whether an alteration of the current arrangements would not make more sense.

Another important argument against this approach is that any debt to EFSF or ESM would be official debt, which would have priority over private creditors and may hinder a sustained return to the sovereign bond market.

Moreover, in more extreme scenarios such as an Irish exit from the Euro, such official debt would have less flexibility than an ELA loan from a Central Bank that has exited from the strictures of the Eurosystem.

VI CONCLUSION

The Euro area summit statement of June 29 included a sentence stating that "The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme." This has provided the first concrete sign that Irish citizens might get some relief from the burden of bank-related debt that was built up in recent years.

The biggest element of this debt stems from the bailout of Anglo Irish Bank and Irish Nationwide Building Society, now merged to form the IBRC. This paper has examined the burden associated with the IBRC, focusing in particular on the promissory note payments scheduled to take place on March 31 each year. My conclusion has been that the best approach to restructuring these notes involves a long-term delay in promissory note payments and a slower pace of repayment of Exceptional Liquidity Assistance.

A restructuring of the promissory notes would require approval from the ECB Governing Council. Many of the Council's members view repayment of the IBRC's ELA debts on the current schedule as essential to avoid setting inflationary precedents in the conduct of monetary policy. However, Ireland's ELA debt is small in the context of the Eurosystem as a whole and the ECB is obligated to support the policies of the EU provided such support does not endanger price stability. Since the EU has now effectively declared the restoration of the stability of Ireland's public finances as a goal, there is a strong argument that the ECB should act to support this goal.

An alternative possibility is for Ireland to seek to replace the promissory notes with long-term funding from the EFSF or ESM. Such a loan would represent an improvement over current arrangements but would also have a number of disadvantages. One of these disadvantages is that loans from EFSF or ESM require political approval from its member states and so such a deal would be viewed in Europe as a second bailout for Ireland, even if it is simply refinancing existing debt.

A deal with the ECB should be Ireland's priority, with replacement funding from EFSF or ESM a less attractive second option.

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