



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Mr Matt Carthy

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European Parliament

60, rue Wiertz

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L/MD/15/86

Re: Your questions (QZ55-60)

Honourable Member of the European Parliament, dear Mr Carthy,

Thank you for your letter, which was passed on to me by Mr Roberto Gualtieri, Chairman of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 22 December 2014.

Your questions cover a broad range of matters, all related to the Irish macroeconomic adjustment programme. Please allow me, therefore, to respond to your questions in a single document.

On the decision not to participate in the Irish banking inquiry

The Executive Board of the ECB carefully considered the letter addressed to me from Mr Ciaran Lynch TD, Chairman of the Irish Joint Committee of Inquiry into the Banking Crisis. In my reply, I underlined that, owing to the ECB's accountability to European institutions and primarily to the European Parliament, the ECB is not in a position to participate in inquiries conducted by national parliaments. The members of the Governing Council were informed accordingly. The ECB stands ready, in due course and in liaison with the Irish parliament, to determine how best to interact on an informal basis, outside the context of the banking inquiry, as has been done with other national parliaments in the past.¹

¹ The ECB President participated in informal exchanges of views in various formats in the national parliaments of Spain, France, Germany and Finland. ECB staff involved in the monitoring of the EU/IMF financial assistance programmes participated in informal closed-door exchanges of views with the relevant committees in the Greek, Cypriot, Irish and Portuguese parliaments. Furthermore, the ECB has had several exchanges, in various formats and at various levels, with national parliaments across the European Union. However, these exchanges neither pertained to the sphere of ECB accountability nor entailed participation in an inquiry committee of a national parliament.

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Finally, let me be clear that while the ECB is accountable to the European Parliament, which implies that the European Parliament has a right to scrutinise the ECB's actions, the ECB was established as an independent central bank. Article 130 of the Treaty on the Functioning of the European Union unambiguously states that the ECB shall not take instructions from Union institutions in carrying out its tasks. This provision is a cornerstone of the EU's institutional framework.

On the circumstances of the publication of the letters exchanged between ECB President Trichet and Finance Minister Lenihan in 2010

The ECB received six requests in the context of its public access regime: four of them sought access to the correspondence between the ECB and the Irish Department of Finance in November 2010, while the other two (received in 2014) requested specifically the letter dated 19 November 2010.² The ECB also received a letter from the European Ombudsman, dated 16 November 2013, as a follow-up to a citizen's complaint about maladministration by the ECB in relation to one of the above public access requests. While the Ombudsman found that there was no maladministration on the part of the ECB and that, at the time of the complainant's request for access, the ECB was entitled to refuse access to the aforementioned letter, the Ombudsman proposed a "friendly solution", inviting the ECB to reassess the content of the letter in view of (i) *the passage of time* from when the letter had been sent and the request for access to it had been made, and (ii) *the prevailing monetary and economic conditions*.

In early 2014, while acknowledging the recent, successful exit by the Irish authorities from the adjustment programme, the ECB considered that the overall context in which the letter had been sent was still relevant. Ireland was (and still is) subject to post-programme surveillance and it also had to be taken into account that the (at the time ongoing) comprehensive assessment could have led to the identification of capital shortfalls in one or more Irish banks. Against this backdrop, the ECB deemed it imprudent to make any disclosure that could have had an adverse impact on the liquidity and funding conditions of the Irish banking system. Accordingly, and in the interests of financial stability in Ireland, it was decided to await the outcome of the comprehensive assessment.

The ECB published the results of the comprehensive assessment on 26 October 2014. At its first meeting thereafter, which took place on 6 November 2014, the ECB's Governing Council evaluated the feasibility of publishing the aforementioned letter, as well as three other letters exchanged between Messrs Trichet and Lenihan during the same period of 2010. In view of the completion of the comprehensive assessment for the Irish financial sector, Ireland's regaining of access to financial markets under favourable conditions, as well as the improved performance and prospects of the Irish economy, as reflected in the GDP and employment data for the first three quarters of 2014, the Governing Council concluded that it was appropriate to disclose these letters. The letters were published on the same day on the ECB's website.

Beforehand, in line with standard practice regarding third-party documents, and on the basis of its public access regime (Decision ECB/2004/3), the ECB had communicated with the Irish Department of Finance on the potential publication of the letters.

² The dates of all these requests are 9 December 2011, 20 August 2012, 27 August 2012, 20 October 2012 and 30 July 2014 and 7 October 2014.

Finally, the ECB is not aware of how the letter ended up being published by the Irish media on the morning of 6 November 2014. It is very regrettable that this leak occurred.

On the provision of emergency liquidity assistance to Irish credit institutions and the role of the Governing Council of the ECB

Emergency liquidity assistance (ELA) refers to the provision of central bank money, and/or any other assistance that may lead to an increase in central bank money, by a Eurosystem national central bank (NCB) to a solvent financial institution or group of solvent financial institutions with temporary liquidity problems, without any such operation being part of the single monetary policy. Responsibility for the provision of ELA lies with the NCB concerned, in this case the Central Bank of Ireland. The legal basis for the decisions to grant ELA to Irish banks stems from Section 5B(d) of the Central Bank Act 1942, as inserted by Section 5 of the Central Bank and Financial Services Authority of Ireland Act 2003, which provides that, without limiting the functions of the Central Bank of Ireland, it is empowered to “provide loans and other kinds of financial accommodation to credit institutions and other persons on the security of such assets and on such terms and conditions as the Board considers appropriate.”

The Governing Council’s related competence is based on Article 14.4 of the Statute of the European System of Central Banks and of the European Central Bank, under which the Governing Council may restrict the performance of national functions, such as ELA operations, if it considers that such operations would interfere with the Eurosystem’s objectives and tasks.³ This means that if ELA is provided in large amounts, the Governing Council needs to assess the features of the transactions, their liquidity effects and whether it would be appropriate to impose specific conditions, in order to protect the integrity of the ECB’s monetary policy. Additional procedures underlying the Governing Council’s role with regard to the provision of ELA are aimed at adequately ensuring that these arrangements and their potential effects do not interfere with the single monetary policy.⁴ Moreover, the Governing Council has to adhere to the prohibition of monetary financing.

In the case of Ireland, the level of liquidity provided by the Eurosystem in support of the Irish banking system had reached about €140 billion (including ELA), or around 85% of Irish GDP, by November 2010.⁵ This represented around one-quarter of the ECB’s total lending at the time – an unprecedented level of exposure to any country, not least in the light of the fact that Ireland’s share in the capital of the ECB was about 1%. As clarified in the letter of the ECB’s President dated 19 November 2010, “whenever ELA is provided in significant amounts, the Governing Council needs to assess whether it is appropriate to impose specific conditions in order to protect the integrity of our monetary policy. In addition, in order to ensure compliance with the prohibition of monetary financing, it is essential to ensure that ELA recipient institutions continue to

³ Article 14.4 of the Statute states that “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. Such functions shall be performed on the responsibility and liability of National Central Banks and shall not be regarded as being part of the functions of the ESCB.”

⁴ The procedures underlying the Governing Council’s role with regard to the provision of ELA aimed at adequately ensuring that these arrangements and their underlying problems do not interfere with the single monetary policy of the Eurosystem. Such procedures are published on the ECB’s website (https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf?e716d1d560392b10142724f50c6bf66a).

⁵ It then reached almost €160 billion (including ELA), or around 100% of Irish GDP, by February 2011.

be solvent.” It is this latter consideration that is reflected in the four points mentioned by Mr Trichet that would ensure the continued solvency of the Irish banking system.

On the matters raised regarding the ECB's involvement in the preparation of the EU/IMF adjustment programme

Staff from the ECB, European Commission and IMF were involved in discussions with the Irish authorities on Ireland's economic and financial situation, as well as the policy measures that the Irish authorities were considering in the preparation of a possible adjustment programme for Ireland. However, a clear distinction should be made between the discussions that took place in the context of the preparations for such a programme and the ultimate decision to request a programme, which was taken solely by the Irish authorities.

Before elaborating further, let me underline, as the ECB did in its replies to the questionnaire of the European Parliament in 2013,⁶ that the ECB does not have any decision-making powers in relation to its role in assessing and monitoring EU/IMF financial assistance programmes in liaison with the European Commission. Instead, it provides advice to euro area countries as input for the decisions ultimately taken by euro area finance ministers. This was confirmed by the European Court of Justice in the Pringle case.⁷

Regarding the specific circumstances you mentioned, on 12-13 October 2010 representatives from the European Commission and the ECB conducted technical discussions with the Irish authorities in Dublin. These discussions concerned the precarious situation of Ireland's public finances and the clearly evident crisis facing the financial sector.

Finally, regarding your question specifically concerning 12 November 2010, there were interactions at staff level to discuss the plans being put in place by the Irish authorities. These included the indirect provision of a number of documents on the financial sector by the Irish authorities to the ECB, via the European Commission; the direct provision of a document concerning fiscal plans; and contacts on organisational/technical issues such as arrangements for a teleconference, meeting time etc. According to our records, we are not aware of any other exchanges between the ECB and the Irish authorities on that day.

On possible burden-sharing in the resolution of credit institutions in Ireland (“burning of bondholders”)

Before discussing the specific events, let me recall three important points.

First, I must be absolutely clear that the ECB does not have any authority to issue instructions to any euro area government or its ministers, in the same way as euro area governments and EU institutions are not in a position to issue instructions to the ECB. The decision on the modalities for the resolution of Irish credit institutions was taken by the Irish authorities, in accordance with the EU/IMF financial assistance programme agreed between the Republic of Ireland and the other euro area countries.

⁶ See https://www.ecb.europa.eu/pub/pdf/other/140110_ecb_response_troika_questionnaireen.pdf

⁷ In the Pringle case, Advocate General Kokott considered that the tasks entrusted to the ECB under the Treaty establishing the European Stability Mechanism (ESM Treaty) “are relatively minor in comparison with those of the Commission.” According to her, given that the ESM Treaty requires the European Commission mainly to act “in liaison” with the ECB “it is not so much that tasks are allocated to the European Central Bank but that it has a qualified right to be consulted.”

Second, when talking about the “burning of bondholders”, it should not be overlooked that there was substantial burden-sharing with holders of subordinated debt issued by Irish credit institutions. Over the period 2009-11 the total amount gained from this burden-sharing was just under €14 billion. At the same time, shareholder write-downs exceeded €29 billion. As such, private individuals and entities endured considerable losses.

Third, the EU governance tools associated with the bail-in of creditors, which were set out in the Bank Recovery and Resolution Directive (BRRD)⁸ and fully endorsed by the ECB, were not available at the time of the events under consideration. Furthermore, there was no precedent at that time in Europe for bailing-in senior bank creditors.

Let me now focus on some of the main events, as the involvement of the ECB in the area of burden-sharing has frequently been misunderstood and, at times, misrepresented. Moreover, when assessing certain policy choices, one has to bear in mind the parlous state of the Irish banking system at the time and the precarious situation of Ireland’s public finances.

It has been noted⁹ that, in principle, the Irish government may have taken the initiative to bail in some senior bondholders well before the start of the programme, considering in particular the grave state of Anglo Irish Bank. However, this option was not pursued by the Irish authorities. The introduction of the Credit Institutions (Financial Support) Scheme (CIFS) 2008 effectively limited the potential for any burden-sharing for the two-year period of its validity. Allow me to take this opportunity to also restate that the ECB (i) was neither made aware of nor consulted beforehand on the implementation of the CIFS guarantee, and (ii) took a critical view of the two-year government guarantee of bank liabilities (see ECB Opinions CON/2008/44 and CON/2008/48). The fact that the CIFS guarantee was ultimately superseded by the Eligible Liabilities Guarantee Scheme in 2009 meant that the above-mentioned limitation on burden-sharing eased in late 2010. By this time, however, the potential for burden-sharing had reduced, in line with the stock of outstanding bank debt.

The CIFS guarantee to some extent relieved the liquidity challenges facing the Irish banking system as a result of the money market turmoil that emerged in 2007 and the unbalanced and then unsustainable funding composition that underpinned large parts of the banking sector. However, it could not fully alleviate these problems, as money markets became illiquid, leading the banks to become increasingly reliant on Eurosystem operations. Over the course of the CIFS guarantee, this substitution of unsecured money market funding with secured central bank funding brought collateral problems to the fore, an issue exacerbated by continued ratings downgrades. Furthermore, the CIFS guarantee did nothing to address the asset quality concerns that plagued the Irish banking sector, impacting their access to funding and, as just mentioned, their available collateral. Concerns about the solvency of Irish banks were not alleviated by a series of stress tests that were completed in late 2010.

⁸ See Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

⁹ See, for example, Pisany-Ferry, J., Sapir, A., and Wolff, G.B., EU-IMF assistance to euro area countries: An early assessment, Bruegel Policy Contributions, 17 June 2013 (<http://www.bruegel.org/publications/publication-detail/publication/779-eu-imf-assistance-to-euro-area-countries-an-early-assessment/>).

By this time, there was evidence of a fully-fledged sovereign-bank negative feedback loop. The weight of the concerns about the banking sector was dragging on the sovereign, and the credibility of the CIFS/ELG guarantee was in question.

In that context, the absence of legislation in Ireland to ensure “depositor preference” is relevant and important, as senior bank bonds were, legally, *pari passu* with bank deposits. This is important from the perspective that senior creditors, threatened with burden-sharing, could have legally challenged any attempt to treat them differently from depositors. The fact that deposits were guaranteed by the State implied that attempts at burden-sharing may have triggered the CIFS/ELG guarantee. The relevance of these points relates to the scope for possible burden-sharing. It is often reported that plans were afoot at the outset of the programme to burden-share with senior bondholders across the banking system. In the light of the above, however, burden-sharing with banks such as Allied Irish Banks and Bank of Ireland, whose retail deposit base had remained relatively stable during the years of turbulence, and acted as a stabilising force, was at risk. Any such deposit outflows would have placed additional funding and deleveraging pressure on the system, which was already under significant pressure. In parallel, reliance on central bank funding would have increased further. Had insufficient eligible collateral been available, this might have resulted in greater reliance on ELA, which from an economic perspective implies a higher level of contingent debt of the sovereign and therefore could have exacerbated rather than ameliorated the sovereign-bank nexus. Increasing reliance on ELA early on in the adjustment programme, particularly by the banks later to be designated as “pillar” banks, would have done little to bolster confidence at a time when the priority was to restore stability to the banking system. In later discussions, the Irish authorities made it clear that they did not wish to pursue the issue of burden-sharing with pillar banks.

In addition, burden-sharing could have been considered a default event, which could have led to a bank being excluded from access to Eurosystem funding. The rules are clearly set out in “The implementation of monetary policy in the euro area: General Documentation on Eurosystem monetary policy instruments and procedures”, which states that the “Eurosystem may suspend, limit or exclude access to monetary policy operations with regard to counterparties that are in default pursuant to any contractual or regulatory arrangements applied by the NCBs.”

In such circumstances, attention may therefore focus on Anglo Irish Bank and Irish Nationwide Building Society. It should be recalled that the amounts available for burden-sharing in these institutions were relatively modest when the financial assistance programme was finalised: less than €3.5 billion in 2011. With proposals to gain in the region of €1.75 billion from burden-sharing with these bondholders, the ECB’s opinion was, and still is, that such gains were insufficient to warrant the risk of the unknown and unquantified costs of burden-sharing at a critical juncture in the Irish macroeconomic adjustment programme, given that the pillar banks had just been recapitalised and the system was being stabilised.

Furthermore, while these entities may have been *de facto* “gone concern” banks, *de jure* they were going concerns and had entered into legally binding restructuring plans with European authorities, to be carried out over several decades. My previous comments concerning the eligibility of defaulted entities for Eurosystem credit operations apply equally here.

Finally, the concerns alluded to previously, on burden-sharing and the associated risks of contagion to other Irish banks and the sovereign more generally, were exacerbated by the uncertainty about the ownership of the bonds in question, given that they were traded in the secondary market. In fact, the only certainty in this respect was that Irish banks and credit unions held some of this debt. It was also not clear that the pillar banks could be ring-fenced from any adverse market reaction.

In conclusion, between a range of constraints, uncertainties and also in the context of highly fragile markets both domestically and internationally, as well as with the benefit of hindsight, the ECB is of the view that, given the very complex and fragile situation the Irish authorities were confronted with, it was the right decision not to burn senior bondholders in Irish banks after the programme had been agreed, as the potential costs of burden-sharing with senior bank bondholders were likely to dwarf the benefits. The actions undertaken by the Irish government during the programme, particularly at its outset, laid the foundations for the significant and rapid rebound in confidence in the Irish banking system, as well as the Irish sovereign and economy more broadly. This virtuous circle may not have materialised had confidence in the banking sector not been so forcefully restored in 2011. The sound and credible policies implemented by the Irish authorities in the context of the financial assistance programme allowed the ECB – within its mandate and rules – to provide substantial support to Irish citizens and the economy via liquidity provision and the advice it gave in the context of its role, in liaison with the European Commission, in the Irish adjustment programme.

For additional details, please see the documentation (including a dedicated Q&A) published by the ECB on its website on 6 November 2014 (http://www.ecb.europa.eu/press/pr/date/2014/html/pr141106_1.en.html), as well as the interview with Benoît Cœuré, Member of the Executive Board of the ECB, published by the Irish Times on 16 January 2015 (<http://www.ecb.europa.eu/press/key/date/2015/html/sp150116.en.html>).

Yours sincerely,

[signed]

Mario Draghi