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Thoughts on Ireland's aid programme

Economics

Research Team

Mark Wall
Economist
(+44) 20 754-52087
mark.wall@db.com

Summary of programme details: EUR85bn of financial support, of which EUR35bn for banks of which EUR10bn is immediate recapitalisation to raise core tier 1 ratios to at least 12%; no haircuts on senior bank debt, but cram-down on subordinated will be explored further; average cost of loans is 5.8%; fiscal conditionality largely unchanged vs. the 4-year fiscal plan; Ireland given an extra 12 months to hit 3% deficit target due to likely weaker near-term growth.

The programme looks good for the stability and sustainability of the Irish banking sector, which is good for Ireland's medium-term growth prospects and therefore good news for the sovereign. This programme is a good basis to end and reverse the negative feedback loop between the Irish sovereign and its banks.

The EU's avoidance of cram-down on senior bank debt is good news for European bank funding in general. The further clarification on the scope of the sovereign debt default clause under consideration by the EU is also positive (for example, haircuts will not be automatic). Nevertheless, from a macroeconomic perspective we remain cautious on Portugal; we remain constructive on Spain.

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Summary of programme details

EUR85bn is the total size, in line with guidance. Ireland will itself contribute EUR17.5bn from its National Pension Reserve Fund (EUR12.5bn) and its cash position (EUR5bn).

The remaining EUR67.5bn will be divided in three equal portions: EUR22.5bn from the IMF; EUR22.5bn from the EFSM; and EUR22.5bn from a mixture of the EFSF plus bilateral loans from UK Sweden and Denmark; the UK contribution is EUR3.844bn.

The EUR85bn is divided into EUR50bn sovereign support and EUR35bn banking support.

The total banking support package is EUR35bn, in line with guidance. There will be an immediate EUR10bn capital injection into the banks. This will raise core tier 1 ratios to at least 12%.

Further recapitalisations will take place in H1 2011 on the basis of a new stress test in the New Year. Any banks whose core tier 1 is seen falling below 10.5% will receive additional capital. Any additional capital requirements will be met through a EUR25bn contingent capital facility established through the programme. The stress tests will include a third party review of asset quality to garner additional credibility.

We think EUR35bn is a good quantum for Irish banking sector support.

There are no haircuts proposed for senior bank debtholders in the programme. Liability management of subordinated bank debt will be "more widely applied" than just Anglo Irish. Comments from the Irish PM suggested that the EU objected to senior cram down on the basis of the impact on the wider bank funding market. A special distressed banking law will be introduced in 2011 for the small 'credit unions' sector.

Recapitalisation is complemented with plans to downsize bank balance sheets. This will be conducted under a Prudential Liquidity Assessment Review (PLAR). This assessment, conducted by the Central Bank of Ireland, will identify deleveraging actions to help reduce reliance on short-term funding. Non-core assets are to be sold. Loan portfolios are to be sold or securitised. NAMA, the bad bank, will be extended to remove further vulnerable land and development loans from Bank of Ireland and AIB by the end of Q1 2011.

The average interest cost of the aggregate loan programme is 5.8%. Ireland will start repaying the loans in 4.5 years and will be finished repaying the loans in 10 years. The IMF aid will be provided through the Extended Fund Facility (EFF), which is a Stand-By Arrangement but with longer duration loans.

ECOFIN have given Ireland an extra 12 months (until 2015) to return the fiscal deficit to 3% of GDP. The international authorities believe this more credible given a more cautious outlook for GDP growth in 2011 and 2012 as a result of the recently proposed fiscal retrenchment.

The fiscal conditionality is broadly in line with what the Irish government proposed in its 4-year fiscal plan last week. The state pension age is to rise to 66 in 2014, 67 in 2021 and 68 in 2028. This was not in last week's 4-year plan but is in line with the outcome of Ireland's National Pensions Framework that the government published in March.

Ireland will discontinue its financial assistance to the EU loan to Greece.

What's good:

1) EUR35bn banking support is a good quantum, in our opinion. EUR10bn is an immediate recapitalisation and the remaining EUR25bn will be a contingent capital line. A new minimum core tier 1 capital requirement is set at 10.5%. In addition, the Central Bank is requiring the banks to raise their core tier 1 targets to at least 12%. The new capital will be in the form of equity (no more promissory notes). This equity capitalisation will cost EUR8bn, with an additional EUR2bn to support deleveraging (e.g., equity into securitisation of loan

portfolios for sale). A new stress test conducted in H1 will determine use of the contingent capital line.

For further details, see the central bank website: http://www.financialregulator.ie

The government will end up owning more of the banking sector, but we think the plan good and should bring private funding back to the Irish banks. Nevertheless, it will take several months to churn through the stress test and the liquidity review. The ECB will have to be cautious about proceeding with liquidity withdrawal as quickly as it intended.

2) Duration of the loans. The only direct information currently available is from the IMF's statement on the deal (http://www.imf.org/external/np/sec/pr/2010/pr10462.htm). The duration will be longer than the 3-year duration of the Greece loans. The IMF statement refers to the loans starting to repay in 4.5 years and repayment will be finished in 10 years. Although the IMF will, as normal, have seniority, the longer duration effectively means they are subordinate to existing Irish government bonds over the next several years. This should help support confidence in the Irish sovereign market as it means sovereign restructuring, were it ever to happen, is a long way down the road.

The reference in the Eurogroup statement to their intent to "rapidly examine the necessity of aligning the maturities of the financing for Greece to that of Ireland" suggests the EU is als 'kicking the Greek restructuring can further down the road' so to speak.

3) The net new borrowing by the Irish State under a worst case scenario for banking is only EUR17.5bn or 11.1% of GDP. The EUR50bn of sovereign funding would have been borrowed by the State in any case were it to have full access to sovereign funding markets. The EUR35bn of banking support is being half paid for via Ireland's National Pension Reserve Fund (NPFR) and the State's cash position.

We do not yet have sufficient details to run a debt sustainability analysis, but by making some simplifying assumptions* we find gross general government debt rising to a peak of around 118% in 2013, with the interest cost peaking at 5.4% of GDP in 2014. This we believe to be sustainable for an economy with the structure of Ireland's.

(* We make the following simplifying assumption: (1) worst case scenario that the full EUR35bn banking package is drawn in 2011; (2) average real GDP growth in 2011-2014 of 1.8%, 1pp less than the Irish government's forecast in the 4-year programme; (3) an average interest rate of 5.8% on the loan (which assumes full, immediate draw down); (4) the 3% deficit target is reached in 2015; (5) gross government debt in 2010 is 95% of GDP, as per the 4-year plan).

4) The extension of the timeframe to achieve the 3% of GDP target. This is not something that Ireland has proposed in the 4-year plan, but the authorities felt that it was more realistic to lengthen the duration of the fiscal adjustment by one more year from 2014 to 2015 given that the fiscal austerity measure are likely to be a burden on economic activity in 2011 and 2012. This will not change the requirement to enact EUR6bn of austerity in the 2011 Budget on December 7, but it avoids having to squeeze the fiscal stance even harder to achieve the 2014 target.

What we don't know yet

1) Today's information is not yet the Memorandum of Understanding. We don't know the economic assumptions underlying the programme yet, for example.

2) It would be useful to get greater clarity around the 5.8% interest rate on the loan. Hopefully that comes with the MoU.

3) We don't know how the contingent capital line works. Will Ireland borrow the EUR25bn and hold the funds in reserve? Will Ireland wait until the stress tests are complete and borrow only what is required? What if subsequent stress tests reveal further recapitalisation

requirements that could be funded from the EUR25bn? Will the programme be flexible to meet those needs later, up to the EUR25bn? This would require new design features for an IMF SBA programme.

4) Will the two independent MPs on which the government is reliant for its working majority come out in support of the programme details? There have been lots of press reports on the government losing the byelection seat last Thursday. Despite the headlines of a blow to the Irish government's majority, this seat was unlikely to be retained by the government. The loss is not new news.

The real political 'news' last week was that the 2 wavering independent MPs on whom the government is reliant for its working majority would vote with the government on the 2011 Budget. The net result is the government has a two seat majority despite losing the byelection. We assume they will also support the MoU when it comes up for a parliamentary vote, but markets will watch the domestic political newsflow for any cues.

We assume the 2011 Budget and MoU will pass, but if there are two factors in today's programme that could fuel domestic political disquiet they are (a) the effective liquidation of the National Pension Reserve Fund to inject capital into the banks, and (b) the fact that there is no burden-sharing beyond subordinated bond holders.

What next

1) The writing of the MoU needs to be finalised.

2) The IMF Executive Board needs to approve its portion of the loan.

3) The MoU needs to be approved by Ireland. The finance minister has said earlier that he thought he had the authority to sign a loan deal, but that we was seeking legal opinion. Politically, however, it would be difficult not to put this to a parliamentary vote. We don't know whether this will be before or after the 2011 Budget vote on December 7.

4) Keep watching the pressure on Portugal and Spain. The Irish programme looks good for the stability and sustainability of its banks and is therefore good for the sovereign. The EU's avoidance of cram-down on senior bank debt is good news for European bank funding in general. The further clarification on the scope of the sovereign debt default clause under consideration by the EU is also positive (for example, haircuts will not be automatic). Nevertheless, from a macroeconomic perspective we remain cautious on Portugal; we remain constructive on Spain.

Appendix 1

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David Folkerts-Landau
Managing Director
Global Head of Research

Stuart Parkinson
Chief Operating Officer

Guy Ashton
Global Head
Company Research

Marcel Cassard
Global Head
Fixed Income Strategies and Economics

Germany
Andreas Neubauer
Regional Head

Asia-Pacific
Michael Spencer
Regional Head

Americas
Steve Pollard
Regional Head

Principal Locations

Deutsche Bank AG
London
1 Great Winchester Street
London EC2N 2EQ
Tel: (44) 20 7545 8000

Deutsche Bank AG
New York
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250-2500

Deutsche Bank AG
Hong Kong
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
tel: (852) 2203 8888

Deutsche Securities Inc.
Japan
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Tel: (81) 3 5156 6770

Deutsche Bank AG
Frankfurt
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Aurora business park
82 bld.2 Sadovnicheskaya street
Moscow, 115035
Russia
Tel: (7) 495 797-5000

Deutsche Bank AG
Singapore
One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

Deutsche Bank AG
Australia
Deutsche Bank Place, Level 16
Corner of Hunter & Phillip Streets
Sydney NSW 2000
Tel: (61) 2 8258 1234

Deutsche Bank Dubai
Dubai International Financial Centre
The Gate, West Wing, Level 3
P.O. Box 504 902
Dubai City
Tel: (971) 4 3611 700

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United Kingdom
(44) 20 7545 8000

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