

PROMISSORY NOTES

Oireachtas Joint Committee on Finance, Public Expenditure and Reform, February 15th 2012.

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In light of the the scale of the funding challenge to Ireland in the medium term, this note focuses on three main areas:

1. An estimate of the scale and importance of the promissory notes;
2. a discussion of the interaction of the promissory note repayments with bondholder repayments, and
3. the need for burden sharing for peripheral states given medium term debt sustainability projections.

Ireland's medium term recovery with and without promissory notes.

Figure 1 outlines the repayment schedule of the promissory notes from 2011 to 2031 in billions of euros. The line to focus on is not the interest repayment schedule (due to the circularity of one part of the State paying interest to another), but the total capital reduction. The taxpayer must underwrite the repayment of €3.1 billion each year either through sovereign borrowing or taxes. The macroeconomic context for this repayment will be well known by the committee members: Ireland's debt to gross domestic product ratio stands at 107% and is projected to stabilise at 119% in 2013 by the NTMA, very close to what many macroeconomists consider unsustainable levels. Figure 2 shows the importance of the promissory notes in Ireland's overall debt profile at the end of 2010. Figure 3 on the next page shows the effect on Ireland's net borrowing for the medium term in billions of euros of deferring the promissory note repayment schedule. Clearly removal of the immediate need to repay the promissory notes increases the likelihood of a return to a sustainable level of debt repayment and a return to the markets in earnest.

Promissory notes and bondholders.

Ireland's banking system now contains three contingent liabilities: the repayment of the remaining senior bondholders, the repayment of the promissory notes, and the unfolding mortgage crisis in Ireland.

It is important to remember that the promissory notes exist because two banks became insolvent and could not access

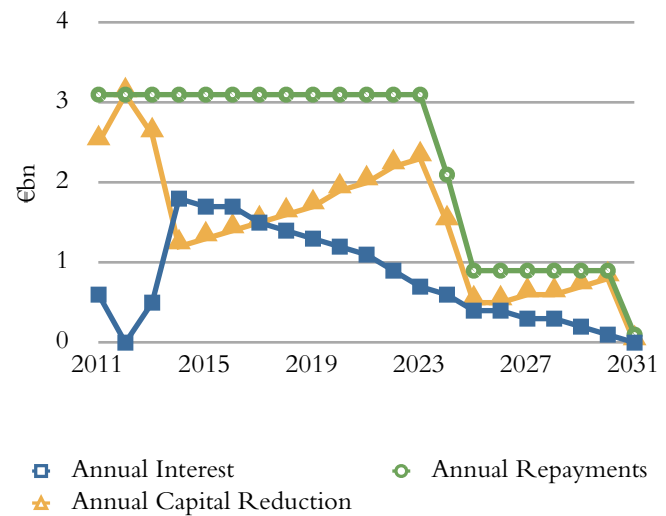


Figure 1: Total interest, repayments, and capital reduction of promissory notes from 2011 to 2031 in billions of euros. Source: Written answer by Michael Noonan TD to Pearse Doherty TD, 27 September 2011. <http://bit.ly/zrgbKM>.

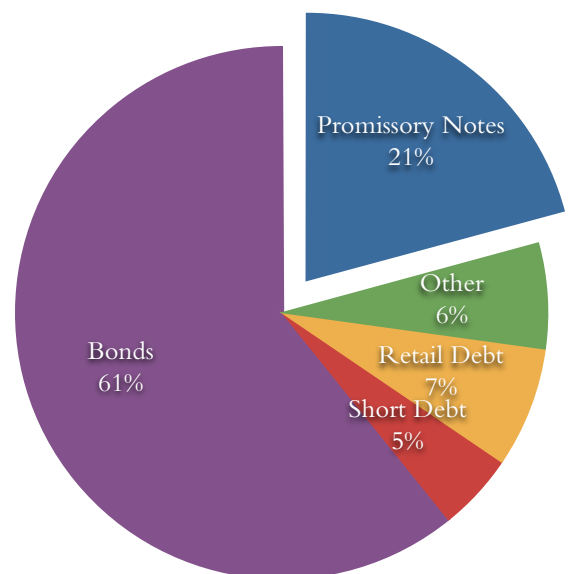


Figure 2: Percentage Composition of Ireland's 148 billion euros of debt at the end of 2010. Source: Department of Finance.

funds in the normal way. The government created the promissory notes to allow the banks to present them as collateral for ELA to the Irish Central Bank, which then allowed the banks to access funds created off the balance sheet of the European Central Bank worth almost €31 billion. These funds need to be repaid, either with taxes or borrowed money. As they are repaid the balance of the ELA on the Irish Central Bank will be reduced over a 15 to 20 year period. Thus the only reason the banks are solvent and liquid in the technical senses of those words is because of the largesse of the Minister for Finance.

Table 1 shows the estimated balance sheet of IBRC as imputed by Prof. Whelan. Highlighted are the asset and liability entries for promissory notes and ELA to the Irish Central Bank, respectively. There is an argument that, by reducing or removing payments for the promissory notes, the funding position of IBRC, and hence the repayment of the remaining bondholders, would be threatened. This is clearly not the case—sufficient funding exists on the balance sheet of IBRC to cover the remaining outstanding bondholders. The debate on promissory notes should therefore take place independently of the debate on bondholder repayment debate.

Having established a position with respect to the payment of promissory notes, it is important to note that the scale of personal indebtedness in Ireland as a result of the property boom of 2002–2007 has still not been addressed, though small steps are currently being taken by policy makers.

Burden sharing and the ECB.

It is important to remember that the current debate within the ECB concerns burden sharing with smaller nations in the future¹. It is also important to note the divergence at times between the ECB's rhetoric and its actions. For example, the ECB said on the 6th of May 2010 that under no circumstances would they intervene in government bond markets. On the 10th of May, they were in the market buying Greek bonds under the securities and markets programme. Similarly, the ECB has mooted a range of divergent treatments for peripheral nations, including Greece, Portugal, and Ireland. For example, the ECB may agree to transfer the value of its holdings of Greek debt using the European Financial Stability Facility (EFSF). The same mechanism could be used to transfer Ireland's promissory notes from outside the Euro system to within it. However, the nature of the repayment schedule and the interest payment on such a maneuver would have to be very closely monitored to ensure the relative freedom of repayment schedules the government has at the moment is not compromised.

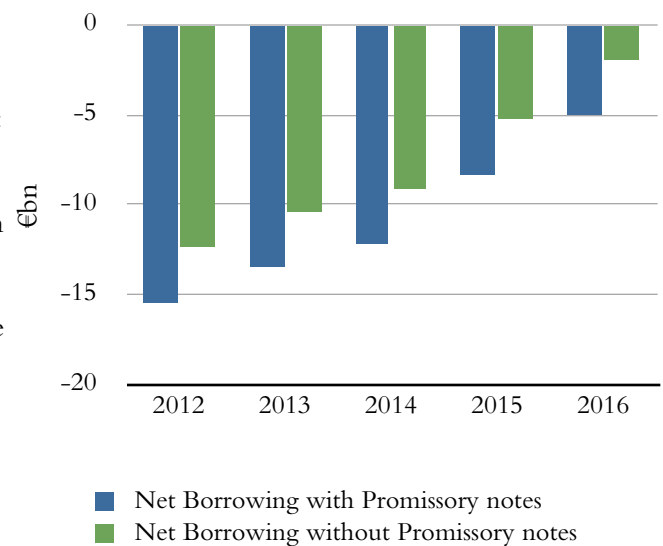


Figure 3: Net government borrowing with and without promissory note payments in 2012–2015 in billions of euros. Source: Budget 2012 Department of Finance, <http://bit.ly/yaL3nQ>.

Assets	€bn	Liabilities	€bn
Promissory Notes	28.1	ELA to Central Bank	42.2
Loans	27.5	Debt Securities	6.3
Other	3.0	Subordinated Debt	0.7
		Euro System Borrowings	6.0
		Deposits	1.1
		Other liabilities	2.3
Total	58.6	Total	58.6

Table 1: Estimated Balance Sheet of IBRC. Source: Karl Whelan.

¹ For an academic perspective on burden sharing, see CAE Goodhart and Dirk Schoenmaker, *Burden Sharing in a Banking Crisis in Europe* *Sveriges Riksbank Economic Review*, No. 2, pp. 34–57, 2006, Available at SSRN: <http://ssrn.com/abstract=888462>