Global Counsel

Will Europe's Spanish solution throw Dublin a debt lifeline?

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Summary

- The European Council deal last Friday opened the door to the prospect of the European Stability Mechanism (ESM) bailout fund directly recapitalising ailing Eurozone banks. This was a political victory for Madrid, and a potentially significant shift in the Eurozone's approach to its problems.

- It also opened the prospect of revisiting Ireland's bailout of its own financial sector, and 'Europeanising' some of the €64bn stake that the Irish state has taken in Irish banks. The deal was greeted as a 'game changer' by Dublin, which capitalised on a lift in investor confidence by returning to debt markets for the first time in two years.

- Such an assessment looks premature. The deal, while unquestionably good news for Ireland, is less of a game changer than it might look. The structure of the Irish bailout and the fact that much of it has been invested in institutions that have ceased to exist, makes it unlikely that other Eurozone states would contemplate Europeanising the associated debt. The requirement that banking supervision in the Eurozone be relocated to the ECB before the ESM undertakes any such lending only raises more questions.

- For investors in Ireland the Council deal may prove something of a red herring. Ireland's improving standing with investors has – or should have - as much to do with the nature of its crisis and its improving fundamentals.

Last week's European Summit in Brussels turned out to be surprisingly substantial. The Summit ignored the paper circulated ahead of the meeting mapping out a wider discussion on the framework for political, fiscal and banking union in the EU and focused instead on practical solutions to the Eurozone's biggest problem: the toxic link between the Eurozone's banks and sovereigns. The acceptance in principle that the Eurozone's European Stability Mechanism bailout fund should be able to capitalise illiquid banks directly without further impairing sovereign balance sheets marked an important inflection point in Europe's crisis. It is thinking about the problem in a new way.

The key advocate of this outcome, and its most obvious potential beneficiary, is, of course, Spain with its looming bank bailout. But it is no accident that the short Summit communiqué indicates that treatment afforded to Spain in principle should also be offered to Ireland. This news was greeted enthusiastically in Dublin. At the Summit itself, Irish Prime Minister Enda Kenny, called it a "game changer" for Ireland, offering the prospect of reversing a significant part of the €64bn capital injection that the Irish state provided for the Irish banking system after 2008.

Irish bond prices this week suggested the market agreed (Fig 1). The Irish Treasury capitalised on the goodwill and rising confidence by returning to the market for the first time since 2010 to raise €500mn in 3 month bills at 1.8%. This Global Counsel Insight note suggests that the deal, while good news for Ireland, is much less of a game changer than it might look. Ireland's improving standing with investors has – or should have - as much to do with the nature of its crisis and its improving fundamentals.

How much of Ireland's debt could actually be Europeanised?

There are two basic sets of issues hanging over the bank recapitalisation agreement for Dublin, one general, and one specific to Ireland. The general issue involves the key condition that the European Council attached to direct ESM bank interventions at the insistence of Berlin. This is the prior establishment of the ECB as a bank supervisor in the Eurozone. This is much easier said than done, and raises a huge number of questions.

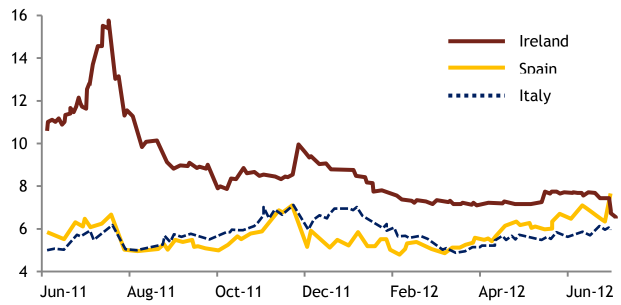

Fig 1: Irish, Spanish and Italian implied 10yr bond yields 2011-2012

Source: Bloomberg

Such as: which banks will be covered? The Council specified only "Eurozone banks", a formulation that fudges Germany's unwillingness to surrender oversight of its Landesbanken and Sparkassen. How will the ECB manage its function as both supervisor and funder of last resort of banks? How will it oversee bank resolution? If this is done through a resolution fund, how will this be raised? If the ESM is to take over the resolution process, who will be empowered to sell assets and on what criteria? The Council's bland phrasing conceals a thicket of political and sovereign compromises that have barely been contemplated. As Berlin no doubt calculated, these questions are likely to take many months to resolve. Before they are, the debt stays on the Spanish and Irish balance sheets.

More importantly for Ireland, the nature of the Irish bailout is likely to limit the scope for dramatically reshaping Ireland's public debt through the ESM. Ireland has, to this point, injected a little over €64 billion into its banking system since December 2008. €20bn of this came from Irish pension reserves and much of this was used to take stakes in Allied Irish and Bank of Ireland. The balance was borrowed – most of it in the form of €35bn from Ireland's €67bn EU/IMF/ECB bailout (Fig 2).

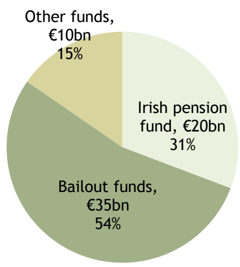

Fig 2: Irish primary and general balance 2007-2015

Source: Public Irish sources

What element of this €64bn might credibly be expected to be 'Europeanised'? This is likely to hang on the valuation of the bank stakes in question. Of the €64bn ploughed into Irish banks, almost €35bn went to institutions that have now ceased to exist – Anglo Irish Bank and Irish Nationwide. It is difficult to imagine the ESM taking responsibility for debts on which it has zero prospect of ever achieving a compensatory return on privatisation or restructuring. Whatever else the ESM attaches to its lending, the viability of the recipient is likely to be a core criterion.

The largest nationalised banks in the Irish system that are still viable have seen their value fall far below the €30bn that has been injected into them. The Irish pension fund values its stake in Allied Irish and Bank of Ireland at just over €9bn. This looks like a much more credible estimate for the likely reduction in Ireland's debt burden.

Beyond this, much depends on how the ECB in particular approaches any renegotiation of the €31bn in promissory notes agreed between the Irish Government, the Irish Central Bank and the Irish Bank Restructuring Corporation, created from the remains of Anglo Irish and Irish Nationwide. The IBRC uses these notes to draw down liquidity assistance from the Central Bank of Ireland, as it has no access to the ECB's liquidity support programmes. The Irish state must repay these notes, with interest, at €3.1bn annually until 2024, and slightly lower rates thereafter until 2031.

Dublin would like the promissory note to be replaced with a longer term loan in the form of bonds from the ESM. It also wants the IBRC to be given permission to use ESM bonds as collateral for ECB liquidity, which would spread the IBRC's liabilities across the entire Eurosystem, rather than simply on the Irish Central Bank. The triple-A rated European sovereigns will be reluctant to concede much ground here, especially in the face of a public lobbying campaign by Dublin. Any general political trade-off between the Europeanisation of Irish debt and greater fiscal convergence in the Eurozone is likely to keep coming back to issues like Ireland's super-low corporate tax rate, on which Dublin has no intention of compromising, even *in extremis*.

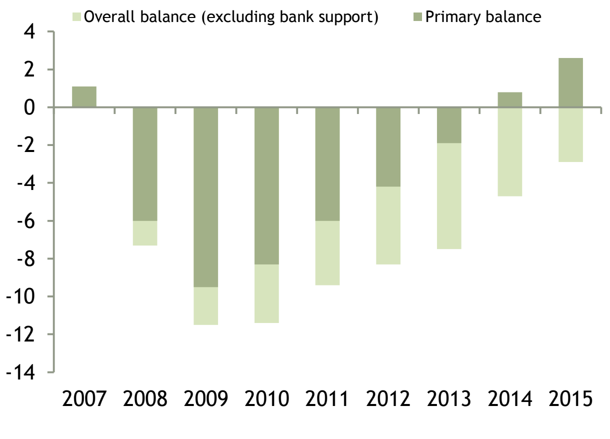

Fig 3: Irish primary and general balance 2007-2015

Source: IMF/Troika 2012. Estimates after 2011

In principle, an ESM stake in the viable nationalised banks in Ireland and a renegotiation of the terms of the promissory notes would reduce Ireland's overall debt and its annual interest burden. A hypothetical €10bn bank stake transfer to the ESM could reduce Irish government debt by around 7% percentage points to a shade over 100%. A restructuring of the promissory note could improve on this significantly. But the suggestion in parts of the Irish media that the €64bn is about to be whisked off Ireland's balance sheet is way off the mark. The likely outcome will be much more modest, and is almost certainly not going to happen quickly.

Why do markets think Ireland is a safer bet than Spain?

The fact that Ireland's implied 10 year yields have fallen below Spain's, when Ireland is the recipient of a bailout and Spain is not, requires some explanation. Investors may have somewhat misjudged the likely value of the Council outcome for Dublin, but positive sentiment probably rightly reflects a range of other factors. The purge in the Irish banking system and a 50% collapse in house prices since 2007 have at least had the benefit of leaving little doubt as to the scale of the Irish banking and negative equity problem. To some degree, the market is still guessing about the scale of the same problem in Spain, and Madrid is paying the price in higher debt costs.

Ireland's bailout in 2010 has released Dublin from a daily confrontation with debt markets and the nagging question of how to handle yields of higher than 6%. Where Spain's fiscal reform agenda remains a work in progress, Ireland's Troika programme has forced the state's hand on a range of public spending cuts and economic reforms. The Irish primary balance deficit has been reduced from 9.5% in 2009 to a projected 4.2% of GDP in 2012 and the Irish economy now runs a small current account surplus that reflects heavy consumer and corporate deleveraging and a small increase in exports. Irish private sector wages have deflated very slightly since 2008.

Nevertheless, Ireland has plenty of pain ahead, even if the restructuring of its bank debt eventually reduces its overall debt burden somewhat. The interest burden from the debt incurred since 2009 will place a significant burden on the Irish public budgets for years to come (Fig 3). Unemployment, at a fraction under 15%, is the third highest in the EU. Ireland's considerable exposure to the stalling economies of the UK and the Eurozone is inevitably having a chilling effect. Industrial production and retail spending are flat and credit levels contracting slightly.

While the government's agenda has certainly not been popular, the Irish public has shown a relative degree of tolerance for the costs of austerity. A referendum on the new European Fiscal Treaty in May 2012, which offered the temptation of a protest vote against the bailout, nevertheless produced a positive endorsement by a margin of two to one. The governing Fine Gael-Labour Coalition continues to poll just short of 50% and the Fianna Fáil opposition remains stuck at around 18% in the polls. The Sinn Fein party, which campaigned to reject the Fiscal Treaty, has fallen from 21% to 16% in most recent polling, apparently losing some support to the governing Fine Gael party.

After a month of media and political grumbling in Ireland that Spain's size would see it secure a better deal than Ireland, the psychological effect of muscling in on Spain's push to reshape the Eurozone's approach to its banking crisis is hard to measure, but not insignificant. So too is Ireland's return to the debt markets this week. These boosts to Irish and to investor confidence are clearly relevant. But without a lot more clarity on what is and is not acceptable to Ireland's European partners, a dose of realism is required about the potential benefits to Dublin of the Eurozone's apparent conversion to the Europeanisation of bank rescues.

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