Restructuring ELA Liabilities — Lessons From Ireland

Law360, New York (February 10, 2014, 12:54 PM ET) -- The Irish banking crisis has provided some insights into the use by European Union member states of emergency liquidity assistance (ELA), which supports financial institutions or markets that are experiencing an exceptional and temporary crisis of liquidity. As other EU member states' banking systems continue to struggle with their debt in 2014, the approach used to restructure the ELA liabilities of the Irish Bank Resolution Corp. merits consideration.

How ELA Works

In many states, the discretionary use of ELA is one of the core functions of the national central bank, which acts as a "lender of last resort." Typically, the national central bank will create money and lend it to a troubled financial institution with the intention that, upon repayment, the money will be destroyed; the aim is to provide support to meet the demands of a crisis without making a long-term impact on a country's monetary policy.

In EU member states that use the euro as their currency, the national central banks have remained in existence, retaining their former powers and functions subject to the restrictions on monetary sovereignty imposed by several legislative instruments.[1]

The banks are entitled to engage in ELA programs unless expressly prevented by a two-thirds majority vote of the European Central Bank's Governing Council. However, any proposed use of ELA still must be communicated to the ECB in advance in accordance with published procedures,[2] giving the ECB a central role in governing the use of ELA within the eurozone.

Despite the ECB's role, the national central banks remain responsible for providing the emergency liquidity, and their member states assume the costs and risks,[3] which makes ELA an exception to the eurozone's single monetary policy. The ECB's involvement in the process has led to some erroneous commentary suggesting that the ECB has lent money to eurozone banks through ELA.

Study of ELA activity is complicated by the veil of secrecy (deployed in the interests of systemic stability) that shrouds not only the negotiation of ELA proposals between the ECB and national central banks, but also the provision of ELA to particular institutions.

In many cases, the existence of an ELA program is discernible only through a close reading of national central banks' published balance sheets, while the identities of ELA recipients will not be publicized. However, during the global financial crisis, this veil was lifted to some extent, as the ELA liabilities of certain eurozone banks to their respective national central banks became public knowledge in the context of the "bailouts" of troubled eurozone states.

Very significant and potentially destabilizing ELA liabilities in certain states were important factors in the negotiation of assistance programs. IBRC was one of the more remarkable known instances of a financial institution with very significant ELA liabilities, and the restructuring of these liabilities may be an instructive example going forward for other member states with troubled financial sectors.

The IBRC Restructuring

The July 2011 court-mandated merger of Anglo Irish Bank and Irish Nationwide Building Society, which had been taken into public ownership by the Irish government during the crisis, created IBRC.

Both banks had suffered heavy losses largely as a result of overexposure to the Irish property lending market. Anglo Irish, the larger of the two, experienced a dramatic loss of access to funds in the years before the merger; between 2007 and 2010, its funding from deposits and debt securities declined from €82 billion to €19 billion.

The Central Bank of Ireland started providing ELA[4] financing to Anglo Irish in 2009. The scale of support given to the bank was vast: At the end of June 2011, Anglo Irish had ELA liabilities of around €40 billion. Irish Nationwide experienced similar problems and also was supported with much smaller amounts in ELA. As a result of the merger, the publicly held IBRC owed approximately €42 billion in ELA debt to the CBI, guaranteed by the Irish government.[5]

To support IBRC's ELA liabilities repayment, the Irish government first issued promissory notes to IBRC, which provided for payments to IBRC of €3.1 billion per year for the period of about 10 years that it would take IBRC to repay the CBI.

However, many commentators on the deal expressed concerns that this approach was not satisfactory, as it allowed a large, long-term burden to remain on the Irish public finances (the annual payments of €3.1 billion would represent about 2 percent of Irish gross domestic product), which would prevent a return to fiscal health. The arrangement also may have contravened the EU's prohibition on monetary financing,[6] although no legal action was taken.

As a result, a more radical restructuring was enacted. An agreement was reached whereby the promissory notes held by IBRC were retired, in return for which the government provided long-dated bonds worth €25 billion. The new bonds have a maturity range from 27 to 40 years and an interest rate of six-month Euribor plus 263 basis points. Next, in a February 2013 parliamentary session, emergency legislation was passed to wind up IBRC, with the result that the bonds ended up in the hands of the CBI.

The key element of the restructuring is that the CBI undertook to sell the bonds to the private sector in accordance with a schedule that imposes a gradually increasing minimum annual sales level until all the bonds are sold in the early 2030s (although, financial stability permitting, the government has stated it may dispose of the bonds as early as possible).

Because the CBI's profits are returned to government funds, the plan means that initially the coupon on the bonds will mostly return to the government, but gradually over time, the amount paid out to private investors will increase as the bonds are sold on.

The result is that IBRC has been liquidated, and its huge and destabilizing ELA liabilities have been replaced by a program of gradually increased borrowing by the government from investors over a 40-year period, with the primary burden falling at a time when inflation, economic growth and a return to fiscal health may be expected to have reduced its impact.

There may be some dispute as to the compliance of the plan with the EU's legislative guidelines — although the bonds were not directly provided to the CBI under the restructuring; the mechanism by which IBRC was forced into liquidation was part of a prearranged scheme.

The ECB has indicated that it will not seek to challenge the restructuring, illustrating further the pragmatic approach to interpretation of EU law that it has routinely employed during the crisis when financial stability is otherwise endangered.

Despite the restructuring's success, the Financial Times reported in September 2013 that Elliott Management, one of IBRC's creditors, was seeking to investigate the circumstances surrounding the liquidation.

What, if anything, might come of aggressive investor action in this case remains unclear. Regardless, the IBRC approach to restructuring ELA liabilities may provide a useful example in 2014, as other EU member states, such as Cyprus and Malta, attempt to come to terms with similar problems in their own banking systems.

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This article was originally published in 2014 Insights, Skadden's sixth annual collection of commentaries on the critical legal issues businesses will be facing in the coming year. To see additional articles from Insights, including discussions on capital markets, corporate restructuring, financial regulation, global litigation, global M&A, governance and regulatory issues, please visit this link: http://insights.skadden.com/

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[1] These include the Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), which set out the powers and functions of the European Central Bank. Note that the ESCB Statute is drafted to apply to all national central banks within the EU, but that its application to national central banks outside the eurozone is limited by Article 139 of the TFEU and Article 42 of the ESCB Statute.

[2] European Central Bank Eurosystem, ELA Procedures, (Oct. 17, 2013), available at http://www.ecb.europa.eu/pub/pdf/other/elaprocedures.en.pdf.

[3] "Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB." Id.

[4] Known in Ireland as "Exceptional Liquidity Assistance."

[5] Karl Whelan, ELA, Promissory Notes and All That: The Fiscal Costs of Anglo Irish Bank (September 2012), available at http://www.karlwhelan.com/IrishEconomy/Whelan-PNotes-September2012.pdf.

[6] Article 123 TFEU: "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the member states … in favor of union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."