Patrick Honohan: Ireland – institutional indebtedness and the banking crisis

Opening statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Joint Committee on Finance, Public Expenditure and Reform, Dublin, 27 March 2012.

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Although I will need to take great care in my statement to protect the financial interest of the State in view of current discussions, recognising the interest and concern of the Committee to understand the various issues surrounding the Promissory Notes, a scheduled amortisation payment of which falls due next week, I will be glad to provide as clear an account of the matter as I can.

The Promissory Notes owned by the Irish Bank Resolution Corporation (IBRC) are part of the legacy of the banking crisis. They represent just one aspect of a large and complex structure of institutional indebtedness involving the Government, the banks and the central banking system, which has resulted from that crisis.

Although some commentators have tended to exaggerate the extent to which the tax increases and spending cutbacks which have to date been put in place in Ireland can be attributed to the banking debt, this debt does hang over the economic and financial recovery of Ireland and – as is generally agreed – needs to be set on a more secure basis.

The Promissory Notes were provided by the Minister for Finance, using powers granted to him by the Oireachtas under the Credit Institutions (Financial Support) Act 2008, as a way of ensuring the compliance of Anglo Irish Bank and Irish Nationwide Building Society – the precursor institutions of IBRC – with the Capital Requirements Directives. This became necessary as a result of the losses entailed in the prices announced in March 2010 and the following months for the various tranches of NAMA purchases.

The pace of the annual cash payment stream provided for in the Notes was, from the outset, structured – perhaps somewhat arbitrarily – as one-tenth of the value of the Note to be paid on March 31 each year, with the total duration of the payment stream being set to ensure the capital requirement. The Notes were reset on several occasions during 2010 to reflect the progressive crystallisation of losses. Interest on the value of the Notes was included at the yield required by the market on Irish Government Securities of comparable maturity at the time of each issue of the Notes. It is relevant to note that the spread on ten year Irish Government Securities above Bunds immediately after the end-March 2010 PCAR announcement, that made it clear (to any that still doubted it) that extremely large banking losses would be incurred by the banks in the NAMA purchases, was only about 125 basis points. Clearly, the cost of refinancing the amortisation payments at such a yield would have been much lower than it is today. The first annual amortisation payment was made in March 2011. (I abstract here from the question of the interest holiday for the first two years).

Meanwhile, it should be recalled that, when, despite the Government guarantees that covered many but not all of them, deposit outflows and bond repayments exceeded Anglo's capacity, the Central Bank, consistent with the euro-area view that no senior bank creditors should suffer losses in the crisis, extended emergency liquidity assistance to Anglo Irish Bank. To cut a long story short, much of this is still outstanding to IBRC, and much of it is secured by the Promissory Notes. Funding such flows is not something that a central bank will normally do for any longer than is necessary.

With the Troika and the other Irish authorities, the Central Bank has been actively studying ways of enhancing the security of the arrangements surrounding the provision of liquidity to IBRC and ensuring that avoidable deleveraging costs to the system as a whole are not incurred in the disposal of non-core assets. This is a large ambition, and the design of a full solution that would achieve the objectives and respect the constraints of all the parties has not yet been finalised.

Given the deepening of the crisis since April 2010 and in particular the loss of market access by the Government and the need to have recourse to the EU-IMF Programme to ensure continued financing of the Government's budget, the sequence of annual cash payment by the Government of €3.06 billion envisaged for the coming years in the Promissory Notes has become a source of risk to financial stability. A way of funding this cash payment over a much longer period would clearly help reduce this risk. Ahead of the scheduled March 2012 payment, the Central Bank has been working vigorously with the ECB and other parties on a mechanism for ensuring such a result in a manner that is at an acceptable cost to Ireland and whose design is beyond criticism from the perspective of Articles 123 and 124 of the Treaty. While some technicalities still need to be resolved, it now seems likely that this effort will be successful.