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REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
(Inquiries, Privileges and Procedures) Act, 2013

Volume 1: Report
Volume 2: Inquiry Framework
Volume 3: Evidence

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Table of contents – by line of inquiry

C2: Role and effectiveness of the Policy appraisal regime before and during the crisis

C2b: Role of advisors in analysing crisis, to include crisis management options

C2c: The liquidity versus solvency debate

C3: Appropriateness and effectiveness of Department of Finance actions during crisis

C3a: Appraisal of conditions prior to increasing the Deposit Guarantee Scheme

Description	Bates Number [Relevant Pages]	Page
Central Bank, Update on Financial Market Developments. Subject to S33 AK CB Act 1942.	INQ00151 [001]	49
Memo from Financial Stability Department to Financial Stability Committee on Short Selling, subject to S.33AK Central Bank Act 1942.	INQ00155 [001]	50
Morgan Stanley, discussion materials on ILP. (Extract)	INQ00075 [003, 005-015]	51-62
Central Bank, Update on Financial Market Developments. (Extract)	CB05971 [004]	63

C3b: Appropriateness of the bank guarantee decision

Description	Bates Number [Relevant Pages]	Page
Bullet Points for cabinet 28 Sep) 08	DOT00161 [001]	65
Statement by An Taoiseach Brian Cowen, 30th September, 2008 (Extract)	DOT00164 [001, 003]	66-67
Dermot Gleeson Notes of events occurring on Monday and Tuesday 29th and 30th Septembers	AIB02291 [001-007]	68-74
File Note of Meeting with Financial Regulator 9.30 am 25 September 2008.	PTSB02347 [001-002]	75-76
Bank Guarantee Scheme – INBS, Letter, presumably received from the financial regulator, regarding Anglo and INBS	DOF03148 [001-005]	77-81
Briefing for Cabinet on the economy, 28 September 2008 (Extract)	DOF03154 [001]	82
IFSRA meeting September 2008, subject to S 33AK, Central Bank Act, 1942.	INQ00163 [001]	83
Financial Stability - Scoping Paper, 24 January 2008	DOF03183 [001-022]	84-105
Draft material for use by Government Senators in Seanad Debate- 8 October 2008/Government decision to safeguard the Irish Banking System	DOF01578 [001-004]	106-109
Letter to Cardiff re exit strategy on Government Guarantee from Alan Gray	DOF02116 [001-002]	110-111
Papers re: contingency circulated at weekend planning session 13th Sept 2008	DOF03317 [001-007]	112-118
Aide Memoire for the Government on Financial Market D Nov 2007	DOF04057 [001-005]	119-123
Minutes of meeting with Bank leads on Government Decision to Guarantee banks	DOF03362 [001-003]	124-126
Briefing to Taoiseach on Government interventions, December 2008	DOF07693 [001-007]	127-133
Narratives pages C3b Extract of CBFSAI Board Minutes 09 2008	JHU00002 [001-002]	134-135

Brian Cowen's witness statement (Extract)	BCO00002 [010]	136

C3c: Effectiveness of reviews of banks' loan books and capital adequacy

Description	Bates Number [Relevant Pages]	Page
European Implications of Irish Decision and Next Steps (Extract)	DOT00364 [001-003]	138-140
Central Bank Annual Report 2007 – Governor's Foreword	PUB00254 [011-012]	141-142
Sector concentration Breach AIB since 03 2006	INQ00007 [001]	143
Email re DSG and financial institution in Ireland	DOF01948 [001-006]	144-149
Narrative on: Operation of Exceptional Liquidity Arrangements for Domestic Banks, March 2011	INQ00008 [001]	150

THEME: C2

Role and effectiveness of the Policy appraisal regime before and during the crisis

LINE OF INQUIRY: C2b

Role of advisors in analysing crisis, to include crisis management options

We were clearly in an unprecedented situation, the dynamics of which were moving very fast. Emergency liquidity assistance is not designed to address a situation when all of the banks are in trouble. It can work in a specific institution which has liquidity problems once it does not come to public notice. The Northern Bank, sorry, the Northern Rock example, proves that in those circumstances the use of ELA can have a more destabilising effect and cause the opposite of what was intended. Putting together an ELA fund from the country's own domestic sources, made up of cash balances from the Exchequer and assets from the National Pensions Reserve Fund and the Central Bank itself and simply applying that to the liquidity requirements of banks was not going to restore international confidence and get capital flowing back into the banks from external sources. The options were narrowing down to a nationalisation plus a guarantee, or simply a guarantee of the system itself. The other options referred to by Merrill Lynch, which had been discussed, were discounted at that stage. It has to be emphasised that no decision was risk free. There was no one good or right option that would guarantee a solution to the problem. It was about trying to pick the least worst option, and make sure that if we had only one go at trying to stabilise the situation, that it would have every prospect of doing so. Trying to forecast where all of this would go next was extremely difficult to predict.

It was strongly stated to us by our own regulatory authorities that this was a liquidity problem and not a solvency problem. At no stage was it contemplated then or, indeed, until the NAMA valuation of loans emerged, that the funding gap for the banks would reach the levels that it did, or that the impairment of loans in the banks would be of the horrific nature or magnitude that came to pass. I was coming to the view that, given what was potentially at stake, whatever we did would have to have an immediate and dramatic effect in stopping the outflow of funds from banks and, indeed, reversing the trend if possible.

Word came into the meeting that the chairman and CEO of the two main banks were looking to meet with us. We further discussed it, and I adjourned the meeting for a short break. During that break I decided to get an external view. Mr. Alan Gray, an economist and a Central Bank board member, was someone whose views I also respected. I phoned him and asked him what he thought of a guarantee option being used. Mr. Gray emphasised that providing a guarantee would, obviously, give an advantage to those institutions to whom the guarantee would apply *vis-à-vis* competitors, since they would have the backing of the Irish Government. In that respect, it was important to be mindful how other lending institutions would regard it, and he stated that compliance with EU state aid rules would be an important factor to bear in mind. In dealing with that issue, it would also be important to be seen to charge a proper fee for the value of that guarantee to those institutions who got the benefit of it. Mr. Gray also stated that if we were considering the introduction of a guarantee of any kind, that it should be strictly time-limited. This would assist in arguing that it was proportionate to meet the serious situation that was being dealt with. I thanked him for this advice. During this break from the main meeting, the Minister for Finance and I weighed up options ourselves in my personal office as to where we were at that stage. We reviewed the discussions from the meeting thus far and he was minded to still go the nationalisation route for Anglo and guarantee the rest of them. I explained my reservations about it and reassured him that nationalisation was something that we couldn't rule out in the future and would remain an option available to us. I also told him that a time-limited guarantee seemed to me preferable than giving an open-ended guarantee which a full nationalisation would entail. I emphasise this point. We were talking the issues through and there was no question of our conversation being in any way adversarial or confrontational with each other. Both of us were deliberating and striving to find the best course of action for the country at this point in time.

I made suggestions to attempt to protect the taxpayer and reduce the risk to the State if such a policy was subsequently decided - firstly, by ensuring any guarantee was for as short a time period as necessary and I argued against any long-term guarantee. I indicated if the State felt obliged to give a guarantee, we should get out of these obligations as quickly as possible. I suggested that in the event of any guarantee, the banks should be forced to pay in full for this and the payment levels should reflect the value to the banks and the risk to the State. Some of these points which I and the other directors made were reflected in the formal, signed-off, agreed minutes of the meeting, and I quote:

> In discussing the option of a Government Guarantee, the meeting noted that the market would have to be convinced of the credibility of the Guarantee. There was also a likelihood of a legal challenge on competition grounds if it was confined to the domestic credit institutions. The meeting agreed that the issue of an explicit Government Guarantee supported by a willingness to supply additional funding, if necessary, warranted detailed consideration. In this context, however, it would be necessary to identify a viable long-term strategy for the industry and [to] pursue this objective vigorously.

I had the distinct impression at the meeting that a guarantee of all banks was the favoured option and probably the only option in serious consideration which was explained to the board. I felt strongly at that stage that all available options should be examined, rather than simply the guarantee option, and I decided that evening to write to the Department of Finance, the regulator and the Governor of the Central Bank. As is evident from my correspondence of 25 September 2008, which I have provided to the committee, I outlined my view on the principles which should be followed: (i) State exposure to be minimised where possible; (ii) the knock-on impact of any decision should be taken into account and the minimisation of contagion; the cost of any assistance to be paid for fully by the sector, even if this means over time; and wider economic implications should be factored in. The best option was, in my view, a European-wide, EC-wide ... ECB-wide action. My opinion was there was a reluctance by the ECB to recognise the scale of the problem or to take necessary responsibility for their role, but I felt pursuing that action was desirable.

On the option of a guarantee of all six financial institutions, as proposed by the Department of Finance and the Central Bank, I was ... felt there was a need to consider different formulations if this was the chosen option. I also raised explicitly my concern over whether it would postpone necessary restructuring of Irish banks. I had concerns over whether a guarantee would be effective in preventing a bank run and what would be the market reaction. This was still a major concern to me in the days and weeks after the guarantee was announced. I also suggested the payment terms could be structured in a way which would neutralise the competitive impacts, i.e. some banks should pay proportionally more. My suggestion implied much higher costs for institutions such as Irish Nationwide and Anglo. I highlighted the need to take action to reduce Exchequer exposure and to restructure the sector. In my written advice on 25 September 2008 to the Governor of the Central Bank and to the Department of Finance, I outlined three other issues which I felt needed to be addressed as well as the immediate issue of liquidity, namely, a response to individual banks with liquidity issues, actions to reduce risk and potential exposure and plans to restructure the sector. The options for action in relation to individual banks which I proposed on 25 September 2008 included management changes, restrictions on loan ... on loans and a restructuring plan, including managing-down of loans.

Over the next few days, it was very clear the crisis was getting much worse and I felt a bank run was now a real possibility. There was a sense of incredible panic in world financial markets

Sunday 28th September

Memorandum from Merrill Lynch

1) Introduction

The Department of Finance and NTMA have been working with the Financial Regulator and the Central Bank of Ireland to establish the current liquidity and financial position of the Irish banking sector. They have appointed PwC accountants to investigate the liquidity position and asset quality of the loan books of Irish Nationwide Building Society ("Irish Nationwide"), Anglo Irish Bank ("Anglo") and Irish Life & Permanent. They engaged Merrill Lynch on 24 September to advise on the liquidity and strategic options available to the Government and Arthur Cox to advise on legal aspects. This is the initial report of Merrill Lynch based on information as at 6pm on Sunday 28th September.

The analysis has been undertaken in a short period of time and is based only on information from and conversations with the three institutions. The implications for the broader financial sector have also been considered as well as the impact on Ireland as a financial centre and as a sovereign issuer.

The markets on a global basis are witnessing unprecedented levels of volatility. In the past two weeks many major financial institutions have either filed for bankruptcy (Lehman, Wamu, Roskilde) or have had to be rescued by either the state (Fannie, Freddie, AIG) or acquired by a rival (HBOS, Alliance & Leicester). Libor levels have, in the past week, risen to highs since 1992 with banks choosing to hoard cash or deposit it with central banks. The Bank of England last Thursday was holding £6bn of bank deposits against a long term average of around £1bn. Much of the Commercial Paper market (circa 90%) is currently rolling overnight. The Irish financial sector is experiencing extreme difficulties with wholesale market access all but non existent. Even post the quarter end (30 September 2008) we feel this is unlikely to improve in the context of a worsening macro economic environment and a general backdrop of deteriorating asset quality.

While Irish banks have not had the same exposure as other banks to structured credit and US mortgage/real estate risks, their loan assets are concentrated in residential and commercial property where asset values have been falling and are expected to continue to fall as the international economy contracts. The liquidity issues facing Irish banks are compounded by investor concerns with regard to the high concentration of commercial property risk in their respective asset portfolios.

The three institutions where these liquidity issues have been most pronounced have been Irish Nationwide, Anglo Irish Bank and Irish Life & Permanent. AIB, Bank of Ireland and EBS, while experiencing reduced access to liquidity continue to have access to wholesale funding (for example with the ECB) and do not have such acute near-term liquidity issues based on the information provided to the Financial Regulator. EBS as a smaller institution is likely to be more vulnerable as time goes on.

It is important to stress that at present, liquidity concerns aside; all of the Irish banks are profitable and well capitalised. However, liquidity for some could run out in days rather than weeks. Anglo Irish has recently approached the Central Bank with a proposal to create a new funding facility that the Central Bank would accept commercial mortgage assets in return for cash. Anglo are rapidly approaching the point where they have exhausted all possible sources of liquidity available via the market or their ECB eligible collateral is close to being fully utilised..

This memo sets out the strategic options available to the Government. There is no right or wrong answer and the situation is very fluid with financial institutions experiencing difficulty and being supported by governments on a daily basis. Preserving flexibility is key and the solution may be different for each institution. The important issue is for the Government to preserve the stability of the Irish financial system overall and to safeguard the interests of individual bank customers to avoid widespread panic. That said, there is a limit on the financial resources available to the Government and there may be a need to preserve firepower as events unfold. The implications of each option in terms of whether it constitutes State Aid also needs to be carefully considered.

It is clear that certain lowly rated monoline banking models around the world, where there is concentration on a single asset class (such as commercial property) are likely to be unviable as wholesale markets stay closed to them. This has inevitably had an impact on our conclusions and we believe it is important to act quickly to deal with these institutions to avoid a systemic issue.

2) Summary description of the reviewed institutions

Further information is contained in Appendix A

Irish Nationwide Building Society

INBS is primarily a retail deposit funded, commercial property lender with a relatively small residential mortgage book of just over €2 billon. The asset quality of the commercial loan book is regarded as being generally good. Based on their own management projections, INBS have liquidity sufficient to meet their needs for around one to two months depending on the level of withdrawals. However there are concerns over the influence of the Chief Executive. In the extreme stress case analysis the total writeoffs including loss of interest income would just deplete most of INBS reserves of €1.8 billon.

Anglo Irish Bank

Anglo are a commercial property lender with loan assets of Eur 72bn. Only 3% of the loan book is currently regarded as impaired by Anglo management however falling property prices are likely to impact their book particularly where they have lent on speculative development. If one was to apply the INBS stress case scenario the writeoffs would by deplete ordinary shareholders and other lower category subordinated debt of €7.5 billon. The main issue for Anglo is a pressing need for liquidity as a result of a sustained outflow of corporate deposits and overnight funding being unavailable to banks of their credit rating. Based on current market conditions, management is projecting a funding deficit of €0.1bn on Tuesday 30th September growing to €4.9bn by 24th October. Anglo have formally requested a short term liquidity advance of €1.7bn from the Central Bank on Friday 26 September for the end of the month.

Irish Life and Permanent

IL&P is a bancassurer with a leading life insurance company and a retail bank focused on providing residential mortgages. The asset quality is good but IL&P rely heavily on wholesale funding and are approaching the limit of their eligible collateral at the ECB. Under a "worst case" scenario, where interbank cannot be rolled and corporate deposits are withdrawn upon maturity whilst retail deposits remain flat, Irish Life & Permanent would have a negative net cash position of €2.1bn by 9th October 2008.

3) Strategic options

The strategic objective is to address the immediate liquidity issues of the three institutions and allow the situation to unfold. Given current instability in financial markets this could happen quite quickly and there could be a need to implement a combination of the options below. All solutions require financial resources from the Government and could add pressure to the sovereign credit rating and the borrowing costs of the Irish Government.

Whilst we set out the various strategic options within this memo, we have also fully considered, and ultimately discounted, one additional outcome - allowing an Irish bank to fail and go into liquidation without any government intervention. Whilst this option would initially have no financial impact to the government, the resulting shock to the wider Irish banking system could, in our view, be very damaging. The ensuing 'firesale' of assets could precipitate dramatic asset deflation and hence force other Irish banks to take significant write downs on their own asset portfolios thus depleting their capital positions. The significant volatility in the equity and capital markets that would likely follow would mean access to any form of new capital for Irish banks would be severely restricted for a protracted period. Therefore, in order to minimise the impact of any bank failure on the rest of the broadly sound domestic financial institutions, we strongly advocate a more controlled interventionist approach.

(a) Immediate Liquidity Provision

The short-term liquidity issues for the banks need to be immediately addressed, most notably at Anglo which may have a net deficit as early as Tuesday 30 September. The wholesale markets are closed and the three banks have limited access to the ECB facility as self originated commercial property assets are not accepted as collateral and Irish Life & Permanent is reaching the limit of its available eligible collateral. If the ECB were to change this stance and accept a broader type of collateral then arguably there would be no need for the Central Bank to offer any additional liquidity.

If that is not the case, the Central Bank should be prepared to provide auxiliary overnight liquidity facilities at **a penal interest rate** to the banks that request it. There is then the question of whether this becomes known to the market. We believe it could be sensible to let it be known that the Central Bank has been asked to provide additional liquidity to certain financial institutions so that debt and equity investors do not criticise the Government if/when further State intervention needs to take place, in particular if equity is acquired in the institutions for zero value. Taking the worst case scenarios of each bank we estimate there could be an immediate funding requirement of €5bn.

(b) State protective custody

The additional liquidity provided would allow Anglo and Irish Nationwide to offset any continuing deposit outflows with liquid assets. However, even if markets stabilise both institutions are likely to find it hard to fund themselves independently and the penal interest rate if they use the Special Liquidity Scheme (outlined below) will deteriorate their earnings. For that reason and to avoid systemic risk, the Government should make preparations for State intervention in either or both institutions, once it becomes evident to the market that they need to intervene. This could occur over a very short period of time i.e. within days, but at the point at which it occurs it will not be a surprise to debt or equity investors as knowledge of the institution's financial position will be obvious and they should expect such intervention in the absence of a private sector solution. At Anglo the majority of equity and debt investors are Irish, UK and US institutional holders, but there are significant retail interests including a major shareholding by Sean Quinn.

Irish Nationwide and Anglo either together or separately could be taken into State custody using either (i) common equity and/or (ii) a preferred plus warrants investment akin to the one used in the Freddie Mac and Fannie Mae situation.

A State guarantee would be given to all depositors and senior creditors as well as dated subordinated debt holders (given the crossover between these two holders) which would again send a strong implicit message to the investor community that this level of protection would be afforded to all other Irish banks. The business would be run off with no new loans extended and it would be logical to use this entity for the base for the "Bad bank" in Option (d) below. Equity holders and undated junior subordinated debt holders would receive nothing providing a capital cushion of €1.4 billion in the case of Irish Nationwide and €7.5 bn in the case of Anglo. It is important that all other creditors are reimbursed to avoid a contagion effect with the other Irish banks that continue to raise capital in the senior and subordinated debt markets.

The investment by State can be in the form of preferred instrument and/or common equity. In either case the Government will own and control the bank and its decision making. The advantage of the preferred investment is that it establishes a clear priority ranking for the government's investment over shareholders, the existing preferred investors, and undated subordinated debt holders. The preferred effectively leaves the shares outstanding, would still require the government to hold public shareholder meetings as well as file regular statements. This may be considered impractical. If the Government were to take over the equity in its entirety there would be no need to report on an ongoing basis and hold any AGMs.

A common equity investment effectively either dilutes or completely removes the existing shareholders and places the government's investment pari passu with the existing common shareholders and below any preferred investment; therefore, it provides the potential for any upside at the expense of the existing common holders who either are heavily diluted or completely removed. This equity investment does not necessarily need to be the funding instrument. As the common ownership does make the State a direct shareholder (and likely the majority or sole shareholder) in the bank and thus responsible for the corporate governance, it can have the bank issue a subordinated instrument that effectively has clear priority ranking to any existing preferred investors and undated subordinated debt instruments. This will provide the government with downside protection as well as current yield. This form of common equity investment is effectively taking over the company and providing funding in consideration. The Fannie and Freddie investments by the US Government is similar in nature and combined the two instruments (see description in appendix C) with a preferred investment coupled with warrants in order to maximise the benefits of the two instruments. It is likely situation specific in terms of what the appropriate form of the investment should be. The State should have flexibility to pursue either or both.

(c) Secured Lending Scheme ("SLS")

In conjunction with the State protective custody option, it is also recommended that the Government introduce a secured lending scheme which would accept both commercial property and non ECB eligible tradable securities as collateral to be either exchanged for government bonds or cash. This would be based on the following terms:

Available:	All Irish Building Societies and Banks listed on the Irish Stock Exchange. Available only once ECB eligible collateral is exhausted by an individual financial institution.
Tenure:	Liquidity provided for any term up to 9 months
Assets eligible:	Irish, UK Commercial loans secured with a first legal charge and certain securities tradable on a recognised exchange
Advance Rate:	No more than 60% of outstanding loan balance for commercial loans / no more than 75% of the lesser of last observable trade / currently marked price of the tradable securities
Size:	€20bn
Cost:	Minimum cost will be Euribor +[150]bps
Disclosure:	System announced but no publication of individual usage to market

Advantages

- Converts non ECB-eligible collateral into immediate liquidity

- The existence of a public announcement of an additional liquidity facility benefits whole financial system and is positive for Ireland
- May assist Irish Life & Permanent's, EBS, AIB, BOI [or INBS] short-term liquidity issues post any action on protective custody of Anglo [and INBS].

Disadvantages

- Of itself does not deal with longer-term funding issues associated with lowly rated monoline businesses whose model is unlikely to be sustainable long-term
- Irish Government could end up funding over €100bn albeit at a highly attractive rate for an unknown period
- Money supply from the Irish Central Bank must be co-ordinated with ECB operations for injecting liquidity

The SLS scheme is recommended because it would offer immediate liquidity and stabilise the sector. The option to subsequently own or separate assets out of the banks into State ownership or to stronger banks will be preserved, and can be done with full market support.

The announcement of the creation of this SLS facility should be made public to the market in order to maximise the impact it could have of promoting confidence that all Irish financial institutions have access to an additional liquidity facility provided by the State for its own institutions. All banks should be coerced to publicly support the SLS facility as a strong indicator of State support for the Irish banking system and no one institution should confirm or deny its use of SLS. However, SLS will only be considered positive for the market if the individual financial institution usage is not made public. Any institution seen or rumoured to be relying on this SLS liquidity facility will likely suffer a dramatic loss of confidence by the wholesale market and result in significant outflows of deposits and will be unable to refinance its short term debt if it is perceived as a substitute or as sign of an inability to obtain longer term funding.

It is an interim solution until either the market settles or a suitor in some cases is found to acquire or stablilise the individual institution. In any event the identity of any individual institution using SLS could become known in a small country and the move into Emergency Lending Access (ELA) could happen sooner than expected.

The Central Bank of Ireland's Emergency Lending Access already performs the role of providing liquidity of **last resort** in a way that would become known to the market due to the fortnightly reporting requirement of the Central Bank. A Bank in ELA in reality is close to the end of its existence because the market will not longer regard it as suitable credit risk to provide funding to.

The SLS would require new legislation which is currently being drafted and should be available before the end of the week. In the meantime the Central Bank is working on auxiliary measures which would allow the primary regulated Irish banks to post security backed by commercial property assets in return for cash or securities at a penal interest rate. This could be announced if needed to stablise concerns about the remaining Irish banks immediate liquidity.

(d) Good banks / Bad banks

If the financial situation worsens there is the possibility of allowing other banks to contribute their bad commercial property loans to the State Banks(s) to allow a State-controlled orderly unwind of property holdings and limit asset deflation. This would also help restore investor confidence in the now 'cleansed' banks and enable them to continue in business.

The structuring of this option would be the most complex and time consuming. Considerations such as third party management required, upside/downside for tax payers, purchase price of the assets and the impact that would have on marks for other bank portfolios would have to be carefully thought through. This system was used in Scandinavia in the early 1990's but only as the second phase of the state rescue of the banks. It is also difficult to predict how long the work out of the assets would take but recent Bank of Ireland published projections show a three to five year period is required to recover 80% – 90% of book value.

(e) Consolidation of financial institutions

Irish Life & Permanent has a good business franchise with a leading life insurance company and a residential mortgage book similar to Bank of Ireland and AIB, which is not experiencing significant arrears. It may be that they can come through the crisis unscathed. However if this looks unlikely, at the same time as providing short-term liquidity facilities, the other large banks can be approached to be ready to acquire and integrate the Irish Life & Permanent business in a private sector transaction. Similarly EBS could be easily acquired and absorbed by an entity with a larger balance sheet. Depending on the acquirer, the competition issues may need to be addressed by the State as they were on the Lloyds TSB / HBOS transaction in the UK.

(f) Guarantee for six Primary Regulated Banks

The alternative to a SLS facility is to offer a complete State guarantee to all depositors and senior creditors of the six primary regulated financial institutions. This should stem outflows and encourage inflows of deposits. However, the scale of such a guarantee could be over €500bn. This would almost certainly negatively impact the State's sovereign credit rating and raise issues as to its credibility. The wider market will be aware that Ireland could not afford to cover the full amount if required. It might also be poorly perceived by other European states if they come under pressure to do the same as liquidity flows migrate. A coordinated response across Europe could make this option more viable. Comments in such regard have already been made by the several European governments.

4. Conclusion

The extension of a discreet emergency facility is important to stabilise Anglo [and INBS] and avoid immediate contagion risk. The market environment is highly uncertain with international developments adding to the pressure on Irish financial institutions. Even if the situation stabilises, the immediate outlook for monoline, single asset class, lenders is increasingly uncertain. In this context, it is important for the Government to be prepared to act quickly and decisively as required to step in and prevent a systemic problem.

Appendix A

1) Summary of capital, liquidity and asset position

Irish Nationwide Building Society

Description: Mortgage provider: 80% commercial, 20% residential

Overview of Loanbook:

- Total size: €11.8bn
  - European CRE: €1.1bn (9%)
  - UK CRE: €5.3bn (45%) } LTV 77%
  - Irish CRE: €2.9bn (25%)
  - Irish residential: €2.4bn (21%) } LTV 51%

- Land Bank exposure, few large loans (>€100m), loans to deposits ratio as at August 2008 of 187%, average maturity of loans is 2 years

- Irish residential:
  - No significant deterioration of book
  - 40% of loans with LTV >75%

- UK and EU CRE:
  - 47% development, 13% construction, 40% asset enhancement
  - 2005-2007 account for 84% of loans

- PwC and Merrill Lynch had a review with Irish Nationwide's CEO and CFO on the loan book. A sample of the top 60 CRE loans (~46% of total) was reviewed. The explanations from management regarding the Company addressed LTV of these loans as well as the quality of counterparty do not seem unreasonable. The short-dated nature of the loans as well as relying on the value uplift in the underlying property could pose risks if the real estate market continues to slide

Capital Position:

Tier 1 Capital:	€1,365m
Which includes:	
Undated junior	
Subordinated	*€0m*
Tier 2 Capital:	€476m
Which includes:	
Dated subordinated	*€314m*

Funding Profile:

- As of 27th September 2008, Irish Nationwide had a net cash position of €3bn
- Irish Nationwide was experiencing net outflows of circa €40m and €11m a day from Ireland deposits and Isle of Man deposits, respectively, in the early part of

last week. Outflows from Ireland deposits reduced to €25m / €20m by the end of last week

- On the basis of a scenario where outflows continue at the rate of €25m and €11m a day from Ireland deposits and IOM deposits, respectively, for the whole month of October, Irish Nationwide's net cash position at the end of October would be circa €2bn. This scenario is deemed to be a "stress" scenario by the management
- Assuming the "stress" scenario is prolonged for the month of November, the Company could have a net cash position of circa €1.3bn at the end of November. Starting December with only €1bn net cash position could prove challenging for the Company given the €630m EMTN redemption in the third week of December
- Management believes that outflows should reduce in the coming weeks
- The company has a €750m ECB repo-able Promissory Note pool (circa €600m taking into account the 20% required haircut) of which about €500m has been borrowed already – circa €100m capacity left
- The company estimates that it has another €600m residential mortgages pool that could be securitised and repo-ed with the ECB at a 16% discount. The company estimates that it would take about two to three months to put in place such programme
- The company has no securitisation programme in place for its €9.5bn commercial real estate portfolio

<u>Anglo Irish Bank</u>

Description: Monoline lender, commercial property assets

Overview of Loanbook:

- Total size: €72bn (as of August 2008)
  - Ireland: €43.2bn (60%)
  - UK: €17.9bn (25%)
  - North America: €9.1bn (13%)
  - Wealth Management: €2.7bn (4%)
  - Other €0.9bn [intercompany lending to Wealth Management]

- Total loans neither impaired nor past due: 97.0%
- Approximately 82% of loan book is CRE, 1% residential and about 17% other corporate loans
- Ireland – top 20 represent 26.5%; ~€13bn (30%) related to land and development loans; 2.9% of loans are on watch list
- UK – top 20 represent 45.9%
- North America – top 20 represent 32.0%
- UK, US and Wealth Management watch list total 2.13%
- Anglo has €9.4bn of available for sale financial assets:

	FV Mar-08	%
Government securities	3.1	33.0%
CDs	0.8	8.5%
Bank bonds	3.6	38.3%
ABS	*0.2*	*2.1%*
RMBS	*1.1*	*11.7%*
CDO	*0.5*	*5.3%*
SIV	*0.1*	*1.1%*
Other listed securities	1.9	20.2%
	9.4	

Capital position

Tier 1 Capital: €7,113m
Which includes:
Preference shares *€370m*
Undated junior
Subordinated-: *€2,151m*

Tier 2 Capital: €2,642m
Which includes:
Undated subordinated *€424*
Dated subordinated *€2,136m*

Funding Profile:

As of 18 Sept, 2008 € in bn	18/09/08	Sept 2007
Corporate Deposits	26.1	29.9
Retail Deposits	16.9	15.4
Private Client	2.5	3.2
ST Debt Capital	5.3	6.9
LTDebt Capital	10.7	14.5
Inter Bank	8.1	5.0
Repos and Others	12.6	1.9
Secured Funding	1.4	1.4
	83.6	**78.2**

- Total deposits went down by €3bn between Sept 2007 and 18th Sept 2008. On 19th Sept, deposits declined by a further €1.1bn
- Repo financing with the ECB went up by €10.7bn over the past year. Assets eligible for ECB repo tenders will be almost fully utilised by 30th Sept 2008
- Based on current market conditions, management is projecting a funding deficit of €128m on Tuesday 30th September growing to €4.9bn by 24th October. This scenario is based on the following assumptions:
  - Wholesale capital markets remain closed and overnight is unavailable on the 30th Sept (but available the following days)
  - €2.1bn realisable of 30th September from recently closed CMBS
- In a "worst case" scenario of significant deposit withdrawals and unavailable overnight funding, Anglo would face a negative cash position of €2.45bn on 3rd October (€4.6bn if CMBS facility is executed)

- If overnight funding becomes available on 1st October but the CMBS is not completed than the shortfall at the end of the week is €2bn (€3.5bn if overnight funding remains unavailable)
- Management have indicated that approximately €30bn (out of the total loan book of €71.9bn) may be suitable for securitisation / collateral.

Irish Life & Permanent

Description: banc assurance – residential mortgage provider mainly

Note that the information on IL&P has not been properly reconciled at this stage with IL&P management

Overview of Loanbook:

Loans and Receivables	30 June 08 (€m)	31 Dec 2007 (€m)
Residential Mortgage loans	36,456	34,817
Commercial Mortgage Loans	2,002	1,861
Finance Leases	1,843	1,666
Term loans/ other	638	601
Money Market funds	148	159
Loans and receivables to JV		90
Net Loans and receivables to Customers	**41,005**	**39,120**

- Residential mortgage loans made up circa 89% of gross loans and receivables to customers
  - Primarily made of first charge residential mortgages
  - 20% are UK loans mostly in the BTL market which are secured on 3 properties on average

Capital position

Tier 1 Capital (gross): €4,798m
Which includes:
Undated junior subordinated *€0m*

Tier 2 Capital: €1,487m
Which includes:
Undated subordinated *€455m*
Dated subordinated *€1,144m*

Funding Profile:

Funding Position at 18 September 2008: Interbank: €1.3bn; ST Market Reps: €2.3bn; ECB €12bn; USCP: €0.8bn; ECP: €0.9bn; X Notes: €0.3bn; French CD: €0.6bn;

Corporate Deposits: €6.3bn; Retail Deposits: €7.7bn; Securitisation: €3.1bn; Long-Term (>12 months): €10.9bn

Note that the numbers above and the statements below are all subject to reconciliation with management

- Corporate deposits had declined to €5.4bn as of 25th September 2008. There are €1.9bn of contractual maturities in September 2008 and €1.8bn in October 2008. The average duration of the overall corporate deposit book is estimated at 28 days
- Of the total corporate deposits, the largest accounts are Irish Life Assurance plc (€1.9bn), BGI (€0.5bn maturing on 29th September 2008) and ABP Investments (€250m maturing on 12th November 2008)
- Retail deposits have been relatively flat. Circa €2.5bn of these are in current and notice accounts which tend to be stable
- Under a "worst case" scenario, where interbank cannot be rolled and corporate deposits are withdrawn upon maturity whilst retail deposits remain flat, Irish Life & Permanent would have a negative net cash position of €89m on 29th September rising to €1.2bn by Friday 3rd October and €2.1bn by 9th October
- Note that management deems this scenario to be extreme as historically circa 80% of corporate deposits roll over upon maturity.
- Based on a 50% deposit outflow assumption, there will be a shortfall of about €200m on Monday 6th October, rising to €500m by 9th October just prior to a €1.8bn increase in collateral available for repo with the ECB

Source: Company data

Appendix B

2) Bank of England Special Liquidity Scheme ("SLS" Overview)

On 21st April 2008, the Bank of England (the "Bank") announced the SLS to enable banks and building societies to swap temporarily assets that are currently illiquid in exchange for UK Treasury bills.

Maturity:
The bills lent under the SLS are for an original maturity of 9 months and will have been created within the month preceding the drawdown. Bills must be delivered back to the Bank 10 days prior to their maturity and will be exchanged for a further 9-month Bill. Banks can renew, at the discretion of the Bank, these transactions for a total of up to 3 years.

The SLS was originally open for a period of 6 months (until October 2008) and was recently extended to January 2009.

Eligible Banks:
All of the banks and building societies that are eligible to sign up for the standing deposit and lending facilities within the Bank's Sterling Monetary Framework.

Eligible Securities:

- UK and EEA Covered bonds rated AAA. The underlying assets must be either residential mortgages (Buy-to-let loans to private residential landlords are eligible) or public sector debt
- AAA-rated tranches of UK and EEA Residential Mortgage-backed Securities (RMBS) backed by UK and EEA mortgages (the underlying asset must not be synthetic)
- AAA-rated tranches of UK, US and EEA Asset-backed Securities backed by credit cards (not synthetic)
- Debt issued by G10 sovereigns rated Aa3 or higher, excluding securities eligible in the Bank's normal Open Market Operations, subject to any settlement constraints
- Debt issued by G10 government agencies guaranteed by national governments, rated AAA
- Conventional debt by the US government Sponsored Enterprises (Freddie Mac, Fannie Mae and Federal Home Loans), rated AAA

Participating institutions may deliver securities held, or formed from assets held on the balance sheet of the participating entity. Subsidiaries' assets are also eligible provided that the subsidiary is owned by the participating legal entity (ownership is defined as holding of a majority of the voting rights is the subsidiary)

Securities, including covered bonds, formed in whole or in part from underlying commercial loans are not accepted by the Bank. Commercial loans include loans to SMEs, including those secured on land or commercial property.

Participants may deliver as collateral only eligible securities held on balance sheet as at 31 December 2007 and eligible securities formed from underlying loans, including sellers' claims on Master Trusts, held on balance sheet at that date. For RMBS issued via a Master Trust where the pool of assets includes mortgages originated after 31 December 2007, 100% of the level of such securities or underlying loans outstanding on balance sheet as at 31 December 2007 will be eligible in the first year of the SLS. In year 2 two-thirds of those securities will be eligible. In year 3, one-third of those securities will be eligible.

Securities, including covered bonds, formed in whole or in part from residential mortgages secured on properties not located in the UK or other EEA countries are not accepted by the Bank.

Securities may be denominated in Sterling, EUR, USD, AUD, CAD, SEK, CHF and JPY (for Japanese government bonds only).

All eligible securities must be rated by two or more of Fitch, Moody's and S&P

Eligible securities will be valued by the Bank using observed market prices that are independent and routinely publicly available.

Collateral substitutions are permitted throughout the life of the schemes

Pricing and haircut

The fee payable on borrowings of Bills is the spread (to be re-fixed every 3 months) between 3m Libor and 3m General Collateral gilt repo, as observed by the Bank, subject to a floor of 20bps. The fee may vary at the Bank's discretion.

Haircut (%)	OMO eligible and G10 Sovereign paper	G10 Government guaranteed agencies	US GSEs	RMBS, covered bonds and Credit Cards ABS
Credit rating (Moody's scale)	Aa3 or higher	AAA	AAA	AAA
All floating rate	1	3	3	12
Fixed rate, under 3 years of maturity	1	3	3	12
Fixed rate, 3-5 years to maturity	1.5	4	4	14
Fixed rated, 5-10 years to maturity	3	8	8	17
Fixed rate, 10- 30 years to maturity	5.5	14	14	22

3% will be added to haircuts to allow for currency risk when securities are non-Sterling

An additional 5% will be applied to own-name eligible covered bond, RMBS and credit card ABS

An additional 5% will be applied to securities for which no market price is observable

Appendix C Examples of Recent Assistance to the Financial sector

Fannie Mae and Freddie Mac

On September 7, 2008, Treasury announced that it had placed Fannie Mae and Freddie Mac in "conservatorship" resulting in significant implications across the companies' capital structures. Treasury's stated goals in appointing the Federal Housing Finance Agency (FHFA) as Conservator: *"...to preserve and conserve the Company's assets and property and to put the Company in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in the Company, enhance its capacity to fulfil its mission, and mitigate the systemic risk that has contributed directly to the instability in the current markets".*

The assistance package consisted in:

1. **Capital injection:** Treasury entered into a Senior Preferred Stock Purchase Agreement with each GSE receiving up to $100 billion and indefinite in duration. In exchange for entering into these agreements, Treasury receives:
   - $1 billion of senior preferred stock in each GSE. The senior preferred stocks shall accrue a dividend of 10% per year, increasing to 12% if, in any quarter, the dividends are not paid in cash, until all accrued dividends have been paid in cash
   - Warrants representing 79.9% ownership in each GSE if exercised (at a nominal price).
     - Exercise price of one-thousandth of a U.S. cent ($ 0.00001) per share, and with a warrant duration of twenty years

2. **Credit Facility:** Treasury has agreed to create a back-stop short-term secured lending facility for each GSE available generally at LIBOR +50 bps
   - The facility will offer liquidity if needed until December 31, 2009
   - Loans expected to be less than 1 month but no shorter than 1 week

   "All loans will be collateralized and collateral is limited to mortgage-backed securities issued by Fannie Mae and Freddie Mac and advances made by the Federal Home Loan Banks."

3. **Support of the Agency MBS Market**: Treasury will set up an investment fund to purchase GSE mortgage-backed securities (MBS) in the open market. This move should assuage investor concerns about the functioning of the market, improve liquidity, and lower borrowing costs. The investment fund's goals:

   "By purchasing these guaranteed securities, Treasury seeks to broaden access to mortgage funding for current and prospective homeowners as well as to promote market stability.
   Treasury is committed to investing in Agency MBS with the size and timing subject to the discretion of the Treasury Secretary. The scale of the program will be based on developments in the capital markets and housing markets".

Implications by category of investors

Debt / MBS	Preferred Equity	Common Equity
■ enhanced ability of the GSEs to meet their obligations ■ Additional security and clarity to GSE debt holders – senior and subordinated ■ Ability to purchase GSE MBS in the open market should improve market liquidity and lower borrowing costs thereby providing additional confidence to investors in GSE MBS ■ Covenants prevent debt from being increased to more than 110% of its debt as of June 30, 2008	■ Preferred stock will continue to trade ■ No voting rights ■ Preferred dividends are suspended ■ Existing preferred shareholders will bear any losses ahead of the government and not already absorbed by common shareholders ■ Covenants prevent purchase or redemption of capital stock ■ Covenants prevent new capital issues	■ Common stock will continue to trade ■ No voting rights ■ No common dividends to existing shareholders ■ Existing common stock shareholders will bear any losses ahead of the government and preferred shareholders ■ Dilution due to issue of warrants ■ Negative impact on EPS available to common due to dividends on senior preferred ■ Covenants prevent purchase of redemption of capital stock ■ Covenants prevent new capital issues

AIG

On September 23rd, 2008, AIG announced that it had signed a definitive agreement with the Federal Reserve Bank of New York aimed at addressing the liquidity needs of AIG. AIG Chairman and CEO Edward Liddy said:" AIG made an exhaustive effort to address its liquidity needs through private sector financing, but was unable to do so in the current environment. This facility was the company's best alternative".

The agreement consisted in:

1. **2 year, $85bn revolving credit facility** provided by the Federal Reserve Bank of New York to provide a
   - Interest to accrue on 3m libor + 8.50%, initial commitment fee of 2% (payable at closing) and a commitment fee of 8.50% per annum on any undrawn amount
   - AIG is required to repay the facility from, among other things, the proceeds of certain asset sales and issuances of debt or equity securities. These mandatory repayments permanently reduce the amount available to be borrowed under the facility

2. **Convertible Participating Serial Preferred Stock** to be issued by AIG to a trust that will hold the Preferred Stock for the benefit of Treasury
   - The Preferred Stock will be entitled to participate in any dividend paid on the common stock, with the payments attributable to the Preferred Stock being approximately, but not in excess of 79.9% of the aggregate dividend paid
   - The Preferred Stock will vote with the common stock on all matters and will hold approximately, but not in excess of 79.9% of the aggregate voting power

- The Preferred Stock will be convertible into common stock following a special shareholders meeting to amend AIG's restated certificate of incorporation.

Implications by category of investors

Debt / MBS	Preferred Equity / Hybrid Capital	Common Equity
■ Enhanced ability of AIG to meet on-going obligations ■ Additional security and clarity to AIG debt holders – senior and subordinated ■ Incentive to reduce balance sheet through asset disposal	■ The fate of hybrid capital holders remains uncertain. Current secondary trading levels seem to indicate that AIG will suspend coupon payments on these securities	■ Common stock will continue to trade ■ Diluted voting rights ■ AIG suspended dividends on Common Stock on 23rd September ■ Existing common stock shareholders will bear any losses ahead of the government and preferred shareholders ■ Negative impact on EPS available to common due to dividends on senior preferred

Roskilde

On 24th August 2008, Roskilde Bank A/S (the "Bank") announced that a new bank (the "New Bank") established by the Nationalbanken and the Private Contingency Association for the Winding up of Ailing Banks, Savings Banks and Cooperative Banks ("Private Contingency Association") has offered to buy all assets and assume all debts and other liabilities of the Bank except hybrid core capital and subordinated loan capital.

The purpose of the New Bank is to carry out banking activities and other legally allowed activities with a view of ensuring the best possible financial return from the winding up of the operations taken over from the Bank.

The agreement consisted:

1. **A capital base contribution at a level of DKK4.5bn**
   - Interest payment on the capital injection was set at spread of 4.85% over the lending rate of the Nationalbanken (corresponding to a total coupon of 9.45% as of 22nd August, 2008)

Implications by category of investors

Debt / MBS	Preferred Equity	Common Equity
■ Enhanced ability of the New Bank to meet on-going obligations ■ Additional security and clarity to New Bank debt holders – senior ■ Suspension of coupon payments on subordinated debt which is by nature deferrable and loss absorbing in Denmark	■ N.A	■ Common stock of the Bank will continue to trade ■ No voting rights ■ Profits generated in connection with the termination of the ownership of the Nationalbanken (after payment of the interest on the capital base contribution) will be transferred to the Bank to be distributed to the subordinated and hybrid capital and equity holders

Northern Rock

Step 1:
The government (Treasury) stepped in to provide liquidity to Northern Rock whilst simultaneously announcing to the market this was in its role as "Lender of Last Resort". Northern Rock was fast approaching the point where they would not be able to meet their obligations as they became due.

This announcement prompted a run on retail deposits due to the then protection scheme in the UK providing cover of only the first £2,000 and 90% of the next £33,000 for each depositor. This run lead to the Chancellor subsequently announcing that all deposits and senior obligations of Northern Rock would be guaranteed for the full amount “during the current instability in the financial markets”.

All wholesale funding was suspended and allowed to roll off but new retail deposits were taken in with a full govt guarantee.

No public data was given on the emergency facility that preceded the SLS. The funding rate on the facility was 'punitive' but again not disclosed.

Step 2:

When all commercial exit strategies were ruled out, Northern Rock was taken into 'Temporary Public Ownership' with a view to a future re-float or orderly run down.

All common stock and non innovative preference shares that had voting rights were wiped out with an independent body set up to assess the compensation levels that would be due to investors.

All other non voting Tier 1, UT2 and LT2 securities continue to pay coupons.

The Government loan continues to pay down but they have announced the intention to convert up to £3bn of the loan into new common equity to ensure the bank is 'adequately capitalised'.

Debt / MBS	Preferred Equity / Hybrid Capital	Common Equity
■ enhanced ability of the Bank to meet on-going obligations ■ Additional security and clarity to the Bank’s debt holders – senior, subordinated, Upper Tier 2 and non voting hybrid Tier 1	■ Only preference shares with voting rights were cancelled ■ Compensation for holders to be determined by an independent body	■ Common equity de-listed ■ Compensation for holders to be determined by an independent body

4) Market Backdrop

Market Backdrop For Financial Institutions

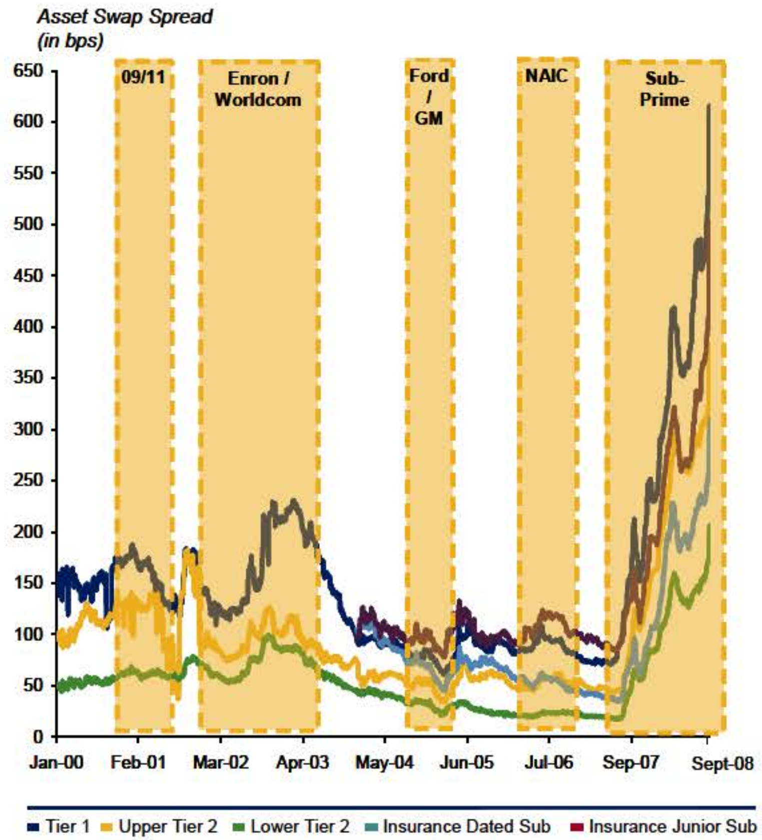
Severe Stresses In The Financial Markets Remain Amidst Volatility

Aggregate Spread Performance By Asset Class

- Over the last few weeks we have seen a dramatic worsening of market conditions. Uncertainty regarding the faith of financial institutions have lead to a total paralysis of the capital markets with only overnight funding currently available
  - USCP volumes circa 90% now only placed overnight
  - Massive flight to quality with the 2 yr Tbill currently yielding 2% nearing the lows reached at the time of the Bear Sterns collapse
  - Banks deposited £6bn in low yielding facility with BoE on Thursday 26th September (vs historical maximum of £1bn) rather than lend to each other

Asset Class	Product Type	Jan / Jun 07	Sept / Oct 07	Nov / Dec 07	Current
CP	A1/P1	-7 / -4 bps	-5 / -10 bps	Flat / -5	Flat / +30 bps
	US CP Outstanding	$2.2 trillion	$1 8 trillion	$1.8 trillion	$1.77 trillion
ABCP	A1/P1	-2 / +5 bps	20 / 30 bps	20 / 40 bps	40 / 50 bps
	US ABCP Outstanding	$1.2 trillion	$892bn	$800bn	$761bn
Senior Unsecured	5y AA CDS	8 / 12 bps	35 / 40 bps	45 bps	100 / 150 bps
	5y A CDS	15 / 25 bps	60 / 70 bps	70 / 80 bps	150 / 200 bps
Covered Bonds	10y Mortgage Backed	7 bps	17 bps	20 / 30 bps	60 bps
	10y Public Sector	-2 bps	3 bps	5 / 6 bps	30 / 35 bps
Securitisation	AAA	10 / 12 bps	35 bps	75 bps	130 / 150 bps
	BBB	45 bps	250 bps	300 bps	400 bps
Bank Capital	Sterling Tier 1 (AA)	70 bps	140 / 170 bps	210 / 230 bps	500 550 bps
	Euro Tier 1 (AA)	80 bps	150 / 180 bps	220 / 250 bps	500 / 600 bps
	US$ Tier 1 (AA)	80 bps	150 / 180 bps	220 / 250 bps	500 / 600 bps
Insurance Capital	Subordinated (A/AA)	90 bps	130 / 150 bps	225 bps	250 / 300 bps
iTRAXX	5y Senior Index	8 / 10 bps	30 bps	50 / 55 bps	135 bps
	Crossover Index	200 bps	300 / 310 bps	370 bps	580 bps
VIX	Equity index	14 points	24 points	28 points	35 points
Government Bonds	2 year Treasury Yield	4.617%	4.157%	3.781%	2.043%

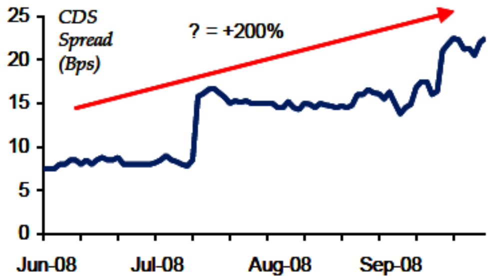
Current Cycle Much More Severe Than Previous



Market Backdrop For Financial Institutions

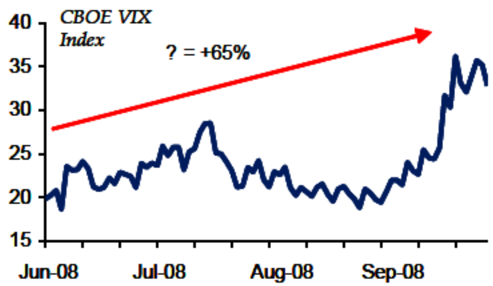
Severe Stresses In The Financial Markets Remain Amidst Volatility

10-Year US Treasury CDS



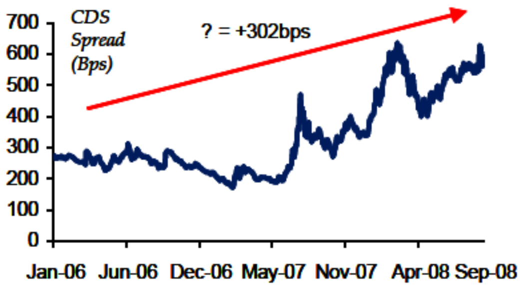
The cost to insure the debt of 10 year US treasuries has risen to an all time high as over the US fiscal position

VIX Volatility Index



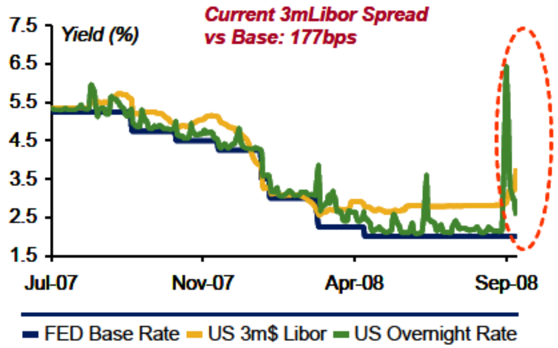
The VIX volatility index, one of the best guides to risk in the market rose close to six year highs as risk aversion jumped

iTRAXX Cross-Over

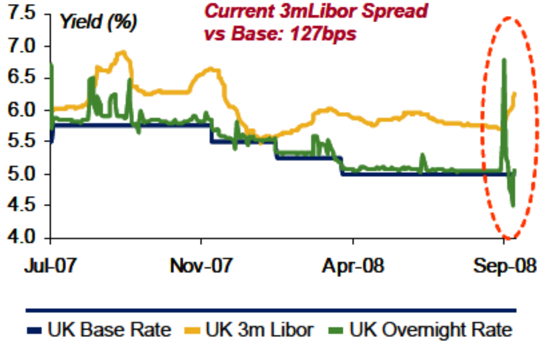


The iTRAXX Crossover index has again breached the 600 mark with substantial pressure being seen on secondary spreads

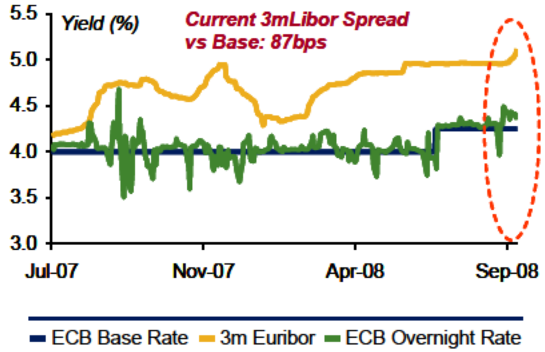
US Interbank Rates



UK Interbank Rates



EUR Interbank Rates



Interbank rates have reached record highs with a large collapse in market liquidity and severe risk aversion being seen. Furthermore, tension is rising as companies and banks face the end of the third quarter next week. Money market funds have traditionally been large sources of liquidity in both the interbank and commercial paper markets but these lenders have seen substantial fund outflows

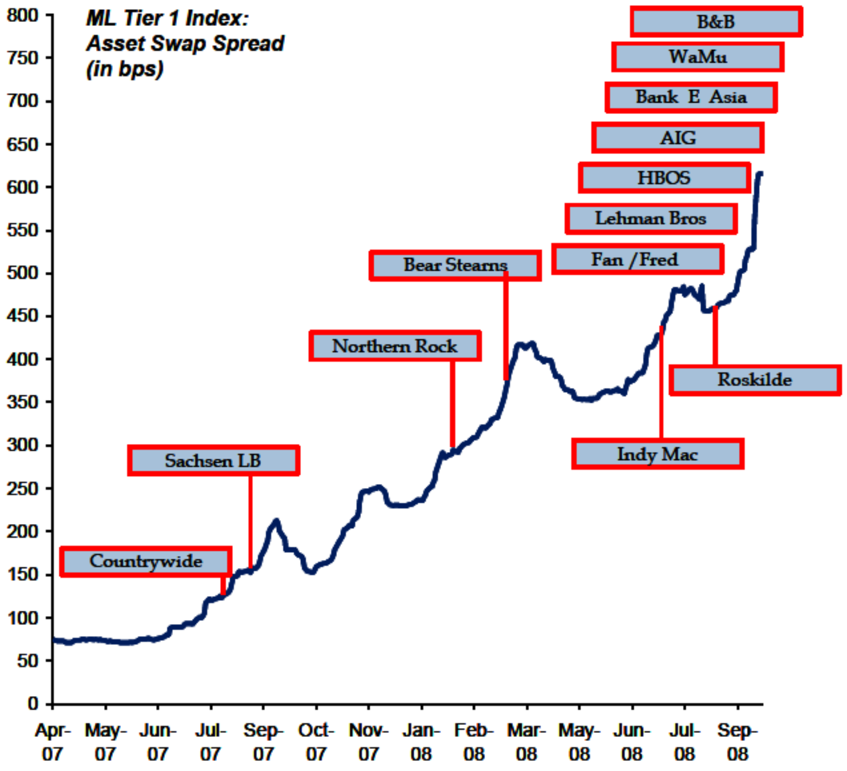
Market Backdrop For Financial Institutions

Acceleration of Bank Failures & Impact on Capital Markets

List of Key Bank Failures

- **Washington Mutual** (Put into receivership on 26th September, 2008)
  - $19bn of expected losses on portfolio - ratings downgrade to non-investment grade – deposit withdrawals and liquidity crisis
- **Bank of East Asia** (Hong Kong Central Bank support on 25th September 2008)
  - Run on the bank following rumours of insolvency
- **AIG** (Federal Reserve intervention on 17th September 2008)
  - Concerns over subprime / CDS exposures & liquidity pressure - $85bn liquidity shortfall
- **HBOS** (acquired by Lloyds TSB on 16th September 2008)
  - Concerns regarding ability to funding – funding gap estimated at c £200bn
- **Lehman Brothers** (Filed for Chapter 11 on 15th September 2008)
  - Concerns regarding insolvency led to liquidity crisis -
- **Fannie Mae & Freddie Mac** (Federal Reserve Intervention on 8th September 2008)
  - Mounting defaults on portfolio lead to concerns regarding insolvency – US stepped in explicit manner to ensure both entities continue to fund
- **Roskilde** (Danish Bank resumed control on 25th August 2008
  - No longer met solvency requirements. Bought by Danish Central Bank after no external buyers found
- **Indy Mac** (Filed for chapter 11 on 11th July, 2008)
  - Depositors withdrew at elevated levels post profits warning. Subsequently seized by US regulators after viewed to fail
- **Bear Stearns** (acquired by JPM Morgan on 16th March, 2008)
  - Concerns regarding exposure to subprime and level of capitalisation triggered a rapid and non-reversible liquidity crisis
- **Northern Rock** (Nationalised by UK Government on 15th February 2008)
  - Capital markets dislocation lead to impossibility to meet funding gap
- **Sachsen LB** (acquired by LBBW on 25th August, 2007)
  - Received emergency funding following the inability of Sachsen LB's ABCP to fund in the CP markets
- **Countrywide Financial** (Acquisition by Bank of America 16th August, 2007)
  - Drew on $11.5B from 40 global banks and liquidity providers following inability to fund in wholesale markets. Subsequently acquired by Bank of America

Bank Failures Substantially Impact Credit Markets



Comments on PwC Report 8 July 2009 – 'Project Parade'

General Comment

The structure of the Society's loan book is widely known, in particular its concentration and the nature and scale of its commercial loan book. The increased level of impairment assessed by PwC is not a surprise given recent revisions by Anglo, AIB, BOI etc.

The report confirms serious deficiencies in management and business systems including impairment recognition at the Society, and is in line with previous views expressed by the Financial Regulator, Arthur Cox and others. A lot of the report is taken up with documenting these deficiencies and notes that losses could be minimised over time by strengthening management and systems – this may not be as relevant given the establishment of NAMA.

Loan book

- The classification used by PwC (for example on pg 4) is unique to INBS and provides little comparison value – except for PwC report 1
- 48% of the loan book is interest roll-up
- Over half the commercial book is UK – with related issues FX risk, stronger (perhaps) property market (e.g. Anglo's impairment rate for the UK is half that of here) – INBS seem to question PwC assessment in this area in particular
- Of the portion of the loan book reviewed by PwC (60% of the commercial book) there is a substantial difference compared to management's views – PwC propose a provision of 25% as opposed to management's 10% or €800m.
- When calculated across the full book the difference is €1.4 billion.
- PwC estimate a total economic loss over the next 2-3 years of €2.4 billion – a 27% loss on the commercial book – feed into NAMA process?
- PwC note that provisioning is inadequate and poorly assessed (e.g. IBNR provision for 2008 calculated on a once off basis in association with the auditors due to critical faults with the procedure for calculating IBNR by the Society)

Capital

- If PwC's assessment is accepted (an increase of €1.6 billion in provisions) – INBS's capital base is completely wiped out. It may be important to consider how possession of this information impacts the Board and its ongoing functioning (i.e. are they obliged to petition to have the Society wound up?).
- PwC assess the range of capital required (without factoring NAMA) from €800m to €1.5 billion.
- PwC note that INBS are proposing a debt buyback – should this be done asap and pre-NAMA?

Funding

- Nothing new in this regard - notes deposit outflows, securitisation, increase in cost of funds etc.
- Does note that no work has yet begun on a commercial securitisation – FR had required this to be completed by end Q 1 of this year

Other

- Former CEO has yet to repay the €1 million bonus paid in November 2008

THEME: C2

Role and effectiveness of the Policy appraisal regime before and during the crisis

LINE OF INQUIRY: C2c

The liquidity versus solvency debate

understood that Robbie Kelleher had issue a sell advice on all Irish Banks to Davy's private clients.

2. Use of Contingency Liquidity

PF outlined the chart which showed the level of eligible assets which could be used current availability of contingent liquidity to the Group from the various central bank facilities. The Group was currently positioning all of its eligible assets so that they would be available for use and it was expected that this work would be completed by close of business on the 30 September.

JB explained that based on the current proposed borrowing from the ECB and the collateral required for the Goldman Sachs transaction the level of collateral at the 3/10/2008 would be circa €23bn. However it should be noted that there is a significant risk to non-GM deposits over the next few days (say €2bn per day) together with further risk (say €1bn per day) of GM deposits falling – if these risks materialise collateral at 3/10/2008 would be €11bn. The following week the estimate based on upon the unwinding of the Goldman Sachs transaction and the continued forecast in customer deposits the balance would be €21bn. However, if one builds in the further risks to both the GM and non-GM deposits as set out above, the collateral balance would be €9bn.

BJG joined the meeting at this point.

JOD gave a recap of the points discussed to date.

3. Government Guarantee

BJG informed the Committee that a meeting had been arranged with the Taoiseach for later than evening at which a group of senior bankers would discuss the possibility of a Government guarantee being provided for all borrowings by Irish institutions (customer deposits, interbank borrowings and debt securities issued). The Committee were of the view that while the issue of such a guarantee would be helpful it would not remove the need for action to address any fundamental issues in any single institution. The Committee prepared a draft of such a guarantee and the list of institutions that it should cover for use by the BJG in his meeting later that evening.

The meeting concluded.

MINUTES OF THE BOARD MEETING
of
ALLIED IRISH BANKS, p.l.c.

held on Sunday, 28 September 2008,
at Bankcentre, Ballsbridge, Dublin 4 at 6.00 p.m.

PRESENT:	Dermot Gleeson	Chairman
	Kieran Crowley	
	Colm Doherty	
	Donal Forde	
	Stephen L. Kingon	via audio link
	Anne Maher	
	Dan O'Connor	
	John O'Donnell	
	David Pritchard	via audio link
	Eugene Sheehy	
	Bernard Somers	
	Michael J. Sullivan	via audio link
	Robert G. Wilmers	via audio link
	Jennifer Winter	via audio link
IN ATTENDANCE:	W. M. Kinsella, Secretary	
	Bryan Sheridan, Group Law Agent	

An apology for inability to attend was conveyed on behalf of Mr. Sean O'Driscoll.

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1. **Liquidity Contingency Plan**

Mr. Doherty reported that under the Liquidity Contingency Plan (referred to in the Group Prudential Liquidity Policy approved by the Board on 21 June 2007), there was a requirement to convene the Liquidity Management Committee ("LMC") if the Bank moved to Adverse Scenario 2 of that Plan. He advised that, while such a move had been made, both he and the Managing Director of Global Treasury were of the view that, because the liquidity problems being faced were systemic rather than AIB-specific, convening the LMC, which was primarily geared to an AIB-specific liquidity event, would serve no useful purpose. He indicated that this change had been approved by the Group Chief Executive.

The change of process, as outlined, was noted.

2. **Strategic Issue**

The Chairman reported on an initiative taken recently by a European financial institution to protect and strengthen its franchise, against the background of the continuing turmoil and uncertainty in financial markets. He outlined some of the implications of the underlying proposal, the due diligence conducted, the conclusions reached by external advisers, and the views of the Group Executive Committee. He then invited comments on the matter.

Following an exchange of views, it was agreed that the initiative was unrealistic and impracticable for a number of reasons, and, accordingly, that is should not be countenanced.

3. **Irish Financial Market**

Mr. Sheehy reported that pressure was building in the Irish financial system, driven by an absence of liquidity. Consultations were being held with the Government and Central Bank and, while the timing of likely events was not known, the authorities expected that two financial institutions would fail (unless

CHAIRMAN'S INITIALS

AIB01B01

AIB02247-001

C2c – Role and effectiveness of the Policy appraisal regime before and during the crisis – Liquidity vs Solvency debate

Information Summary (Section33AK)

Note: All references are aggregated

Document Category	Time Period
Meeting Minutes	Q3 - 2008

In Q3 2008 the Financial Regulator met with the Chairman of a medium-sized financial institution.

The main points arising from the meeting were as follows:

- The Chairman believed that there was an 'agenda' against his financial institution which was being orchestrated by a Government Department.
- The quality of the institution's loan book was better than its closest competitor.
- Loan levels expected to reduce by a billion in the current year, with no significant level of commitments.
- However it would be difficult to quantify cashflow needs as outflows cannot be predicted.
- Fee income would be strong in the current year - €50m.
- Could meet non repayment of €625m of outflows stopped.
- The Chairman noted that talk of €2.5 billion of losses was 'crazy'.
- The investment bank, retained to review the institution's loan books, does not believe that there are risks beyond net assets.
- The Chairman noted that the institution was an open book for anyone to look at. It is property with problems that can be managed.

(6)

International Economic Consultants

Indecon

Status: Personal and Strictly Confidential

Addressee Only

Mr. Kevin Cardiff,
Second Secretary,
Department of Finance,
Government Buildings,
Upper Merrion Street,
Dublin 2.

25th September, 2008

Dear Kevin,

Please find a confidential personal note in the attached envelope.

Kind personal regards,

Yours sincerely,

Alan W. Gray

Indecon (Ireland), Indecon House, 4 Fitzwilliam Place, Dublin 2, Ireland.
phone: + 353 1 677 7144 **fax:** + 353 1 677 7417 **email:** mailbox@indecon.ie **web:** www.indecon.ie

directors: P.Mullarkey (Chairman), A.W.Gray (Managing), D.S.King, P.Muller, J.McGuire.

International Economic Consultants

Indecon

Status: Personal and Strictly Confidential

Addressee Only

Mr. Kevin Cardiff,
Second Secretary,
Department of Finance,
Government Buildings,
Upper Merrion Street,
Dublin 2.

25th September, 2008

Dear Kevin,

Please find a bullet point note on some preliminary ideas which I agreed with Dave I would send to you and to him and John H. I hope these are of some use but I know that your own thinking may already be ahead of this on many issues.

If I can be of any further assistance just call.

It is great that you are available in these very challenging times and I know how difficult some of the judgement calls may be.

Kind personal regards,

Yours sincerely,

Alan

Alan W. Gray

P.S. As I mentioned previously, well done on the Ministerial Statement and the increase in the deposit scheme to €100,000 which were key decisions. With you leading the team responding to financial services developments I can sleep at least 2 hours a night! Pity George Bush did not have your inputs.

Indecon (Ireland), Indecon House, 4 Fitzwilliam Place, Dublin 2, Ireland.
phone: + 353 1 677 7144 fax: + 353 1 677 7417 email: mailbox@indecon.ie web: www.indecon.ie

directors: P.Mullarkey (Chairman), A.W.Gray (Managing), D.S.King, P.Muller, J.McGuire.

CHALLENGES

A. IMPROVE LIQUIDITY IN BANKING SECTOR.

B. RESPONSE TO INDIVIDUAL BANKS WITH SPECIFIC LIQUIDITY ISSUES.

C. ACTIONS TO REDUCE RISK AND POTENTIAL EXCHEQUER EXPOSURE IN SPECIFIC INDIVIDUAL BANKS.

D. PLANNING TO FACILITATE RESTRUCTURING OF SECTOR.

A. Improve Liquidity in Banking Sector

Options	Preliminary Comment
European Responses	
(i) Specific ECB Wide Initiative	
(ii) Some Changes to Eligibility Rules to facilitate greater access for certain types of commercial mortgages without rating or access for part of syndicated loans	Potential to influence may be very limited but ECB potential role merits on-going investigation. Key issue is that initiatives are not introduced subsequently which could have been of assistance.
Potential National Responses	
(i) Government/Ministerial Statement indicating a State guarantee will be provided if required or an intention to provide such a guarantee but with no immediate legislation.	Danger of being seen as too weak and probably better to have no statement. Any system wide initiatives must be seen as sufficient so that there is not ongoing initiatives launched.
(ii) State Guarantee of All Loans of Banks Incorporated in Ireland with Banks paying the cost for this similar to retail deposit protection scheme.	Merits serious consideration if it would be credible and if there was a positive market reaction. Credibility may depend on how any challenge on State aids is viewed by the market. Also issue is whether it would postpone necessary restructuring and impact on image of Irish banks. Also need to consider could it lead to a withdrawal of existing facilities until legislation is in place. Probably not but worth considering. State Aid issue is relevant but key is not whether it could be successfully challenged but whether markets believe it would be overturned and therefore impacts on credibility. In this context it is worth reviewing the European Commission's ruling that the State guarantees provided by the German Government which gave Landesbanks including West LB a State guarantee, was in breach of EU State Aids. Interestingly, it appears the European Commission's ruling required an ending of the guarantee by a specified date i.e. July 18 2005 rather than a retrospective impact. The basis for the decision appear to be that it gave Landesbanks an advantage in the cost of raising funds where they had access to funds at AAA rates rather than A or below. Also relevant is the more recent decision of the Polish Government to put an end by 30th June 2008 to the unlimited State guarantee employed by the Polish Post Office which enabled the Post Office to obtain finance on more favourable terms giving it an advantage over competitors. While information on this is a bit limited my preliminary understanding is that the Polish Government may have made this agreement with the Commission to terminate the guarantee in order to end an EU investigation. My reading of these developments is that State Guarantees constitute aid where a commercial operator would not have given a guarantee in comparable circumstances. Indicating that the cost would be borne by recipients would also be key and this does not appear to have been in place where schemes have been deemed to be State aid. Structuring this so that it meets this 'commercial' criteria to the extent possible would be helpful. It may, however, be the case that in the current international crisis everyone is more relaxed re State aids and competition issues and potential challengers may be more interested in getting covered under the scheme or pushing their Governments to do likewise.
(iii) Temporary State Guarantee with a defined timeline in light of exceptional developments for a period paid for by the sector	Has some clear merits over an unlimited guarantee but there is a risk of a market event when the guarantee ends. This option, however, may merit detailed analysis and consideration.
(iv) State Guarantee either with defined timeline or open ended paid for by participating banks but with payment terms being structured in a way which neutralised the competitive impacts i.e. where AA+ would pay proportionally less than A rated banks etc.	This has some merits as it may encourage consolidation/restructuring. It may also reduce State aid concerns to some extent. Could be sold as all participating banks paying full costs of the scheme.
(v) Banks to themselves set up a Liquidity War Chest in the light of international liquidity difficulties and with State providing a guarantee the cost of which would in turn be paid for by participating banks	Probably not feasible this week but might be possible next week if market developments improve somewhat. Merits detailed consideration, although there would be some resistance from banks as they would be using up their individual liquidity options but I think it has some merit depending on timing.

B. Response to Individual Banks with Specific Liquidity Issues

Options	Preliminary Comment
(i) Seek a trade sale to a strong, credible institutional buyer	Best option but unlikely to be feasible in the current circumstances but should be pursued.
(ii) Liquidity to be provided by a combination of commercial banking and State sources	Not an option this week but might be feasible in certain circumstances. This represents second best option in my view.
(iii) Liquidity to be provided by State sources on a confidential basis and, if sustainable	This is next best option but essential to explore appropriate conditions and commitments and for the 'costs' to be paid by institution. Also essential that other market options are pursued first.
(iv) Swapping sovereign bonds for assets which would then give access to ECB	Probably requires legislations and has risks. Essential for strict conditions and need to cap the levels.
(v) Nationalisation	Negative system wide impacts are clear and this has all the disadvantages of options (ii), (iii) and (iv) and scale of the Exchequer exposure and level of funding required is likely to be much greater when contagion impacts are taken into account.

C. Actions to Reduce Risk and Potential Exchequer Exposure in Specific Individual Banks

Options	Preliminary Comment
1. Restrictions on Loans 2. Management Changes 3. 'Agreed' restructuring or Strategic Plan including managing down of loans	Detailed bank specific plan needed including what commitments would attach to some support under B.

D. Planning for Restructuring of Sector

Needs significant thought and analysis.

<u>Principles Inherent in Above Analysis</u>

(i) State exposure to be minimised where possible.

(ii) The knock on impacts of any decisions taken into account and minimisation of contagion.

(iii) The cost of any assistance to be paid for fully by the sector (even if this means over time).

(iv) Wider economic implications factored in.

PRUDENTIAL CAPITAL ASSESSMENT REVIEW

The Central Bank and Financial Regulator has carried out an exercise to determine the forward-looking prudential capital requirements of certain of the Irish credit institutions covered by the government guarantee. The Prudential Capital Assessment Review (PCAR) process for Allied Irish Bank, Bank of Ireland and EBS has been concluded and the results are set out below, together with the status of Anglo Irish Bank, Irish Nationwide Building Society and Irish Life and Permanent.

The Prudential Capital Assessment Review (PCAR) assesses the capital requirements arising for expected base and potential stressed loan losses, and other financial developments, over a 3 year (2010-2012) time horizon. It involves the Central Bank and Financial Regulator making an assessment of the recapitalization requirements of the credit institutions in order to satisfy both a base case and stressed target capital requirement.

The PCAR has been undertaken to determine the recapitalisation requirements of the credit institutions with reference to both:

- A target level of 8% core tier 1 capital should be attained after taking account of the realisation of future expected losses and other financial developments under a base case scenario. This test is designed to ensure the credit institutions are capitalised to a level which reflects prudential requirements and current market expectations, after taking account of forecast loan losses through to 2012. As a further prudent requirement, the capital used to meet the base case target must be principally in the form of equity, the highest quality form of capital, with 7% equity as the target level. In calculating the requirements, individually specified amounts have been added to the institutions' estimates of expected losses to take account of the uncertainty of loss forecasts for particular portfolios.

- A target level of 4% core tier 1 capital that should be maintained to meet a stress scenario or a portfolio level sensitivity analysis. This capital test, which is similar to that employed by US and UK supervisory authorities, is designed to ensure the credit institutions have a sufficient capital buffer to withstand losses under an adverse scenario significantly worse than currently anticipated.

The Financial Regulator has required the credit institutions that have completed the exercise to prepare recapitalisation plans to comply with the additional capital specified by the PCAR. The level of additional capital required for each institution under the PCAR analysis is set out below. This amount of capital set by the PCAR process must be in place by the end of 2010.

Recapitalisation to the target requirements specified in the PCAR will provide market participants with the confidence that the institutions have a strong capital base after realising forecasted expected losses and that a prudent capital buffer is in place to withstand additional losses in adverse stress conditions.

PCAR Methodology

The PCAR has involved the Central Bank and Financial Regulator making an assessment of the recapitalisation requirements of the credit institutions involved in the exercise in order to satisfy both a base case and stressed target capital requirement.

A team of prudential supervisors, credit specialists and treasury specialists in the Financial Regulator, supported by Central Bank economists and financial stability specialists, conducted the PCAR by:

- Assessing the provisioning estimates of each credit institution, their Basel capital model outputs, expected loss forecasts, funding costs and projected operating income;
- Reviewing independent third party estimates of provisions and expected losses conducted on specific credit institutions' portfolios;
- Reviewing likely and stressed scenario loan loss projections for portfolio categories by credit rating agencies and other sources including regulatory agencies;
- Reviewing the outcome of modelled base and stress macro-economic scenarios that we specified and mandated the credit institutions to calculate;
- Using information received from NAMA in respect of the first tranche of "haircuts" as the basis for estimating the NAMA loan losses[1];
- Applying prudent buffers to estimates of expected loan losses;
- Applying prudent adjustments to base case and stress scenario funding costs and treasury asset losses;
- Applying knowledge of the quality of loan portfolios gained through our more intensive supervisory interaction with the banks, including observation of Credit Committee deliberations; and
- Benchmarking our analysis to the approaches taken by other leading international financial supervisors.

[1] Credit institutions may apply to the Financial Regulator by 30 June 2010 for a downwards revision to their capital requirements, if the haircuts on subsequent tranches are materially lower than the first tranche or the quantum of loans to be transferred is lower.

The PCAR methodology assessed the capital requirements arising for expected base and potential stressed losses, and other financial developments, over a 3 year (2010-2012) time horizon.

The PCAR required the assessment to take account of changes to EU prudential banking capital requirements that have been formally adopted, even if they have yet to be implemented. This does not include the "Basel II plus" changes that are still at consultation stage, although the potential changes were noted as part of our overall assessment of target capital levels.

Stress Test

In this test the capital requirement of 4% core tier 1 capital is designed to ensure that banks will be adequately capitalised even after experiencing a hypothetical adverse macroeconomic scenario or unexpected severe losses on particular loan portfolios. This capital level is equivalent to that established by the UK Financial Services Authority[2] and similar to that established by the US Federal Reserve, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency[3].

The stress test requirement is based on a severe scenario of hypothetical adverse macroeconomic conditions and therefore involves an element of judgment. The stress test inputs **do not represent a forecast** of likely economic developments by the Central Bank and Financial Regulator, instead they are much more adverse than what is considered likely.

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[2] FSA Statement on its use of stress tests, 28 May 2009

[3] Joint Statement by US Authorities on the Treasury Capital Assistance Program and Supervisory Capital Assessment Program, 6 May 2009. The Committee of European Banking Supervisors has also conducted bank stress testing exercises but has not set a common buffer stress capital requirement, leaving this to national discretion. The result of the adverse scenario was that on aggregate Tier 1 would remain above 8% and no single bank would fall below 6% Tier 1.

The Central Bank and Financial Regulator required firms to stress test their portfolios to the higher of:

- The firms estimated loan losses in a stress scenario based on a delayed macroeconomic recovery scenario prescribed by the Central Bank and Financial regulator[4] and,
- Application of severe sensitivity shocks to the loan book at a portfolio specific level. This included loan loss rates of 5% for mortgages in Ireland and non-NAMA developments property loan losses of 60% in Ireland and 35% in the UK. We emphasise that these are not forecast or expected loss levels, and are disclosed to show the extent of the stress that has been applied in the test. These loss rates are not based on any macroeconomic scenario and therefore should not be interpreted in that manner.

It is the losses established under the portfolio level sensitivity approach that have provided the binding stress case capital requirements, rather than the macroeconomic scenario.

The use of stress testing to benchmark prudential capital requirements will become a part of the regulatory framework operated by the Central Bank and Financial Regulator.

Recapitalisation Plans

The Financial Regulator has required the credit institutions to prepare recapitalisation plans in light of the PCAR results. The credit institutions are required to set out their plans to ensure that capital is in place by the end of 2010 to a level calculated by reference to the base capital target, after taking account of projected expected losses, including bank-specific and other adjustments. We will permit credit institutions to take account of projected asset disposals, based on valuations confirmed by independent third parties, where these are well progressed at year end.

The credit institutions are also required to set out their plans to ensure that capital is in place by the end of 2010 to a level calculated with reference to the stress capital target, taking account of stressed losses and other adjustments. We are currently assessing various approaches to meeting the stress capital target and in principle we will permit credit institutions to take account of contingent capital facilities which trigger at a level of 5% core tier 1.

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[4] As the starting point for determining the stress capital requirement, the banks were provided with a specified macroeconomic scenario based on a hypothetical delayed economic recovery, involving negligible GDP growth in 2011 and 2012, persistent unemployment increasing to 14.7% in 2012, a further cumulative house price decline of 24.8% in the years 2010-2012 beyond the 31.5% decline reported and other parameters. The severity of the stress test takes account of the circumstances of the Irish economy and its position in the economic cycle.

PCAR Results by Bank

The capital requirements resulting from the PCAR exercise are:

Allied Irish Banks plc ("AIB"):

(1) An additional €7.396 bn of equity capital to meet the base case target of 7% equity, before taking account of projected asset disposals, and

(2) €4.865 bn of Core Tier 1 capital, less any equity generated under paragraph 1 excluding conversion of preference shares held by the Government, to meet the base case target of 8% Core Tier 1. This additional Core Tier 1 capital will also satisfy AIB's stress case target of 4% Core Tier 1.

The Governor & Company of the Bank of Ireland ("BOI"):

(1) An additional €2.66bn of equity capital to meet the base case target of 7% equity, and,

(2) In meeting this requirement provided at least €0.25 bn of new Core Tier 1 is raised, then Bank of Ireland also meets (a) the base case target of 8% Core Tier 1, and, (b) the stress target of 4% Core Tier 1.

EBS Building Society ("EBS"):

(1) An additional €875m of Core Tier 1 capital to meet the base case target of 8% Core Tier 1, and,

(2) Contingent capital of €120m of Core Tier 1 capital to meet the stress case target of 4% Core Tier.

Other Institutions for which the PCAR has not been completed:

Anglo Irish Bank Limited ("Anglo"):

The PCAR for Anglo has not yet been undertaken because discussions on its restructuring plan between the bank, Government and the European Commission are still at a formative stage. If the bank's preferred option – which is to carve out a much smaller but viable going concern banking entity with the remainder becoming an asset management entity – is approved by the European Commission, the PCAR will be applied to the balance sheet of the new banking entity.

As an interim measure, Anglo Irish Bank will require an additional €8.3 billion of capital to meet current minimum capital requirements, pending conclusion of the restructuring discussions and the application of the PCAR.

Irish Nationwide Building Society ("INBS"):

The Financial Regulator has estimated the capital shortfall to meet current minimum capital requirements for INBS at €2.6 billion. In line with all credit institutions, INBS must comply with this minimum regulatory capital requirement on an ongoing basis.

Irish Life & Permanent plc ("ILP"):

ILP was not included in the first wave of PCAR as it has not received a government capital injection and is not taking part in NAMA.

The PCAR process for ILP will be completed over the coming months as the institution's restructuring plan is developed.

Appendix: **The PCAR Map**

Base Capital Calculation

Start with Current Capital of bank and forecast Operating Results

Deduct impairments on NAMA loans

*Deduct i*mpairments on non -NAMA loans until 2012

Make Adjustments on bank specific basis:

Add/Deduct: changes to NAMA volumes and % haircut

Deduct: regulatory adjustment for loan loss uncertainty

Deduct: adjustment for funding cost risk

Deduct: Other amendments to forecast operating results

Amend: Risk Weighted Assets to reflect impact of impairment and other changes

Determine Capital Shortfall for base case ratios based on adjustments

Add: Capital injection by 31 December 2010

Result: Target Base Capital of 8% Core Tier 1 of which 7% Equity

The PCAR Map

Stress Capital Calculation

Start with Current Capital of bank and forecast Operating Results

Deduct impairments on NAMA loans

Deduct impairments on non NAMA loans until 2012

Make Adjustments on bank specific basis:

Deduct: changes to NAMA volumes and % haircut

Deduct: hypothetical stress losses through to 2012 derived from the higher of:

(a) the prescribed macroeconomic scenario
(b) the prescribed portfolio level sensitivity loss rates

Deduct: regulatory adjustment for funding cost risk under stress scenario

Deduct: Other amendments to forecast operating results *(same as base)*

Add: capital injection by 31 December 2010-03-25 or Contingent Capital Facility

Amend: Risk Weighted Assets to reflect impact of impairment and other changes

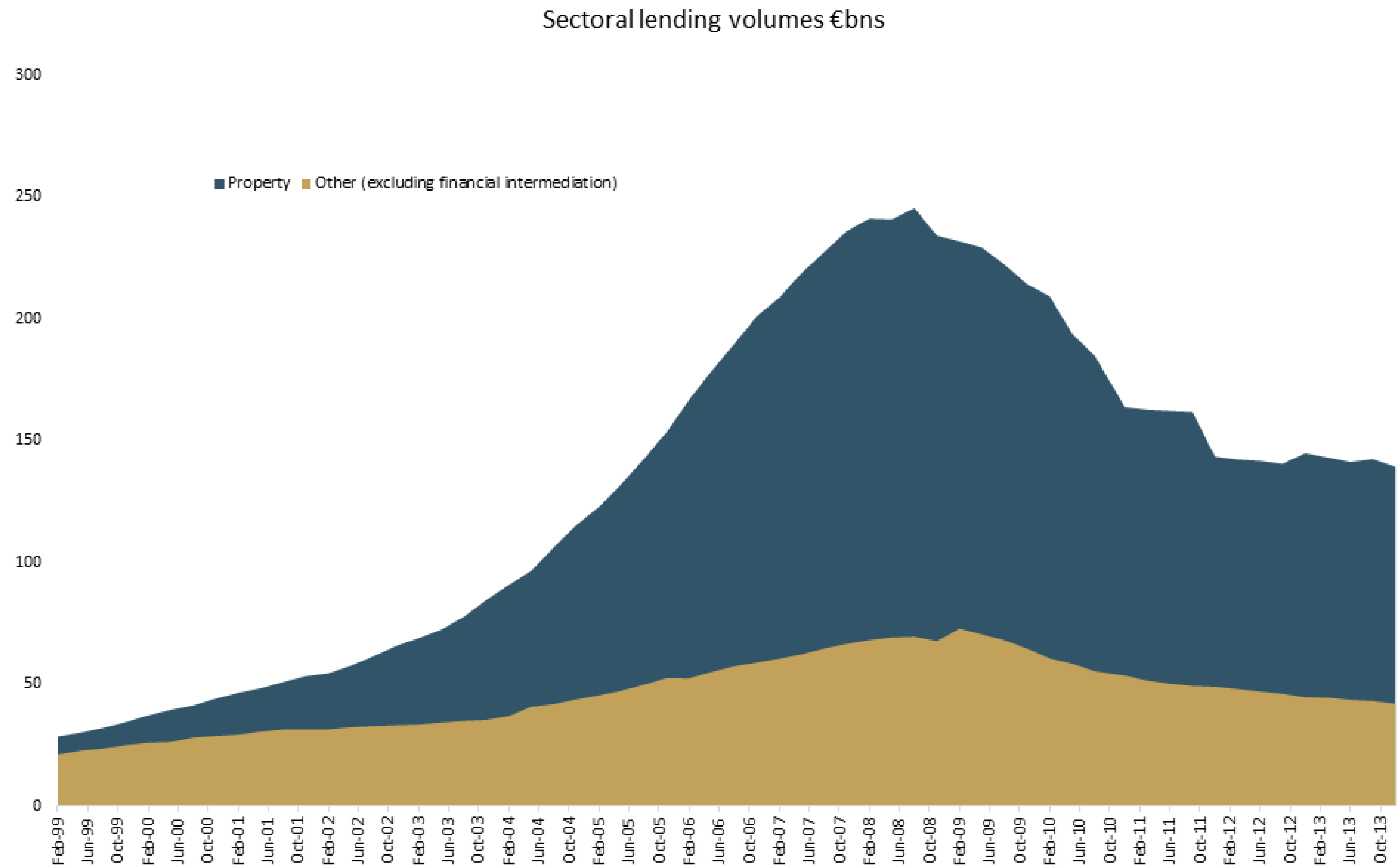
Determine Capital Shortfall for base case ratios based on adjustments

Add: Capital injection by 31 December 2010

Result: **Target Stress Capital of 4% Core Tier 1**

An Roinn Airgeadais
Department of Finance

Massive increase in credit



THEME: C3

Appropriateness and effectiveness of the Department of Finance actions during crisis

LINE OF INQUIRY: C3a

Appraisal of conditions prior to increasing the Deposit Guarantee Scheme

R2b: Nature and effectiveness of the operational implementation of the macro economic and prudential policy

Information Summary (Section 33 AK)

Note: All references are aggregated

Categories of Documents summarised:	Q4 2008 IFSRA Board Report on Trading in shares of a certain financial institution
Time period covered:	Q4 2008
Document Name:	B016-F03-0022.pdf
Bates No.:	CB01789

A report was prepared for the Board of IFSRA The report noted that an investigation into potential market abuse in connection with trading of shares of one financial institution over a 4 day period in Q1 2008.

Its conclusions were:

"Despite extensive investigations, there is no evidence of market abuse having occurred during the period under examination; there is evidence of circulation of rumours, including circulation by stockbrokers; there is one remaining line of investigation, which is unlikely to produce evidence of market abuse, but which will be pursued to its conclusion; and the analysis of market developments available in retrospect suggests that internal information systems at the time could have been stronger and, in that eventuality, we would have understood better what was happening".
The report noted that the ISE was asked to review the evidence available to it (covering market transactions and orders). Regarding the outcome, the report noted:
"The Exchange concluded from its review of order book activity that they could identify no prima facie case of market abuse under the Market Abuse Regulations. With the limited information available to it, the Exchange, needless to say, could not draw conclusions in relation to the broader pattern of trading."

R2b: Nature and effectiveness of the operational implementation of the macro economic and prudential policy

Information Summary (Section 33 AK)

Note: All references are aggregated

Categories of Documents summarised:	Q3 2008 Internal Report from the Monetary Policy Financial Stability Unit to the Financial Stability Committee on short selling of shares
Time period covered:	Q3 2008

Document Name:	USB02-0215.PDF
Bates No.:	CB05669-004

A report was prepared for the Financial Stability Committee in Q3 2008, the report summarised " Recent issues relating to short selling", it incorporated a report on short selling written in Q2 2003.

The report noted :

"The issue of short selling has received a lot of attention over the course of 2008. This is due to the fact that the practice of short selling is considered to exacerbate market turmoil adding to volatility and risk in the market. Short selling has therefore been seen as a contributory factor in the problems experienced by financial institutions in particular, on the back of extreme share price declines in recent months."

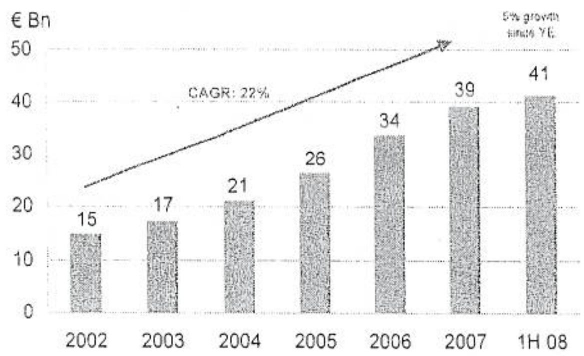
"Data from euroclear shows that the percentage of Irish bank shares on loan, and in particular at [large Irish bank], has increased in recent times. While this is not a direct measure of level of short selling it does give an indication of the companies in which short sellers are taking an interest".

"The SEC responded in July by introducing emergency measures preventing "naked" short selling. The SEC made it mandatory to borrow (or agree to borrow) the stock before selling it. This measure was in place until mid-august. The SEC continue to look at possible options aimed at preventing abusive short selling. The FSA also introduced measures earlier this year in response to events, by introducing new disclosure requirements for significant short positions."

Banking – Loan Portfolio

- Loan book at IL&P viewed as generally low risk, due to predominantly secured nature of lending activity, but areas of greater concern include:
  - 2006 vintage mortgage lending (first time buyer and buy-to-let) due to lending criteria in force and subsequent house price declines
  - Tracker mortgages portfolio, due to inability to reprice unprofitable lending
  - CHL / UK specialist mortgages
  - Commercial lending portfolio, given vintages and more limited track record
- Despite contained development in impairments, provisioning likely to deteriorate considerably
  - Management assumes 8 bps for FY 08E and cumulative 60-80 bps over three years as a stress scenario
  - Avg. brokers assume peak provisions of 39 bps in 2010
- Suspension of higher risk lending, with UK new business suspended since March and withdrawal from Irish BTL and commercial lending
  - But reduced churn / refinancing levels offset funding benefits

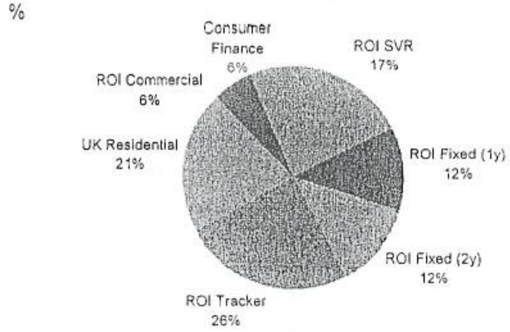
Loan Book Growth



Source Company Information

Loan Book Split

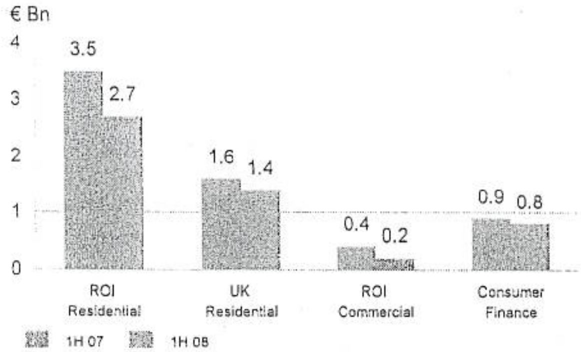
Total Loan Balance: €41.2 Bn (1H 08)



Source Company Information

Bank New Lending

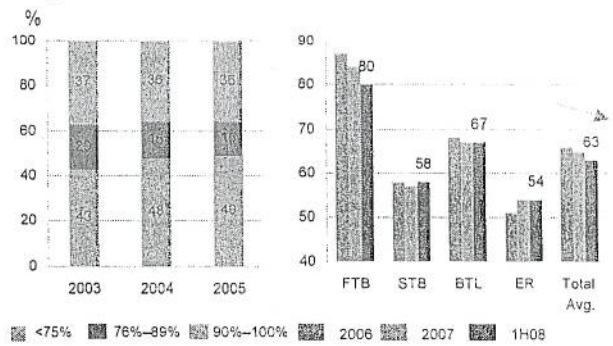
Total New Lending: €5.1 Bn (1H 07: €6.3 Bn)



Source Company Information

ROI Residential New Lending

Avg. LTV



Source Company information, Broker reports

Ratings Sensitivity

Main issues concerning rating agencies

- Both rating agencies have ILP's ratings on negative outlook
- Main driver is IL&P's constrained funding position and its impact on profitability
- Asset quality also a potential concern, but so far resilient
- After deduction of insurance capital, S&P sees bank capital as low
- We see a key short-term risk as increased asset encumberance driven by increased reliance on secured funding, either ECB or bilateral

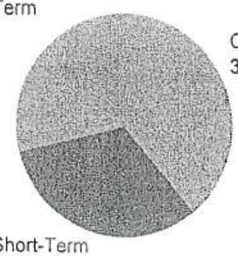
Summary of Main Rating Agency Concerns

Area of Concern	S&P A/Negative/A-1	Moody's Aa3/Negative/P-1
Funding and Liquidity	• Constrained funding profile is main driver of negative outlook • High loan/deposit ratio of 281% (6/08) • Disruption to unsecured funding has led to a reliance on secured funding and an increasing encumbrance of assets • Shortening maturity profile	• High reliance on market funding is main driver of negative outlook • Significant eligible collateral for ECB • Relatively high use of ECB repo (12% of total funding) • Liquidity ratio weakened to 23% at YE07 • Low liquidity score of 'D+' in scorecard
Profitability	• Profitability under pressure as a result of higher funding costs • 2008 expected to deliver a low NIM of <100bps • Increasing provisioning will also constrain profitability	• High reliance on market funds expected to lead to a lower level of profitability
Asset Quality	• Irish mortgages so far resilient, although recent vintage high LTVs a potential issue • Concerns over CHL and Irish consumer finance books	• Relatively high exposure to BTL sector in UK and Ireland • Deteriorating environment in Ireland • Lending at high LTVs up to mid-2007
Capital	• Strongly capitalised on a stand-alone basis, but S&P looks at ratios will 100% and 50% deductions of insurance capital • On this basis, capital looks low	• Moody's does not adjust for insurance capital and therefore sees capital as acceptable

IL&P Funding Overview

- As at 30th June Irish Life & Permanent's funding profile consisted of 39% customer deposits, with the remaining 61% wholesale funding
  - Although a significant proportion, c. 60%, of customer deposits are corporate
- Within the last year debt securities in issue has decreased significantly (-42%). Consequently IL&P has increased deposits by banks by more than five times
- *"In respect of margins, higher funding costs will impact the full year net interest margin in the bank with an expected outcome for the full year of between 98 bps and 100 bps."* IL&P 2008 Interim Report

Funding Mix
30 June 2008



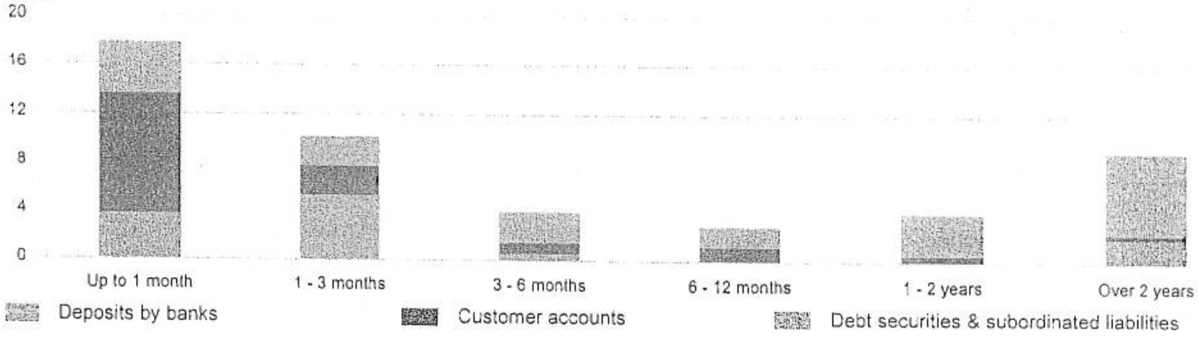
Source Company 2008 Interim Report

Excerpts From Balance Sheet Liabilities
€ MM

	30-Jun-2008	31-Dec-2007	% Change	30-Jun-2007	% Change
Deposits by banks	11,801	10,011	+17%	2,018	+585%
Customer accounts	14,597	13,376	+9%	14,429	+1%
Debt securities in issue	11,744	15,371	-24%	20,233	-42%
Subordinated liabilities	1,661	1,599	+4%	1,650	+1%

Source Company Annual Report

Irish Life & Permanent Liquidity Position
YE 2007
€ Bn



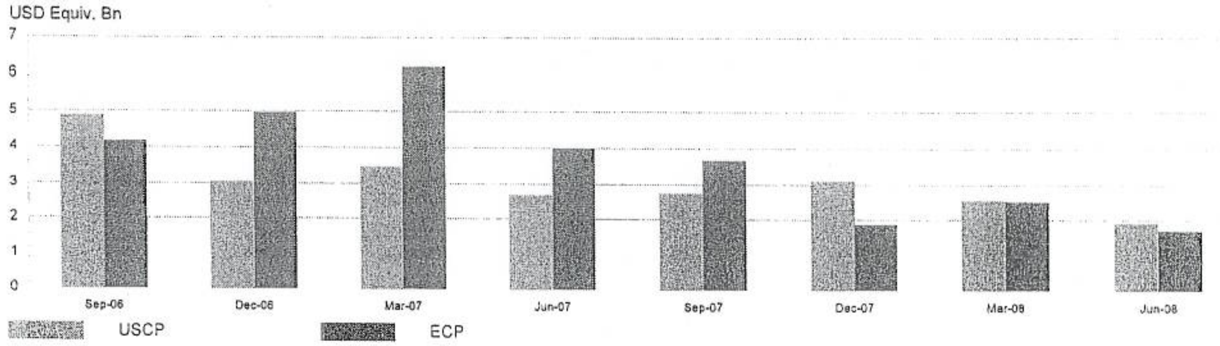
Source Company Annual Report

Morgan Stanley

IL&P Commercial Paper Volumes

- IL&P's US CP and ECP volumes have progressively decreased throughout the year (note that data beyond June-08 is unavailable from public sources)
- IL&P's US CP roll dates are unavailable from public sources, but a table of the ECP outstandings is shown to the right
  - IL&P's total ECP outstandings according to the database 'CPWare' are $1.74 Bn
  - the weighted average maturity of IL&P's ECP outstandings is currently 50 days

CP Volumes Outstanding



Source Moody's

Current ECP Outstandings for IL&P

Issue Date	Currency	Nominal Amount, MM	USD Equiv., MM		Maturity Date	ISIN
06-Mar-08	GBP	4.0	7.1		22-Sep-08	XS0351874218
08-Sep-08	USD	12.0	12.0		22-Sep-08	XS0387278855
28-Aug-08	EUR	15.0	21.3		22-Sep-08	XS0385556260
04-Aug-08	EUR	50.0	70.9		24-Sep-08	XS0381760130
31-Jul-08	EUR	48.0	68.0		26-Sep-08	XS0381248979
30-Jul-08	JPY	6,500.0	60.6		29-Sep-08	XS0380285709
22-Jul-08	EUR	30.5	43.2		29-Sep-08	XS0378800196
21-Apr-08	EUR	12.5	17.7		30-Sep-08	XS0359913950
17-Jul-08	EUR	27.5	39.0		01-Oct-08	XS0378029721
11-Sep-08	EUR	150.0	212.6		06-Oct-08	XS0387958308
11-Jul-08	JPY	6,000.0	55.9		07-Oct-08	XS0376583240
08-Aug-08	EUR	15.0	21.3		11-Oct-08	XS0382585833
07-Jul-08	EUR	14.0	19.8		14-Oct-08	XS0375400487
03-Jul-08	USD	11.0	11.0		14-Oct-08	XS0374355203
01-Sep-08	GBP	33.0	58.9		21-Oct-08	XS0386005754
30-Jun-08	CHF	35.0	30.9		21-Oct-08	XS0373976108
29-Aug-08	EUR	200.0	283.5		22-Oct-08	XS0385578827
15-Aug-08	EUR	25.0	35.4		30-Oct-08	XS0383773883
26-Aug-08	EUR	150.0	212.6		31-Oct-08	XS0385078182
10-Sep-08	USD	30.0	30.0		04-Nov-08	XS0387857294
21-Aug-08	EUR	200.0	283.5		28-Nov-08	XS0384664610
20-Aug-08	EUR	20.0	28.3		08-Dec-08	XS0384359146
22-Aug-08	GBP	67.0	119.6		05-Mar-09	XS0384827936
		Total	1,743.35	Weighted Average Maturity	50 days	

Source CPWare, Dealogic

IL&P Current Redemptions

- Based on public information it is quite challenging to ascertain the weekly redemption profile of IL&P
  - However the ECP and term debt redemptions that are publicly disclosed indicate that last week was particularly significant

Irish Life & Permanent Current Redemptions

Maturity Date	Market	Issue Date	Currency	Amount (Local Currency, MM)
Last Week (Week Commencing 15th September)				
19th September	Term Debt	27-Aug-2004	USD	268.0
19th September	Term Debt	18-Mar-2007	EUR	75.0
19th September	Term Debt	30-Nov-2005	USD	760.0
This Week (Week Commencing 22nd September)				
22nd September	Term Debt	22-Mar-2007	EUR	175.0
22nd September	ECP	06-Mar-2008	GBP	4.0
22nd September	ECP	08-Sep-2008	USD	12.0
22nd September	ECP	28-Aug-2008	EUR	15.0
24th September	ECP	04-Aug-2008	EUR	50.0
26th September	Term Debt	23-Mar-2004	USD	5.9
26th September	ECP	31-Jul-2008	EUR	48.0
Week Commencing 29th September				
29th September	ECP	30-Jul-2008	JPY	6,500.0
29th September	ECP	22-Jul-2008	EUR	30.5
30th September	Term Debt	29-Mar-2007	JPY	10,000.0
30th September	ECP	21-Apr-2008	EUR	12.5
1st October	ECP	17-Jul-2008	EUR	27.5
2nd October	Term Debt	02-Oct-2006	EUR	50.0
Week Commencing 6th October				
6th October	ECP	11-Sep-2008	EUR	150.0
7th October	ECP	11-Jul-2008	JPY	55.9
9th October	Term Debt	07-Oct-2003	USD	6.3
11th October	ECP	08-Aug-2008	EUR	15.0

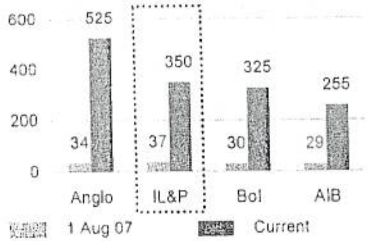
IL&P Term Funding

- We anticipate that term funding markets for banks rated below AA will remain dislocated with periods of significant volatility and continued high spreads in the coming months
- IL&P's senior CDS has widened considerably in recent months and is currently quoted at 330/370 in 5 years
- IL&P has a €15 Bn Euro Medium Term Note Programme, but unlike the other large Irish banks it does not have access to the US markets for term debt via a debt shelf

Irish Banks CDS Spreads

5-Year Senior Unsecured

Mid, bps

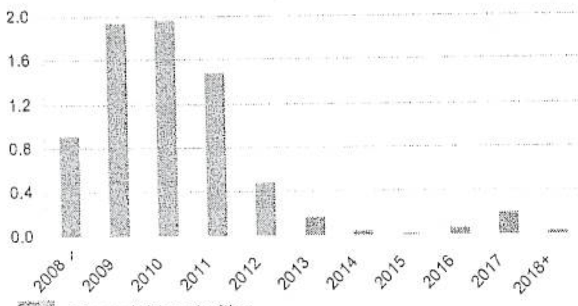


Source Morgan Stanley as of 19 September 2008

Morgan Stanley

Irish Life & Permanent Term Debt Redemptions

EUR Equiv., Bn

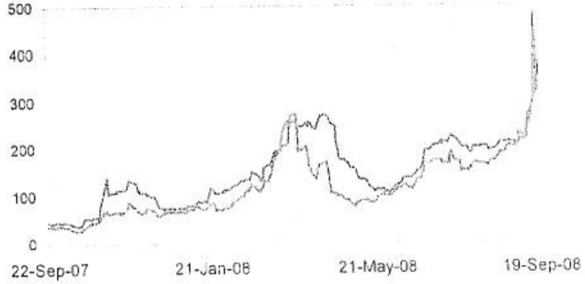


Notes Bloomberg, Securitsations are not included

IL&P CDS Performance [3]

Last 12 Months

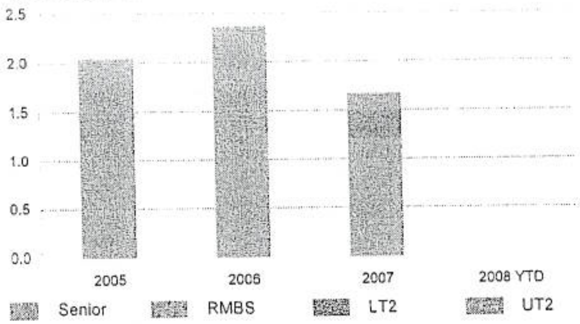
Bps



Source Markit as of 19 September 2008, Morgan Stanley Trading

Irish Life & Permanent Public Term Debt Issuance [2]

EUR Equiv., Bn

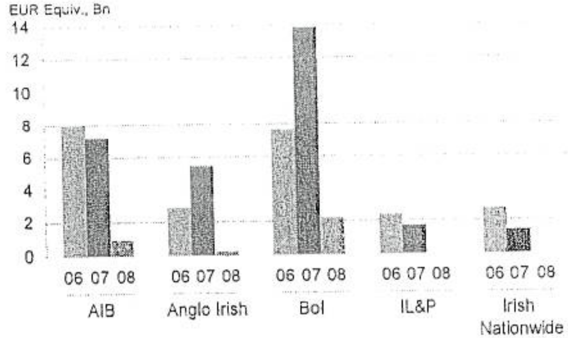


Source Morgan Stanley, Dealogic

Irish Financial Institutions' Historical Debt Issuance Volumes

2005-2008 YTD

EUR Equiv., Bn



Source Dealogic

Notes

1. 2008 redemptions remaining as at 20th September
2. USD 250mm equivalent or greater
3. IL&P CDS data from Markit, adjusted per Morgan Stanley Trading data as of 19 September 2008

- In late August we received detailed investor feedback on Irish bank names from the Morgan Stanley sales team
- Whilst some investors would be able to look at the larger institutions, in general there is limited appetite for new issues from Irish banks

Debt Investor Commentary

European Term Debt Investor Feedback on Irish Banks

As of 22nd August

[redacted]

- No lines for Irish banks.
- Highly sceptical on Irish banks.
- No to Irish banks.
- OK on Irish names, but only for small size portfolio diversification. Only in fixed rate Euros.
- No interest in Irish names.
- Have a line for several Irish names, but have a natural bias towards AA rated issuers. Prefers 3 - 7 year maturity and EUR but can look at GBP.
- Full on Irish banks.
- No interest in Irish banks.
- Generally interested in AA rated names. Have a line for AIB/BOI. Anglo Irish / IL&P rating too low.
- No interest in Irish banks.
- Will look at Irish banks on a name by name basis. Have a line for AIB, but are full on BOI. Main interest in 2 year Euro FRNs.
- No interest in Irish names unless spreads are very attractive. Generally look at 2 year Euro FRNS.
- Bought the Bank of Ireland 2yr Euro FRN, but the bond underperformed.
- Not fully opposed to Irish names, but not buying short dated senior currently.
- Negative on Ireland.
- Doesn't like Irish names.
- Name specific. No interest in Anglo Irish. AIB and BOI - no interest right now but there will be a time when they will look at them again.
- Not keen on Irish names.
- Not keen on Irish names. Doesn't envision not getting money back, but their credit department probably won't approve for time being.
- No lines for Irish banks.
- No to Irish banks.

Source: Morgan Stanley Sales

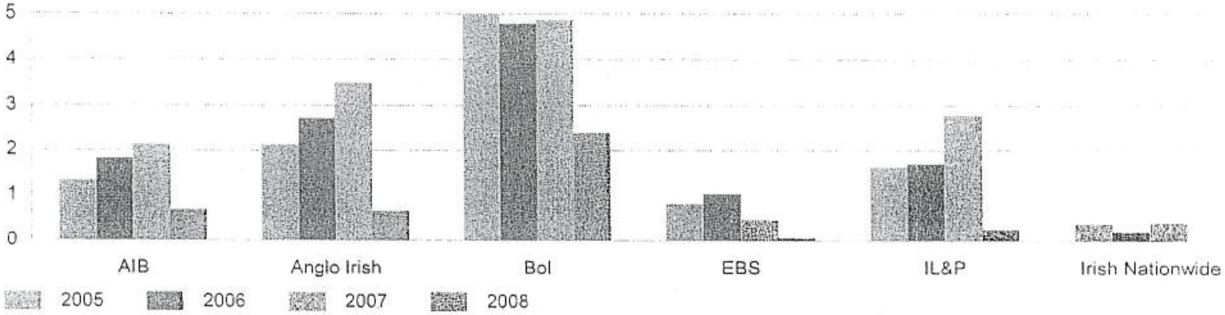
Private Placement Market

- 2008 YTD has seen significantly reduced private placement volumes across all of the Irish banks
  - Demand for structured notes in the market generally is significantly reduced
  - Vanilla private placements are being issued at spreads similar to the public markets
- Even though IL&P is highly flexible in the kinds of structures it can issue in MTN format, unfortunately due to reduced credit appetite and an inability to issue covered bond private placements 2008 volumes have significantly reduced

Irish Banks' Total Private Placement Issuance Levels

2005 – 2008 YTD

EUR equiv., Bn



Source MTN Ware, Dealogic as at 19th September

Irish Life & Permanent's Ability to Issue Private Placements

- Irish Life & Permanent is the most flexible private placement issuer in Ireland in terms of size, structure and maturity and has in the past been able to raise a large proportion of their annual funding needs through structured notes. However, in the recent market dislocation investors have become much more aware of counterparty risk and have been less willing to invest in Irish credits, particularly those with weaker ratings.
- Other Irish issuers have counteracted the fall in senior unsecured private placements through short-dated covered bond private placements to some extent. Irish Life & Permanent does not have a covered bond programme and could therefore not compensate for the shortfall in senior unsecured through covered bond issuance.
- Generally, the conditions for private placements given the current market environment have deteriorated as investors are less inclined to buy illiquid paper. Investors only consider private placements 1) if the issuer pays a generous new issue premium to secondaries or 2) if the particular maturity is not available in the public markets (e.g. 1yr paper) or 3) if they want a tailor-made currency / structure.

Existing IL&P Securitisations

- IL&P currently has 8 RMBS transactions outstanding under its two securitisation programmes
- The deals are each structured as stand-alone transactions and IL&P's ongoing obligations are clearly defined
  - For example, in most structures, IL&P performs various functions (including swap provider) which are subject to ratings downgrade triggers
- Bonds which have been issued since the onset of the market dislocation have been retained and can be used as collateral for the ECB facility if required
- From February 2009, the terms applicable to the ECB Repo Facility will become more onerous
  - Will require third party involvement to utilise UK mortgages under cross-currency / close association rules

Irish Life & Permanent

Existing Securitisations

Vehicle	Principal Amount	Expected Maturity	Publicly Issued	Retained for ECB
Auburn Securities 3 plc.	£400 MM	November 2009	Yes	No
Auburn Securities 4 plc.	£1,000 MM	October 2009	Yes	No
Auburn Securities 5 plc.	£450 MM	November 2010	Yes	No
Auburn Securities 6 plc.	€4,150 MM	November 2010	No	Yes
Auburn Securities 7 plc.	€2,360 MM	August 2045 (1)	No	Yes
Fastnet Securities 2 plc	€2,150 MM	June 2012	Yes	No
Fastnet Securities 3 Ltd	€8,000 MM	November 2049 (1)	No	Yes
Fastnet Securities 4 Ltd	€6,500 MM	June 2013	No	Yes

Notes
1. No coupon step-up

Securitisation Funding

Considerations

- IL&P has already securitised a large portion of its mortgage book and is holding the bonds in reserve
- This may help to address immediate liquidity concerns in the short term
- However, ECB funding is available for a maximum of 6 months only and must be rolled on maturity with pricing set by way of auction
- Existing deals will be subject to the new regime which applies from February 2009
- At present we estimate that IL&P has up to c. €26 Bn of ECB eligible collateral, and the potential to create an additional c. €6 Bn
  - Of this we believe that approx. €11 Bn has been utilised, excluding increased ECB drawings since 1H08
    - As domestic, non-clearing institutions increased their drawings by 25% or €5 Bn in July alone, we expect IL&P to have used some of this capacity

Morgan Stanley

- The securitisation market remains largely closed to new issuance. Accordingly, IL&P would need to access either the ECB Refinancing Facility or market counterparty repos in order to fund their residential mortgage assets
- The terms attaching to market repos have become increasingly onerous since the onset of the credit crunch. On this basis, we would expect IL&P to continue to lean towards the ECB Facility
- At 31 December 2007, IL&P had available to it ECB Eligible Collateral of €17.2Bn (€20Bn nominal collateralised asset pool) against which drawings of €5.3Bn had been made (reduced to €3.9 Bn at 1H08)
  - IL&P has since issued and retained a further €8.9Bn of ECB Eligible Collateral
  - On this basis, and assuming that the residential mortgage book balance is €36.5Bn, we estimate that IL&P has an unencumbered residential mortgage loan book of approx. €6.5Bn against which it should be possible to raise in the region of €4.5-5Bn of ECB Eligible Bonds
- IL&P also has a commercial loan book of approx €2Bn; we estimate that it may be possible to raise a further €1-1.5Bn of ECB Eligible Collateral against these assets (assuming a rating of less than AAA)
- Offset against this is the extent to which assets have been pledged by IL&P in relation to its announced €3 Bn term funding issuance in June / July – potentially c. €4 Bn
- It is important to note that, with effect from February 2009, the eligibility criteria applicable to the ECB Refinancing Facility will become more restrictive:
  - IL&P will not be able to act as cross currency swap counterparty on a securitisation of its own Sterling denominated UK Loans and would need to appoint a third party swap provider (making funding more expensive)
  - The applicable haircuts will increase significantly (up to a maximum of 16.4% from c. 2%)
- Although the changes will enter into force on 1 February 2009, there is no reference to existing arrangements being grandfathered and so, while it is not clear, it appears that the changes will apply to all collateral and counterparties (existing and new) as of the effective date

Source IL&P investor Reports; ECB Eligibility Handbook

Key Funding / Liquidity Pressure Points

Key Pressure Points

Instrument / Source	Amount / Data Point	Risk / Issue
Bank Deposits *(ex. ECB etc.)*	€2.3 Bn at FY07	• Stripping out ECB and secured repo funding from bank deposits, IL&P suffered a €1.76 Bn outflow in bank deposits in 2007 • With IL&P's credit rating downgrade since then, this funding source is vulnerable
Other "Bank" Deposits	€2.4 Bn non-ECB secured at FY07 €3.9 Bn ECB at 1H08 (€5.3 Bn at FY07)	• This secured funding is relatively secure, with the ECB funding dependent on continuing provision of existing facilities and non-ECB secured funding primarily a function of price (at least €2 Bn term secured in 1H08, at 115bps spread) • The pressure arising from this funding source is the reduced position of unsecured creditors, which has been commented on by rating agencies in a number of previous situations (e.g. B&B downgrades)
Customer Deposits	€14.6 Bn at 1H08	• IL&P increased customer deposits by €1.0 Bn in 1H08, but signalled that this was achieved with significantly stronger growth in corporate deposits than retail deposits • Corporate deposits, based on UK experience, are highly sensitive to ratings actions / other events due to internal treasury policies etc., and typically short-notice (e.g. B&B lost c. 30% of non-retail deposits in 1H08) • Retail deposits are typically more resilient, but can still react suddenly to negative newsflow, with direct access (i.e. internet and telephone) accounts most vulnerable
Debt Securities	€11.7 Bn at 1H08	• This has reduced from €20.2 Bn at YE07
Term Funding	*c. €9 Bn at 1H08*	• *2H08 is a period of significant pressure for IL&P's term funding, with c. €1.95 Bn of maturities, and minimal issuance possible* • *Late September is an exceptionally challenging period, with c. €1.15 Bn of maturities from 12 September to 22 September*
Commercial Paper	*c. €2.5 Bn at 1H08*	• *IL&P's CP access, both USCP and ECP, has been contracting steadily since the onset of the credit crunch, and the maturity has been shortening*

Potential Options Available

- In the event of IL&P encountering difficulties, there are a range of possible actions that the Government could undertake to lend support
- These would have to be measured against the capacities and objectives of the Government, e.g.
  - Sector stability requirements
  - EU state support rules
  - Financial capacity of State
  - Precedents
  - Moral hazard

Potential Options

Action	Decsription	Advantages	Issues
Provision of Equity Capital	Underwriting of rights issue by State	• Explicit support for institution / sector • Primary responsibility remains with existing shareholders • Relatively small commitment	• Does it address liquidity / funding challenges? • Issue of State support / involvement may alter behaviour
Acquire Loan Books	Purchase mortgage assets direct from IL&P	• Addresses loans to deposits ratio and reduces funding pressure • Also underpins confidence in house prices	• State takes on credit risk • Acquisition of book at a discount may exacerbate concerns / capital impacts • Equal treatment calls from other institutions
Specific Instrument Guarantee	Guarantee new funding to market,e.g. covered bond	• Funding comes from market, not State • Underlines State support and confidence	• State takes on credit risk • Does it prejudice other instruments? • Precedent for other institutions
Funding Guarantee	Explicit promise by State to provide all necessary funding for a period (e.g. 2 yrs)	• Removes immediate liquidity risks • Provides breathing space for restructuring	• Will funding be available for term longer than guarantee? • Does State bear credit risk first, or subordinate existing funding?
Merge Banks	State support, funding or equity, for bank mergers (e.g. Anglo)	• Creation of stronger institutions better positioned to address current environment • Leaves issues primarily with private sector	• Risks of cross-contamination within sector • Will merged entities address funding challenges?
Good Bank / Bad Bank	Statewide institution to acquire problem assets	• Provides clarity for sector / institutions • Allows normal lending to resume in economy	• State bears credit risks • Asset acquisition prices may create capital issues

order to try to tap into new sources of funding. However, the Irish banks are only a small number among many internationally trying to access international funds.

Capital

As of yet the Irish banks have not required captial to bolster balance sheets. There is a perception that if capital was required in the current market they might not be able to access such funds in international markets, or would have to pay such a high premium for such capital that it would affect their credibility in the market. A domestic or international institution would be unlikely to wish to increase or take on exposure to the Irish property market in the current market envirnoment.

Lending

The banks' long term funding dificulties are affecting their lending behaviour, with lending currently extremely tight. Property developers who have not yet begun to repay their loans are being encouraged to raise funds, either by renting out the property, or by selling at a reduced price. New projects are not being started and the pace of completing current developments has decreased. While no immediate problems (ie default) are seen in this area, there are <u>no</u> signs of the current difficulties ending soon. If builders begin to default, and the banks are unable to refinance their exposures, this will have significant consequences for the banks in terms of profits and credit provision, as well as access to funding, and will have a further negative impact on sentiment regarding the Irish market.

Specialist lending (including subprime)

A number of specialist mortgage providers – Start Mortgages, IIB – have withdrawn some of their products from the markets due to difficulties in accessing, and the cxost of, wholesale funding.

Conclusion

Internationally and domestically, financial market conditions have worsened in the last month, and the curent conditions are returning to those experienced during the end of last year – the worst point of the turmoil thus far. The key issue this time is the increasing realisation that markets are not going to improve soon and may even deteriorate further and Irish banks are perceived to be particularly vunerable owing to negative international sentiment towards Ireland generally. The CBFSAI contiunue to monitor the situation, particularly the impacts for Irish banks. The DSG is continuing to work to coordinate inforamtion flows between the Central Bank, the Financial Regulator and the Department of Finance and to strenghten contingecy planning in line with EU requirements.

THEME: C3

Appropriateness and effectiveness of the Department of Finance actions during crisis

LINE OF INQUIRY: C3b

Appropriateness of the bank guarantee decision

Bullet Points for cabinet 28 Sep. 08

Banking crisis globally – US, UK (Bradford and Bingley), Europe (Fortis, Dexia in trouble)

Generalised shortage of liquidity – liquidity being gradually withdrawn from banks all over – Ireland not an exception

Situation exceptionally difficult for some banks, but all affected

Seeking to avoid State intervention – markets may be assisted by US rescue package

But must prepare for worse outcomes – interventions may include:

Buy time by providing short term liquidity, but must nurse our own liquidity

Legislate to guarantee/take control of more troubled institution(s). If this arises it will be emergency legislation, and may have knock on implications for other institutions

Pressure banks to consolidate (may not happen quickly enough)

Any intervention by us will require putting the credibility of Ireland behind institutions – this will probably raise our own funding costs and may seriously strain our ability to raise funds in the market

Governor of Central Bank in touch with ECB

MINISTER FROM D DOYLE

ABOVE SUMMARISE POSITION ON FINANCIAL MARKETS.

AS OF 9 A.M TODAY THE GOVERNOR HAS NOT HEARD FROM TRICHET.

28/9

Statement by An Taoiseach,

Mr. Brian Cowen, TD,

Dáil Éireann,

30th September, 2008.

In recent months, the international financial system has been affected by unprecedented turmoil and dislocation.

Credit markets, which are central to meeting the medium-term funding needs of the financial system, have effectively closed. Inter-bank lending rates have increased very significantly thereby escalating the cost of finance to financial institutions.

Recent developments in the US have created major structural issues for the global financial system. Ireland as a small, highly open economy with a significant financial sector closely integrated in the international financial system cannot be immune from these developments.

It is clear that we are witnessing extraordinary volatile times and the exact extent of the impact of this volatility has yet to fully emerge. It is the job of Government to pursue the establishment of the right context for economic recovery and to deal with whatever new issues come our way with determination and purpose.

Ireland, Anglo-Irish, Irish Life and Permanent, Irish Nationwide and the EBS.

The Government has taken this decision following advice from the Governor of the Central Bank and the Financial Regulator about the impact of the recent international market turmoil on the Irish Banking system.

The guarantee is being provided at a charge to the institutions concerned and will be subject to specific terms and conditions so that the taxpayers' interest can be protected.

The guarantee will cover all existing aforementioned facilities with these institutions and any new such facilities issued from midnight on 29 September 2008, and will expire at midnight on 28 September 2010.

I also wish to confirm to the House that the Financial Regulator has advised that all the financial institutions in Ireland will continue to be subject to normal ongoing regulatory requirements.

The decision taken by Government is designed to remove any uncertainty on the part of counterparties and customers of the six credit institutions. The Government's objective action is to maintain financial stability for the benefit of depositors and businesses. This decision is in the best interests of the Irish economy.

Notes of events occurring on Monday & Tuesday (29th & 30th September 2008) (Dictated, on weekend or 3rd to 5th October)

In the afternoon of Monday the 29th September I received a phone call from Richard Burrows the Governor of the Bank of Ireland. At that stage there was extreme turmoil in the markets particularly in relation to the Anglo share price which was down almost 50%. There have been various feedback between senior members of Management team and various echelons of Government and the Regulator and there was a clear impression (without anything explicit being said) that Anglo was in serious trouble and that the plan of the authorities was to take Anglo and Irish Nationwide (who had different problems) into some sort of State care and provide some sort of support for the remaining four banks.

Richard indicated that he felt that matters were so difficult that we should seek to speak with the Taoiseach and the Minister for Finance. He indicated that even if AIB were not going to attend that Bank of Ireland would be making this approach anyway. I consulted the CEO and we agreed that it would be a good idea to go and speak to the Government given the fraught state of the situation which was compounded, shortly after, by the decision of the House of Representatives not to support the Paulson Plan. Both Richard Burrows and myself had received phone calls from Sean Fitzpatrick during the afternoon of the 29th.

We had a very brief conference call between myself and Richard and the two CEO's; there was very little discussion; what was needed was fairly clear; it was agreed that Richard would set the broader context and I would set the narrower local context but that the technical submissions to the Government would be largely left to the CEO's. We arrived at Government buildings at 21.30pm and an official indicated that what was expected was that we would set out our views on what should be done; we would then be asked to withdraw and the authorities would consider the situation.

Notes of events occurring on Monday & Tuesday (29th & 30th September 2008) (Dictated, on weekend or 3rd to 5th October)

We were given the facility of a room to wait in (what I knew as the new cabinet room) and we were then taken to the conference room immediately adjoining the Taoiseach's office where we were met by the following;

a) The Taoiseach
b) The Minister for Finance
c) The Attorney General
d) The Governor of the Central Bank
e) The Secretary General of the Taoiseach's Department and of the Department of Finance
f) Mr. Cardiff from the Department of Finance
g) Mr. Eugene McCague of Arthur Cox and Company
h) At one stage later in the evening we were joined by Mr. Tony Grimes from the Central Bank and in the later stages of the night when Governor Hurley had to leave, Mr. Grimes took his place.

Richard Burrows gave a brief introduction for a couple of minutes covering the deteriorating national and international situation and then I spoke for a couple of minutes. I had prepared some very rough notes on two pages which I retain. The contextual points I made were as follows:

- The Paulson Plan turned down.
- Rumour on New York Stock Exchange that Irish Stock Exchange would not open the next morning.
- A question from an English newspaper to our press office as to whether our shares were going to be suspended.
- I said that the contagion was spreading from the infected patients to the healthy (the analogy of infected patients [redacted] Oireachtas had been used in various exchanges involving the Central Bank and the Government).

- I indicated that markets were beginning to ask why Irish Nationwide had not been dealt with and why Anglo had not been dealt with; was there some systemic issue in Ireland that prevented them being dealt with; I indicated that the decisive action that had been taken for example in relation to Fortis in Belgium, Holland and Luxembourg and in relation to Dexia also beginning to contrast unfavourably with the absence of action in Ireland.
- I indicated that Irish Nationwide had got under the radar because they had no share price, their bonds were trading at 0.20c on the Euro and their credit default swaps were 27% over Libor.
- If the market believes that all Irish Banks are in some way connected (which they are not) and that the weakness of Anglo and Nationwide, was misunderstood by the market as in some way affecting the stronger banks.
- I indicated that the remedial action which we propose (this had been agreed with Bank of Ireland) was that the sick banks by which I meant Anglo and Nationwide should be taken out, (by which I meant nationalisation) or taken into some sort of administratorship (or some other form of protective custody) and some sort of guarantee provided for the remaining banks; this is not the first time that the Government would have heard this conversation and it had been generated in the course of that day and previous day in conversations between Regulators and AIB as well as other banks.
- I said that there was a danger that if the two weak banks were not dealt decisively, there could be a market conclusion that the authorities here were in denial and that both the guarantee and the taking out of weak banks was needed; the guarantee wasn't certain to work but it had a better chance of working if the two weak banks were taken out.

- The final point I made related to the form of the guarantee; an initial draft had been furnished (I think by Bank of Ireland) and was in a form which we thought was too bare; I mentioned that a guarantee had to read correctly to technical eyes in Foreign Central Banks (I mentioned Peru, Libia and Russia). We furnished a more extensive formula (which we had brought with us) as to the sort of instruments and deposits that should be covered. (This formula was eventually adopted later in the night pretty well word for word).

Eugene Sheehy and Brian Goggin elaborated the suggestions in the current situation. All of this was done at the invitation of the Taoiseach. There was very little response from the official side and we were thanked and asked to withdraw. We went back a number of times during the night but there were long gaps sometimes for an hour up to almost two hours.

When we went back there was more response from the official side, especially from Governor Hurley, the Minister and Secretary General Doyle. Governor Hurley was very clear that it would be dangerous to take down an Institution (and the reference here was clearly to Anglo; Nationwide has in our view deep seated trouble but it was not urgent trouble) in the middle of the week. I specifically remember Governor Hurley saying that it could be "disorderly" and that there could be "a fumble" if it was done mid week. He indicated that the priority was to get to the weekend; things could be dealt with "in an orderly manner". He asked us to indicate what liquidity we could provide to Anglo on Tuesday and for the rest of the week. This was all in the context of a guarantee going to be provided by the Government. We furnished our draft guarantee to the Government at a very early session. We left the meeting and Eugene and I were given a separate room by Mr. Lennon the Taoiseach's programme manager in one of the side corridors. Eugene contacted John O'Donnell and Colm Doherty and the treasury team and I understand Brian Goggin was doing the same with his team.

Notes of events occurring on Monday & Tuesday (29th & 30th September 2008) (Dictated, on weekend or 3rd to 5th October)

After a lot of toing and frowing we came up with a number of formulae which would allow us to extend the liquidity which we could provide to Anglo. Particularly we could bid at an ECB auction the following day provided our collateral was processed by the Central Bank during the night. Mr. Grimes indicated that he would need a billion in the morning for Anglo and 4 billion later in the day. Because the auction was on the following day (Tuesday) if the bids were successful, the funds would not become available until Wednesday. The Central Bank indicated that they had some funds which could be used to supplement ours on the Wednesday. A key requirement is that the Government, the Central Bank or the NTMA would guarantee to return the 5 billion to us on Monday 6th October. A promise from Anglo would not be acceptable.

Eventually it was concluded that AIB and Bank of Ireland could each produce 5 billion to tide Anglo over to the weekend. Before the end of the night steps were taken to start putting the collateral together to allow us to be ready for the ECB bid process in the morning; we would agree that we would bid up and pay a high price to get this extra liquidity on behalf of Anglo.

In the course of the evening Eugene also made another suggestion which had come from our Treasury people namely that non qualifying assets (of which we had about 10 billion) could be used with the NTMA, to provide further liquidity; as I understand it (I may not be fully correct in this) the NTMA would apply a haircut to our collateral, they would give us Government bonds which we would present to the Central Bank which they in turn would present to the ECB which would result in a generation of further liquidity.

Notes of events occurring on Monday & Tuesday (29th & 30th September 2008) (Dictated, on weekend or 3rd to 5th October)

It is certainly the case that Eugene emphasised to the Treasury team that we were to search every nook and cranny for the extra liquidity and come up with the best ideas possible and I am absolutely satisfied that we did this and responded fully to the request from the Governor of the Central Bank made in the presence of the Taoiseach to assemble as much liquidity as we could to help Anglo to the end of the week. This is not withstanding the self evident fact that we were now stretching our own liquidity to help a competitor.

It was all done however on foot of the very clearest representations from the Central Bank Governor made in the presence of the Government (although not endorsed by the Government) that an orderly dealing with Anglo would occur at the weekend. The Government made clear that they were not making any agreement with us simple hearing submissions. And the Government would then make their own decision. The Attorney General said to me personally that I should understand that the Government were not undertaking to do anything with any particular institution and I said I understood that.

During the course of the night we suggested to the authorities that a sentence in their draft statement about the guarantee which said something like "the Financial Regulator has informed the Government that all the Irish Banks are solvent" was probably unnecessary and possibly dangerous in the sense that Anglo shares would be traded on foot of it, which could lead to complications for the Government.

There were some other people present in the corridors or in adjoining rooms who I met. I met Mr. Neary and had a short and fully agreeable personal chat with him (he introduced me to one of his colleagues whose name I don't remember) and I also met Padraig O'Riordan in the corridor who is the Managing Partner of Arthur Cox and as I understand it was part of Mr. McCague's team assisting the State. I gained the impression (and it is only that) that the Government were satisfied with our response on providing liquidity and that at least in principle the decision to provide the guarantee might have been made in advance of our arrival; I am less sure about the position of the Government in relation to saving the two troubled institutions but quite clear that Governor Hurley's request to the Banks was to allow the authorities, time to arrange to take those two institutions into some sort of care.

File Note

Meeting with Financial Regulator 9.30 am 25 September 2008

Attendees :

F.R. Pat Neary, Con Horan, Mary Burke

IL&P Denis Casey, Peter Fitzpatrick

The meeting was arranged at short notice at my request to ensure the F.R. was fully briefed on the dire conditions in credit markets and on the emerging critical situation for our funding. We advised the F.R. that cash markets were closed, that all short term funding with the exception of Irish corporate deposits were being withdrawn as they matured. This situation is not IL&P specific. We advised that at the current rate of outflow we would hit a funding crisis at the end of next week. We had a further store of assets which we could use as collateral - €1.8 billion would be available from 12 October.

F.R. confirmed that the situation was not unique to IL&P. All Irish banks are experiencing outflows. The DOF, Financial Regulator and Central Bank were working to come up with solutions that would protect the Irish banking system. These were big decisions with far reaching consequences. It was essential that what ever decision was made was effective in dealing with the emerging problem.

They asked whether the Minister's statement of the previous weekend offering comfort around the safety of money placed with Irish institutions had helped. We confirmed that while it had provided some comfort to local commercial / corporate depositors it had not been sufficient to persuade international debt providers. We cited an example of a counterparty who told us that he couldn't take an implicit government guarantee to his credit committee.

We discussed whether an explicit guarantee was required and whether this would be effective. We indicated that we thought this was what was needed at this stage. P.N. the scale of such a guarantee would run to €500 billion. We pointed out that the Government didn't have the resources to fund the Irish banking system and that a guarantee was the only viable solution.

P.N. indicated that such a guarantee would come at a price. Banks had done well in the good times. If the State stepped in to underwrite the system now then the taxpayer would expect to participate in the upside in the future. The guarantee was likely to require some surrender of equity. We said the situation had gone beyond protecting equity.

P.N. indicated that decisions would be arrived at imminently that would reshape the banking system in Ireland. He gave us comfort that liquidity support would be available to us to tide us over if that were needed.

[redacted]

Oireachtas L

Denis Casey

25/WB/03

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David K. Drumm
Group Chief Executive

ANGLO IRISH BANK

Strictly Private & Confidential for the attention of the addressee only.

Mr. Patrick Neary
Chief Executive
Financial Regulator
PO Box 9138
College Green
Dublin 2

13 September 2008

Irish Nationwide Building Society

Dear Pat

I refer to our meeting today in relation to the above.

The difficulties currently being faced by the Society in funding itself are likely to worsen. The capital markets are firmly closed to it and it is highly vulnerable to ratings downgrades and negative news flow which in time will erode depositor confidence.

I believe however that the issue is not confined to Irish Nationwide but is in fact a threat to the international perception of the health of the Irish banking sector generally. Therefore it is in the best interests of the country that the matter be dealt with speedily and comprehensively.

I strongly believe that the best solution to this issue is for the Minister to state publicly that no regulated Irish financial institution will be allowed to fail. I fully understand the resistance of the larger players to this measure, as systemic support is already implied in their case.

I want to stress to you again that any solution not involving Anglo Irish Bank will lead to problems in terms of negative perceptions toward our bank. Indeed consideration should be given to the possible negative implications for the other smaller Irish financial institutions.

It is for this reason that I have proposed the solution we discussed and which at your request I have attached in writing.

I look forward to discussing this with you as soon as you have had a chance to consider it.

Yours sincerely

David Drumm
Group Chief Executive

Proposal for Anglo Irish Bank to acquire Irish Nationwide Building Society

A. Financial Structure:

Anglo would acquire a 100% interest in INBS for a consideration equal to the net assets of the Society as ultimately realised.

Consideration for the acquisition would be in the form of Anglo shares, to be paid on final realisation of the net assets. To avoid a 'run' on member deposits in the meantime, a condition would be inserted that a member will only qualify for ultimate payment of their equity interests if they have maintained a (to be determined) minimum balance with the Society for a period of not less than 12 months post acquisition.

Anglo's interest would be held through a wholly owned subsidiary company which is a bankruptcy remote SPV, which is not consolidated into the Anglo Group for the purposes of calculating regulatory capital.

Likewise, the member's equity interest in the Society (the 'General Reserves') will not be consolidated into Anglo's shareholder equity.

B. Minister for Finance role

The Minister would provide support on three levels:

1. To publicly undertake to make up any deficit in net assets after the loan book has been realised and all liabilities (other than members equity) repaid. That is to say, any losses incurred in realising the loan assets will first be absorbed by member's equity (plus any profits accumulating) and then if any loss remains, by the Minister (see illustration attached).

   The Minister could consider putting a (say) two year time limit on this on the basis that any deficit (per audited accounts) could be paid into the SPV by the minister at the end of the period at his option.

2. To provide a funding and liquidity backstop to the SPV to provide cover for any loss of funding. This will be explicit and made public.

3. To provide funding and liquidity 'comfort' to Anglo to cover the risk of any secondary 'contagion' effects. This presumably would be provided by allowing Anglo to use commercial loans as collateral for a backstop liquidity facility. This would not be made public.

Proposal for Anglo Irish Bank to acquire Irish Nationwide Building Society
(Continued from previous page).

C. Anglo's Role

1. To intensively manage the loan book in order to achieve maximum recovery and ultimately to turn all assets into cash, pay all liabilities and return any net surplus to the members in the form of Anglo shares. The Minister's interest could be further protected by a board appointment to the SPV.

2. To effect synergies between the businesses where possible. In this regard Anglo would intend to re-brand the branch network and invest in and thereby enhance the existing retail franchise.

3. Anglo's 'fit' in terms of its relevant skill base and customer relationships bring added value in terms of maximising the outcome for all stakeholders.

NOTE

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7/10/10

27/1MG/38

Briefing for Cabinet Meeting, Sunday 28 September 2008

The Economy

- The economic data which have become available in recent weeks have been very weak. The latest CSO data show that the economy contracted in the first two quarters of this year and was therefore in recession. While the analysis of these data hasn't been completed yet, GDP activity is now expected to contract by around 1½% for this year.

- Combined with external developments over the past week or so - especially in relation to the international financial market difficulties and the continued deterioration in the outlook for many of our trading partners - it is difficult to see where growth will arise for next year. It is unlikely on the external front (through an improvement in exports) and it is almost certain that domestic demand will contract next year (given that housing completions are set to decline further).

- Therefore, while the situation is currently being assessed, it is increasingly likely there will be no growth - and possibly another contraction in activity - next year. Today's memo assumes zero GDP growth for 2009, but the risks to this are very much to the downside.

- The Department of Finance will continue to assess the situation over the coming week or so, bearing in mind that other commentators such as the ESRI and Central Bank will publish revised forecasts shortly. In addition, the IMF will also publish forecasts for growth in our main export markets. At this stage, the indications are that the forecasts from other commentators for Irish growth for next year will be negative.

The Public Finances

- In the Memo to Government of 17 September, it was indicated that a tax shortfall of the order of €6½ billion was likely in 2008. September is a key month for tax revenue and while we do not have full month data yet, early indications suggest that the poor performance in tax receipts witnessed over the summer months is continuing. The end-year call will be finalised in the light of the September outturn and the Department of Finance will publish an updated view on expected tax position on Thursday (2 October) with the publication of the end-quarter Exchequer Returns.

- If this tax shortfall is increased then this will automatically feed into the 2009 base, making the starting position worse.

- Given the weakness in tax receipts this year, particularly in the second-half of the year, it is likely that there will be some further contraction in tax receipts in 2009 <u>on an unchanged policy basis</u>.

- On this basis, tax receipts of the order of €41½ billion, representing around 26% of GNP would be achieved. If that materialised, then this would mean that revenue levels would be somewhere around the 2005/2006 levels.

B3a: Effectiveness of bank's funding and liquidity strategies and risk management Appropriateness of funding sources, mix, maturity profile and cost.

Information Summary (Section 33 AK)

Note: All references are aggregated

Categories of Documents summarised:	Meeting with four covered banks Q4 2009
Time period covered:	Q4 2009

Bates No: CB07442 CB07447 CB07445 CB07444

Minute were prepared by the Central Bank of four meetings held on the same day where the Central Bank reviewed the latest market activities with four of the covered banks and assessed liquidity issues. Each of the minutes looks into the short term liquidity issues that those banks were having. The consensus was that all of the four covered banks were having some concerns about liquidity.

In general, they all had concerns about the deposit base and about the reductions in this deposit base. Those with access to the US market had seen liquidity dry up. All shortfalls were being replaced by ECB funding.

Talks of nationalising two of the covered banks were discussed and the likely impact/risk to the other covered banks that this would have.

24 January 2008

(37)

CONFIDENTIAL

Financial Stability Issues – Scoping Paper

1. Introduction

The purpose of this paper is to identify significant issues relating to the options available to the Irish authorities in the case of a systemic threat to financial stability, as well as consider any issues regarding the structures currently in place to oversee financial stability planning arrangements and also to manage a financial crisis. It examines the legal framework within which any crisis management operations must take place and any possible questions regarding the legal powers available to the Minister and the Central Bank and Financial Services Authority of Ireland (CBFSAI). The paper also includes some analysis of the recent difficulties in the UK financial system, following the experience of Northern Rock and any implications this may have for financial crisis management here. The paper examines these issues by reference to two key scenarios – a financial institution that is solvent but is experiencing liquidity problems and an institution that is insolvent or heading towards insolvency.

This paper focuses on the domestic framework for managing financial stability issues. Work is on-going at EU level on enhancing the effectiveness of the EU stability framework by clarifying the existing arrangements for resolving cross-border financial crises and their use, while stressing the primacy of private sector solutions and minimising moral hazards. Arising from EU requirements there are a number of work streams that need to be addressed by our Domestic Standing Group on Financial Stability (DSG). These include developing a national contingency plan and carrying out a crisis simulation exercise. Ecofin Ministers recently adopted conclusions setting out further steps, at both EU and national levels, for the development of financial stability arrangements. The conclusions include common principles for cross-border financial crisis management and a roadmap for enhancing cooperation and preparedness and for reviewing the tools for crisis prevention, management and resolution. A new EU level MoU between supervisors, central banks and finance ministries will include a common analytical framework for the assessment of systemic implications of a potential crisis to ensure the use of common terminology in assessing the systemic implications of a cross-border financial crisis by relevant authorities and common practical guidelines for crisis management to reflect a common understanding of the steps and procedures that need to be taken in a cross-border crisis situation.

2. Overall approach to crisis management – spectrum from constructive ambiguity to transparency

At the outset it is important to draw attention to variety of approaches that can be taken by the authorities to financial stability planning and contingency planning arrangements for crisis management on a spectrum from constructive ambiguity to complete transparency. A policy of constructive ambiguity towards financial stability planning involves not sharing full information about public authorities' likely actions in a financial crisis, in order to minimise moral hazard. In such circumstances a financial institutions cannot be sure in what circumstances the CBFSAI will intervene and so they are encouraged to monitor and manage risks that might otherwise be ignored if an institution was confident that the CBFSAI would definitely intervene. Transparency regarding the preparations and preparedness of authorities for a financial crisis may help support public confidence in the event of a crisis but it may also constrain authorities' actions in any given crisis due to expectations of their actions. It may also condition or influence public perceptions of the likelihood of a financial stability event.

The authorities in Ireland have practiced constructive ambiguity regarding financial stability planning to date. For the future it would seem appropriate to maintain this approach. However, the existence and ongoing development of the EU framework for crisis management on a cross-border basis provides an opportunity to communicate, as appropriate, the existence of financial stability planning structures in Ireland in line with EU requirements in the interests of greater openness and transparency.

3. Scenario 1 – An institution that is illiquid but solvent

If an institution is experiencing liquidity difficulties[1] and has exhausted any opportunities for accessing liquidity in the wholesale maket the first step should be for it to seek liquidity from the European Central Bank (ECB) in normal operations. This liquidity would of course require eligible collateral. In Ireland, a large proportion of banks balance sheets can be used as collateral for liquidity provision; through for example the use of mortgage backed promissory notes. Intensive use of eligible assets for liquidity under "normal" Eurosystem conditions is likely to be noticed by the market. If this liquidity is not sufficient to restore liquidity to the institution, the institution may approach the CBFSAI for emergency liquidity assistance (ELA). The view of the CBFSAI is that the requirement for the ELA provision to an Irish bank would signify the existence of a serious threat to the long-term sustainability of the financial institution in question because of the 'stigma' that would attach to it. It is important to highlight, therefore, that ELA provision would be an interim measure while urgent consideration was given by all parties to the available options for rescuing the bank.

3.1 CBFSAI role in this situation

The authority responsible for the provision of ELA to an illiquid institution is the CBFSAI. The CBFSAI is preparing a paper outlining the basis, legal powers and other considerations relating to the provision of ELA and this will form an appendix to this paper when completed. On account of the CBFSAI's statutory independence for monetary operations, on behalf of the ESCB, emergency lending would be at a national central bank's own risk and the CBFSAI would therefore advise the Department before providing such assistance. This would take place through, for example, the DSG or other official channels. As the CBFSAI is a member of the ECB, provision of ELA must be reported to the ECB, either *ex post*, or in advance if it exceeds €500mn. The ECB could prohibit the ELA provision if it is deemed to interfere with the single monetary policy. It is very important to note that the CBFSAI is prohibited from providing ELA to an insolvent institution. Therefore if there is any concern that a financial institution seeking ELA is insolvent, the CBFSAI would not be in a position to provide liquidity support without the question of some guarantee arising from the Exchequer. However, it is recognised that this type of assessment is very difficult in a situation of financial stress. The issues that arose in relation to the performance of the Bank of England's Lender of Last Resort function in the case of Northern Rock highlight a number of important issues requiring consideration in the context of the scope for ELA support. These are discussion at Section 3.6 of this paper below.

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[1] For the purposes of this paper, illiquid/illiquidity is taken to be a situation where a financial institution is unable to convert its assets into negotiable instruments that can be used to meet its obligations. Also for the purposes of this paper, insolvent is taken to be a situation whereby an institution has insufficient assets to meet is obligations.

While it is not necessary to make public immediately the provision of ELA, the support would appear on the CBFSAI's balance sheet without referring to the recipient and could therefore prompt unhelpful market speculation, which could exacerbate the financial situation of the individual institution or the market generally. In addition, it seems unlikely that information that an Irish bank was in receipt of ELA would not come into the public domain in any event. The requirement for a PLC to make a disclosure to this effect under Stock Exchange rules also needs examination.

3.2 <u>Department/Minister's role in this situation</u>

Traditionally, it would be considered that the Minister for Finance does not have a specific role when an institution is illiquid but solvent and there is no legal role for the Minister in such an event. However, following the impact of the provision of ELA to Northern Rock in the UK on public confidence in that institution and the financial system generally (see below), it is likely that if the provision of ELA came into the public domain the Minister and the Department would in practical terms very quickly become involved in terms of the management of the potential broader financial stability issue.

Therefore the Minister and Government could quickly find itself in a situation where there was pressure to give assurances that the State was prepared to support the bank in difficulty or provide guarantees to its depositors. Other guarantees which the Minister might consider giving include guarantee to banks regarding interbank lending to pre-empt overall withdrawal of market liquidity and guarantee to CBFSAI regarding losses that may occur on ELA. The broader issue of communication and maintaining confidence in the financial system raises the issue of whether the CBFSAI or the Minister / Government should take the lead communications on financial stability concerns. Consideration needs to be given to the requirement to communicate with the public but also with the international financial community whose assessment of overall financial stability conditions would be expected to be critical to the broader systemic impact of difficulties in any individual financial institution.

The important question also arises in this context what options may be available to the authorities to initiate actions to address its emerging concerns about the bank's liquidity, solvency or stability in advance of a crisis situation emerging into the public domain.

3.3 Impact of ELA provision on confidence in the institution

As the recent liquidity difficulties at Northern Rock have shown, while an institution may be illiquid but solvent, the public perception of a requirement for ELA is that the institution is in trouble and at risk of collapse. The announcement that Northern Rock would receive ELA from the Bank of England triggered a bank run which was only stemmed by the Chancellor's announcement of a 100% guarantee for deposits in Northern Rock. It may be the case that the question of such a guarantee would now arise in any similar situation in Ireland in the future to prevent depositors withdrawing their money once any ELA provision is disclosed to the market.

In circumstances that there may be specific concerns regarding the position of the financial system as a whole in Ireland, on account, for example, of its dependence on property related lending, a further effect of ELA provision on confidence in the financial sector may take place in international wholesale markets, as other banks lose confidence in an institution and are no longer willing to lend to it. This could lead to a general decline in confidence in the Irish financial sector as a whole – depending on the reasons for the ELA provision in the first place – and has the potential to cause a systemic issue even if the initial institution is still solvent and the position of the Irish financial sector is in objective terms sound. As summarised above, in current market conditions, any difficulty in a significant individual Irish bank could be expected to raise very serious concerns regarding the stability of the Irish financial system overall. It is imperative therefore, that a successful resolution is secured at the earliest possible stage in the development of the crisis., and that, as much as possible any guarantee or interbank lending required would be in place in advance of any public knowledge of ELA provision.

3.4 Importance of communication and media management strategy (Department and CBFSAI)

The "Northern Rock effect" demonstrated that communications re any ELA provisions and the deposit protection scheme in place would be vital in the case of a crisis. Statements by the FSA, the Bank of England and the Chancellor that the bank was solvent did not prevent depositors losing confidence in Northern Rock and large queues forming as depositors queued to withdraw their deposits, worsening the liquidity position of Northern Rock even further. The evolution of the Northern Rock crisis in the UK and the information that has subsequently emerged regarding conflicts between the authorities on the resolution of crisis, highlight the case for a swift pre-emptive response to difficulties at the earliest possible stage. The longer the crisis continues the greater the risk of contagion.

A formal crisis communications procedure between the press offices of the three authorities should be established as part of the overall package of crisis management procedures to enhance the effective of public communications. A set of generic "Questions and Answers" documents and templates for media communication could be developed in advance to enhance any pre-emptive response.

3.5 Actions undertaken by the UK authorities following Northern Rock's difficulties

Since Northern Rock difficulties began the UK authorities have taken a number of actions in order to maintain financial stability. These are:

- The Bank of England provided ELA to Northern Rock and also announced that it would provide ELA at the same terms to any other institutions who ran into similar difficulties
- Following the run on Northern Rock deposits the Chancellor announced that all current deposits in Northern Rock would be 100% guaranteed and it was clarified with the UK Treasury that the guarantee extended to Irish depositors and wholesale deposits.
- The level of deposit protection was increased to 100% of the first €35,000 in any account
- The Treasury guarantee was extended to all new deposits, including wholesale deposits, placed in Northern Rock
- Northern Rock customers who withdrew from ISAs in Northern Rock were allowed to keep their tax benefits providing the money was redeposited in an ISA (in Northern Rock or another institution)
- The guarantee was extended to a variety of exisiting and future unsubordinated wholesale obligations.

Arising from this legal advice is required from the Office of the Attorney General on the legal scope available to the Minister to provide an increased level of guarantee if required particularly at short notice (over and above DGS levels).

3.6 CBFSAI's assessment of issues raised by Bank of England that impeded its lender of last resort function

The CBFSAI is currently examining the four legal issues identified by the Bank of England as impeding its lender of last resort function. These are:

- **The Takeover Code**
  This legislation forces takeover bids to be disclosed and sets out a long procedure for takeovers – the Governor of the Bank of England, Mr Mervyn King, said that this prevented him from organising a takeover and presenting it as a "done deal"
- **The Market Abuse Directive**
  This defines what behaviour is considered insider dealing and provides for disclosures to the market – Mr King said this meant that any lending operations to Northern Rock had to be disclosed.
- **The insolvency regime in the Enterprise Act 2002**
  This provides a framework for the winding up of companies – for banks it means that depositors have their accounts frozen. Mr King said that this made it rational for people to queue for their deposits back
- **The Financial Services Compensation Scheme**
  This sets out the rules for the limited guarantees on UK banking deposits – Mr King said that the fact that this only covered up to £35,000 made it more important for people to withdraw their money from Northern Rock.

The Department may need to seek its own legal advice from the Office of the Attorney General in relation to these maters and any potential implications for the Minister/Department, to identify issues and possible options in resolving a financial crisis.

4.Scenario 2: An institution that is insolvent (or approaching insolvency)

If a period of illiquidity continues it is likely that an illiquidity institution will move closer to insolvency. As referred to above, it is important to note that, from the outset, any major financial institution drawing on ELA will be in very serious financial difficulty and is likely to be in need of rescue. A situation that commences as one where an institution has difficulty in converting assets into financial instruments (cash, credit instruments) can deteriorate quickly (e.g. withdrawal of deposits by depositors, reluctance of lenders to provide credit facilities, etc.). In circumstances that liquidity is not freely available, any sustained poorly managed mismatch between the short-term liabilities and the longer-term asset can quickly lead to a situation whereby an institution becomes unable to meet its obligations as they fall due, i.e. it becomes insolvent because of its illiquidity. Furthermore a perception that an institution is in difficulty can lead to the discounting of the value of its assets by the market such that the value of its assets falls below its liabilities. Where lending to the financial institution in question is secured over its assets, any deterioration in asset quality will give rise to increased financial demands from its creditors.

Given the importance of the principle of the precedence of private sector solutions, the first decision is whether the State should take any action to assist an institution at risk of insolvency. Responsibility for maintaining the solvency of an institution lies with its Directors and shareholders should try to ensure that any institution they invest in is solvent and will remain so for the foreseeable future in order to realise profits from their investment. The costs of insolvency should not transfer to the State simply because the institution in question is a bank (or other financial institution). The role of the authorities is to maintain financial stability and not to bailout shareholders of insolvent institutions. Thus the preferred outcome for an insolvent institution may be its failure and subsequent orderly wind-down. However, it may be the case that an institution is considered systemically important, ie the failure of this institution is believed to be likely to have a serious effect on the financial system in general and may thus cause financial instability. An institution of this nature is also described as "too big to fail" (TBTF). If a financial institution is considered TBTF, in order to maintain financial stability overall, it is likely that the State will intervene in order to prevent the failure of that institution. The intervention may take the form of assisting the institution until a private sector buyer can be found (as is happening with Northern Rock) or consideration could be given to taking the institution, or elements of it, into public ownership (See also Appendix 2)

4.1 Definition of systemically important institution (TBTF)

A TBTF financial institution is defined as one whose failure is believed to be likely – both directly through its impact on the real economy and indirectly through the risk that contagion effects will threaten the stability of other financial institutions – to provoke a systemic failure of the financial sector overall. Formally defining an institution as TBTF in advance of any difficulties is not a viable strategy for two main reasons:

i) It would cause moral hazard as the institution expects that the State will intervene and it will be rescued if it should run into difficulties.

ii) The systemic impact of the failure of an institution may vary depending on a number of factors, for example public confidence in the system in general or general financial market conditions. If public confidence is low, the failure of any institution could cause systemic problems and so in this case any institution may be TBTF. Another reason an institution may be systemic important relates to the type of difficulties encountered by the institutions. If there is a perception that this type of difficulties (eg exposure to the property market) is likely to affect more than one institution this could also mean that its failure would have systemic consequences.

The failure of even a small bank which is not systemically important in itself may not be acceptable in certain circumstances because of fear of contagion at a time of market uncertainty or for political deposit protection reasons. Thus the decision to classify an institution as TBTF, indicating that the State is likely to intervene, should be taken on a pragmatic, case-by-case basis in light of prevailing economic and financial circumstances. The information provided by the CBFSAI to the Minister and the Government, assessing the nature and scale of a financial crisis and the importance of the institution in the financial system is of critical importance when designating a financial institution as TBTF. It also needs to be borne in mind that a further lesson from the Northern Rock situation is that the state of public confidence may be such that what, in objective terms, may not be a systemically important financial institution (i.e. one that is TBTF) may need to be treated as one on account of the potential impact of its collapse on public confidence in other financial institutions and the financial sector generally.

4.2 Role of CBFSAI if an institution is insolvent

It is important to note that the CBFSAI is legally prohibited from providing ELA to an insolvent institution. As referred to above, it will be difficult particularly in a crisis situation to differentiate clearly between an illiquid and an institution at risk of insolvency. In any event an illiquid institution can quickly become insolvent. It is therefore essential that there is close co-operation, co-ordination and communication between the three institutions comprising the DSG to ensure that the tools available to manage a crisis situation are effectively deployed in a crisis situation.

The CBFSAI could continue to lend to an insolvent institution if it was given a guarantee or letter of comfort from the Minister / Government. The role of the CBFSAI in lending to an insolvent institution is thus defined by the actions of the Minister for Finance. There are, however, significant issues regarding the Minister's legal powers in this area (see below).

It is also important to note that under Company Law it is the responsibility of the Board to determine whether an institution is in a position to meet its obligations as they arise or not. While the CBFSAI, in discharging its role as lender of last resort, would clearly be involved in intensive monitoring of the financial status of the bank to which it was lending, a decision that the bank had become insolvent and ongoing support required State involvement would take place at the point that the bank was being placed in administration. This highlights the case that early action is required to respond to a situation of financial distress in a bank with a view to achieving a market-based resolution.

4.3 Role/Legal powers of the Minister in this situation

As outlined above, if an insolvent bank sought ELA, the CBFSAI would be legally prohibited from extending it. However, if the bank was systemically important and the Government agreed to extend a guarantee to it liabilities, then this would turn it from an insolvent bank into an illiquid but solvent one (with the State guarantee backing up its capital), so that the CBFSAI could inject liquidity to prevent contagion effects in the wider financial system.

In regard to guarantees, Public Financial Procedures (PFPs) provide that a guarantee may be issued only where there is specific statutory authority to issue such a guarantee. Statutory power to guarantee borrowing is provided under the State Guarantees Act, 1954 (which allows the Minister for Finance to guarantee borrowing by any body named in the Schedule to the Act or added to the Schedule by Government order) or under the specific legislation governing a particular body.

The statutory power to guarantee, whether under the State Guarantees Act, 1954 or other legislation is normally subject to a cash limit above which guarantees cannot be given in respect of a particular body. The use of the State Guarantees Act for guaranteeing borrowing has diminished and the practice now more usually adopted is to provide borrowing and guaranteeing powers in the particular legislation which relates to a specific State body.

"Letters of Comfort" is a somewhat loose term used to describe a form of written assurance to lending institutions or others in relation to borrowing or other financial commitments where there is no statutory power to guarantee or where guarantees up to the statutorily authorised level have already been given. PFPs state that such letters are objectionable as they may be interpreted as imposing a contingent liability on the Exchequer without Dáil approval. Detailed instructions in relation to letters of comfort have been set out in Department of Finance Circular 4/84. The main principle contained in these instructions is that a letter which expressly, or by implication, gives a guarantee or undertaking not already authorised by legislation should not, in any circumstances, be issued. The CBFSAI's view is that a letter of comfort from the Minister to cover the CBFSAI's risks would not be sufficient for the CBFSAI to lend to an insolvent institutions – a comprehensive guarantee would be necessary.

The discussion above would seem to suggest that in order for the Minister to provide the CBFSAI with the guarantee it requires to assist an insolvent institution legislation is required. However, if this legislation is passed in advance the advantages of constructive ambiguity may be lost as it will be clear that the State may "bailout" an insolvent institution. Legislation may also require that the circumstance in which such a letter of comfort be provided are laid out which could cause moral hazard, as institutions would know when and how the State would intervene if they were in difficulty. The existence of such powers in the Statute Book could also compel the Minister to act to save an institution that would otherwise not be saved and reduce the flexibility available to the Minister to deal with any particular institution. It may be the case therefore that the solution is to prepare legislation *ex ante* of a crisis but only enact it if required. The difficulty this raised is that the time frame for dealing with a crisis may be quite limited and the Dáil may not be in session when the legislation was required.

In line with what has taken place in other jurisdictions the existence of explicit legal powers may not be required providing the Minister / Government is in a position to announce the intention to provide the required guarantee / support with the appropriate approval of the Oireachtas in due course either in relation to legislation or through approval for a Vote. The CBFSAI's view is that it would not be able to act on a "promise of a guarantee" given the prohibition on their lending to insolvent institutions.

If the State is to intervene to support an institution it may choose to assist the institution to remain a going concern while a buyer is found, which would require liquidity assistance and the guarantee outlined above. However, another option which may be available to the State is to nationalise the institution. In these circumstances, the State may simply takeover the entire institution or takeover the part of the institution that is in difficulty (creating in effect a "bad bank"). The nationalisation of a bank would be likely to be a temporary measure. If the entire institution was nationalised, it might be then be sold on, after it had recovered from its difficulties. If a "bad bank" was formed then this bad bank might be run off or put in examinership. Any form of nationalisation may require legislation. A number of important legal / constitutional points are likely to arise vis-à-vis shareholders' rights under Company Law in respect of which legal advice is required.

4.4 Principles guiding public intervention

A paper prepared by the Department of Finance in 2005 identified the following as important principles which should guide State intervention to resolve a banking crisis:

- The support given is transparent and public
- The attractiveness and public funding needs of the programme shall be minimised. The economic responsibility of the owners of the bank receiving support should be realised as widely as possible - shareholders should not be protected against losses.
- The terms of the programme should support the efficiency of the banking system and contribute to necessary structural adjustment.
- The State should be afforded the opportunity to participate in any upturn in the fortunes of the rescued entity
- The State should seek value for money
- The State's contribution to the rescue should be remunerated on commercial terms at least

- State support should be conditional - opportunities for exerting leverage from the support should be fully exploited.
- The rescue plan must have a good prospect of success and have a high probability of returning to the State any funds provided over the longer term
- Prompt intervention should reduce the cost of intervention and will promote efficiency
- The impact of shareholder interests should be assessed.

There will of course be an inevitable tension between these desiderata and the risk (because of the delay associated) of failure to avert the crisis.

An Ad Hoc Working Group on Financial Stability (ADWG) was established in September 2006 by the ECOFIN Council to explore ways to further develop financial stability arrangements in the EU. The Final Report was presented to the ECOFIN Council. The core of their Final Report, which formed part of the Ecofin Council conclusion in October 2007, is a set of 13 policy recommendations, 9 principles and a detailed strategic roadmap for actions out to 2009 involving action mainly in two areas – extending the 2005 EU Memorandum of Understanding on cooperation in financial crisis situations and developing voluntary cross-border cooperation agreements. The principles, which are to be applied to cross-border financial crises, are listed below:

Common Principles for cross-border financial crisis management

1. The objective of crisis management is to protect the stability of the financial system in all countries involved and in the EU as a whole and to minimise potential harmful economic impacts at the lowest overall collective cost. The objective is not to prevent bank failures.
2. In a crisis situation, primacy will always be given to private sector solutions which as far as possible will build on the financial situation of a banking group as a whole. The management of an ailing institution will be held accountable, shareholders will not be bailed out and creditors and uninsured depositors should expect to face losses.
3. The use of public money to resolve a crisis can never be taken for granted and will only be considered to remedy a serious disturbance in the economy and when overall social benefits are assessed to exceed the cost of recapitalisation at public expense. The circumstances and the timing of a possible public intervention can not be set in advance. Strict and uniform conditions shall be applied to any use of public money.
4. Managing a cross-border crisis is a matter of common interest for all Member States affected. Where a bank group has significant cross-border activities in different Member States, authorities in these countries will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden. If public resources are involved, direct budgetary net costs are shared among affected Member States on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries' supervisory powers.
5. Arrangements and tools for cross-border crisis management will be designed flexibly to allow for adapting to the specific features of a crisis, individual institutions, balance sheet items and markets. Cross-border arrangements will build on effective national arrangements and cooperation between authorities of different countries. Competent authorities in the Member States affected by a crisis should be in a position to promptly

assess the systemic nature of the crisis and its cross-border implications based on common terminology and a common analytical framework.

6. Arrangements for crisis management and crisis resolution will be consistent with the arrangements for supervision and crisis prevention. This consistency particularly refers to the division of responsibilities between authorities and the coordinating role of home country supervisory authorities.
7. Full participation in management and resolution of a crisis will be ensured at an early stage for those Member States that may be affected through individual institutions or infrastructures, taking into account that quick actions may be needed to solve the crisis.
8. Policy actions in the context of crisis management will preserve a level playing field. Especially, any public intervention must comply with EU competition and state-aid rules.
9. The global dimension will be taken into account in financial stability arrangements whenever necessary. Authorities from third countries will be involved where appropriate.

While these type of guiding principles should clearly inform the decision making made in a crisis situation, it needs to be borne in mind that every crisis situation is different and that a rigid adherence to any one principle is unlikely to be consistent with effective and successful crisis management.

4.5 Company Law provisions and the interaction of these provisions and financial stability objectives – difficulties, etc

While it may be desirable to consider a special insolvency regime for dealing with banks this paper simply presents the three courses of action currently available under company law should an institution be insolvent or nearing insolvency.

The Department produced a summary of these provisions which is attached at Appendix I. These three mechanisms are summarised below. The Court Protection route seems to offer the most advantageous approach to dealing with a problem financial institution, if intervention at this level is to be considered.

Appointment of a receiver for all or part of the assets

Receivers are usually appointed by creditors in respect of a charged asset once the conditions (default etc.) specified in the agreement creating the charge for the appointment occur. The receiver's main function is to realise the security for the benefit of the creditor. Appointment of a receiver to a financial institution would immediately erode confidence in its solvency, require supervisory intervention and probably precipitate a request for appointment of either a liquidator or examiner.

Appointment of a liquidator (under three forms of winding up);

There are three form of winding up:

- The members (voluntary winding up of a solvent company)
- The creditors (voluntary winding up of an insolvent company)
- The Courts (compulsory winding up for insolvency or other reasons).

The functions of a liquidator are to wind up the affairs of the company and realise its assets for distribution. The appointment generally puts an end to the directors' powers

The CBFSAI may petition for the winding up of a bank on four grounds:

- that it may be unable to meet its obligations to creditors
- has failed to comply with a direction under S21 of the Central Bank Act (CBA) 1971
- has ceased to carry on banking

- in the interests of depositors.

Liquidation has a number of practical effects:

- It freezes the assets and the transactions of the company;
- It freezes all actions against the company;
- It terminates all contracts of employment;
- Payments to creditors etc. would generally not commence until the liquidator has established the true state of affairs of the company

The appointment of a liquidator is primarily intended to provide for an orderly winding up of a firm's affairs. However this would have serious implications for customers and other users of financial institutions, which are not contemplated in the normal framework for dealing with liquidation. There could be delay or uncertainty in relation to repayment of short term commercial deposits and settlement of other payment transactions. This would have knock on effects on liquidity for both in the payments system and commercial transactions (e.g. ,money held by solicitors and others towards the conclusion of contracts). Given the importance of confidence in the financial services sector, the appointment of a liquidator (or receiver) to one financial institution, would likely lead to financial stability concerns arising in the wider system.

Appointment of an Examiner (Court Protection)

The protection and examination procedure is designed to save all or part of the undertaking and to prevent it being wound up. Only the CBFSAI may apply to the Courts for examinership in the case of a credit institution which is supervised by it. Creditors' rights are restricted from the moment the petition is presented. An application to the Court should demonstrate that the company is insolvent or likely to become so (5 tests are provided) and satisfy the Court that there is a reasonable prospect of ensuring the survival of all or part of the undertaking. The immediate effect of court protection is to provide the company with extensive protection against creditors, claims, realization or repossession of assets against which security was given, liquidation and receivership, from the time of application. While this would freeze the company's transactions, the examiner can be given extensive powers to continue its operations pending the putting in place of the final rescue package. Examinership would mean the closure of the entity until a new owner or other solution is found. This could have serious implications for the overall payment system if the bank is amajor clearing bank. To realise the benefits of examinership a guarantee of deposits may be required.

Where necessary, in order to secure the survival of the company, the examiner may certify liability in respect of certain transactions, thus making them an expense of the examination which would then have priority over other debts of the company. There also may be scope for using the Deposit Guarantee Scheme (DGS) to pay out deposits. It may be possible to maintain some essential banking services during examinership.

Critical Banking Functions

The failure of any bank could have negative impacts on critical banking services such as automated payments and direct debits that are now an integral part of payments systems on which the economy is reliant. It may be possible for certain critical functions to be taken on by another provider but this approach would of necessity be uncertain and ad hoc in nature. Mechanisms to maintain critical banking functions would be important from the point of view of protecting consumers and helping to maintain market and consumer confidence.

The recent UK discussion paper 'Banking reform – protecting depositors – indicates there different approaches to resolving bank difficulties in other countries. The US has a distinct insolvency regime for banks involving wide powers for special administrators appointed to carry out resolutions. These special administrators are generally answerable to the banking regulator rather than the courts. Bridge Banks involves either the transfer of the assets and liabilities of the existing legal entity to a new legal entity or the transfer of the existing legal entity to new openers. The new (bridge) bank would then continue to provide the critical banking functions while either a recapitalisation or a permanent transfer of business to new owners was organised. Some European countries have special arrangements for banks in trouble including provisions for authorities to appoint special or provisional administrators with discretion over the initiation of measures, including the ability to apply them to banks before they are technically insolvent.

In looking to the case for the reform of deposit protection and banking stability systems in Ireland, recent developments in the UK and the subsequent assessment of how the Northern Rock situation might have been better handled, highlight a number of issues for review and examination as follows:

- Does Ireland need a new insolvency mechanism specifically for banks and other credit institutions?
- If it is decided to maintain the legal mechanisms currently available under Company Law are there any reforms that would be desirable?
- Is it clear that examinership is the best available winding down mechanism if the aim of the State is to "rescue" the bank?
- What mechanisms are available to ensure that essential banking services in circumstances that a retail financial institution is the subject of examinerhip or administration.

4.6 Implications of State Aid rules for any actions undertaken to assist an insolvent institution

The EU framework for competition is laid down in Articles 81-89 of the EC Treaty. Article 87(1) declares that "any aid granted by a Member State through State resources in any form whatsoever which distorts or threatens competition...shall...be incompatible with the common market." The EU Commission is responsible for decisions on this issue and must be notified by a Member State of any State aid measures. The Commission's assessment of whether an action is state aid is based on the 'private investor test' – a State measure is State aid if a private investor would not be willing to provide the aid under similar circumstances. Article 87(1) does apply to the banking sector. However, liquidity support for solvent institutions is not considered State Aid.

Article 87(3)(b) provides for a possible derogation for actions taken to "remedy a serious disturbance in the economy of a member state." Thus if measures to deal with a systemic crisis support the whole national financial system and do not duly distort competition and are limited to what is strictly necessary then these measures could be declare compatible with EU competition law. However the Commission takes the view that a crisis at a large bank does not automatically entail derogation.

The conclusions of the Economic and Financial Affairs Council (ECOFIN) meeting 9 October 2007 invites the Commission to "endeavour to clarify when a major banking crisis could be considered by the Commission such as to provoke a 'serious disturbance of the economy' within the meaning of Article 87(3)(b) of the EC Treaty and state aid rules" and "to consider streamlining procedures focusing on how state aid enquires under such critical circumstances can be treated rapidly." The outcome of the Commission's work could have a major impact on the scope for Member States to take action to avert systemic crises.

State Aid and Northern Rock
The European Commission is monitoring the situation regarding the provision of a State guarantee of Northern Rock deposits by the British government. In September a Commission spokesperson said it was too early to tell whether it has State aid implications. The spokesperson also said that the Commission is generally supportive of rescue efforts when there is a systemic risk of collapse and this type of support has a six-month limit and has to be granted on normal market terms so as not to distort competition with other financial institutions. If it lasts over six months, any official aid could not be considered as rescue support and would require a restructuring to be carried out.

On 25 October the UK Chancellor of the Exchequer told MPs that the European Commission had raised no objections to the facility provided to Northern Rock. That suggests it is not being treated as State aid under European rules.

The EU treatment of UK support for Northern Rock will be monitored closely to draw any lessons relating to the possible implications in the area of State aid for the provision of a government guarantee to the CBFSAI to support a financial institution in difficulty, to understand fully the extent to which the terms of any such guarantee are prescribed by the State aid rules and to assess the implications of any positions taken by the European Commission on the UK Government's guarantee of all Northern Rock deposits for any future measures undertaken in order to prevent a systemic crisis.

4.7 Deposit Guarantee Scheme:
The UK public's reaction to the liquidity difficulties at Northern Rock and the UK Chancellor's provision of a 100% guarantee of all deposits in Northern Rock, which has subsequently been extended to include new deposits, has led to calls for a reassessment of the effectiveness of the deposit guarantee arrangements in the EU as a whole under the terms of the EU Deposit Protection Directive. The Ecofin Council, at its meeting on 9 October last, decided on a preliminary set of issues to be analysed and addressed following the recent market turbulence. These include reviewing possible enhancements of the deposit guarantee schemes in the EU. This review is to be undertaken by the Commission and the EU's Financial Services Committee on which Ireland is represented. This review is to report by mid-2008. The work carried out on this review and its conclusions will be important inputs to the process of ensuring that arrangements to safeguard financial stability in Ireland continue to conform to international standards.

The legislation governing the Deposit Guarantee Scheme (DGS) in Ireland is the Deposit Guarantee Directive Regulations which came into force in 1995. Ireland provided the minimum level of protection - €20,000 or 90% of the loss, whichever is the lesser. This is significantly less than the 100% of deposits up to £35,000 now provided in the UK. The UK Chancellor has also stated that he plans to increase this protection to £100,000. However, the UK banking industry has already voiced significant opposition to an increase in deposit protection to this level on account of the funding implications.

An issue arises as to how a payout of the scheme would be funded. Currently the DGS stands at €455 million. However it is likely that the requirement to compensate depositors would be greater than this figure. There is a requirement in the Deposit Guarantee Directive Regulations on the CBFSAI to pay all eligible depositors. The CBFSAI have therefore concluded that it is implied that if the DGS is not sufficient to meet the loss amount the CBFSAI must meet the balance. The Regulations allow the CBFSAI to go back out to credit institutions and seek additional contributions. It is considered though that these contributions are limited to the initial amount in the fund. It is unclear whether, if more than twice the current value of the fund was required, the CBFSAI could or should cover the balance. The question also arises of the pace at which participating credit institutions would be in a position to replenish the DGS fund and the implications for maintaining the attractiveness of Ireland as an investment location for banks, since they can provide services from abroad on a broad basis.

The speed at which deposits can be repaid may be extremely important in maintaining consumer confidence in an institution and may be something that should be examined in the review.

The two possible uses of the DGS identified are:

- to assist illiquid and/or insolvent institutions ie could the deposit protection scheme be used to financially assist a (systemically important) institution?
- to service depositors during an examinership – as discussed above examinership may be the best insolvency proceedings option in the case of an insolvent bank. However, as all assets including deposits would be frozen, could the DGS be used to allow depositors to access (some of) their deposits during the examinership?

The Directive does not seem to explicitly prohibit a fund from having additional responsibilities, so long as it offers that minimum level of protection. However, such an option would have to be considered in the light of State aid rules if its was to be introduced now and would require primary legislation, if it was found feasible to define a purpose that did not conflict with State Aid rules. This issue will of course require further detailed examination.

In developing Ireland's position and contributing to the EU review, it will be necessary to examine what is the appropriate level of deposit protection in Ireland balancing 'moral hazard' and the requirement to maintain confidence in the stability of the financial system; the implications in the case of future financial stability events of the 100% guarantee of deposits in Northern Rock given by the UK Chancellor in order to restore confidence in an institution (or to prevent a 'bank run'); as well as the manner in which deposits are repaid, and particularly the speed at which customers receive their compensation. Consideration is also required of the scope for the DGS to be used to maintain financial stability in ways other than simply repaying deposits in an insolvent institution.

5. Scenario 3: Unclear whether institution is illiquid or insolvent

This paper details two scenarios: (a) bank is illiquid but solvent (section 3), and (b) bank is unequivocally insolvent or unequivocally approaching insolvency (section 4). In periods of normal financial tranquillity, it may be fairly easy to distinguish between these two cases. A third case in which it is uncertain as to whether the bank is merely illiquid or is indeed insolvent may constitute a more realistic scenario. Banks are increasingly involved in financial markets activities either directly through proprietary dealing in financial markets, lending for the purpose of asset purchase by their borrowing clients or through off-balance sheet guarantees and underwriting for financial market participants. In a period of severe financial markets turmoil, it may be very difficult to determine the true worth of the bank's assets including its net contingent assets. A fortiori, it is much more difficult for a central bank or a financial regulator to know whether the bank is just illiquid or has become insolvent, especially in the light of the incentives a bank may have to disguise its true state of health from a central bank or financial regulator.

Given this uncertainty, the central bank may end up making one of the following two judgment calls. Firstly, it may lend to an institution which turns out to be insolvent. This is prohibited according to the general terms and conditions relating in the Documentation on Monetary Policy Instruments and Procedures (CBFSAI, 2005), which says that counterparties must be financially sound. However, the definition of soundness (i.e., subject to at least one form of EU/EEA harmonised supervision) is not especially precise or helpful. In any case, the risk associated with this judgment call may not be in any way damaging to the Bank since, in the case of bankruptcy of the counterparty, the Bank can always sell off the collateral. But the loss to the Bank is not the only consideration. An insolvent bank which succeeds in borrowing from the Bank will almost certainly be tempted to "gamble for resurrection" which could exacerbate the prevailing financial market turmoil and damage the banking system's financial reputation.

The second potential risk consists of refusing to lend to a bank because it wrongly considers it to be insolvent when in reality it is merely illiquid. This is potentially much more serious. The refusal to lend may drive a sound bank into liquidation. This presumes that it cannot get liquidity in the private secondary money market (as many banks are currently finding it hard to do). If it is then unable to meet its obligations to its creditors then one or other of them could petition, successfully, for the winding up of the bank. So a bank could become insolvent under private company law when it is easily solvent under the total liabilities / total assets definition of insolvency relevant to the CBFSAI and IFSRA

Urgent Next Steps

- Seek legal advice from the Office of the Attorney General as a matter of urgency on the legal issues highlighted in this paper.
- Identify and discuss with the CBFSAI key issues that arise in dealing with the emergence of financial difficulties in a systemically significant Irish financial institution.
- Complete preparations for and participate in the DSG's crisis management simulation exercise.
- Prepare crisis management manual for the Department in line with EU requirements.
- Review any specific issues arising to ensure that there is clarity as between the roles and responsibilities of all participants in the national DSG structure including in relation to communication.

Company Law intervention Mechanisms

1 Company Law provides for three forms of external intervention in the running/affairs of an insolvent (or potentially insolvent) company. In ascending order of relevance to a financial institution these are:

- Appointment of a receiver for all or part of the assets;
- Appointment of a liquidator (under three forms of winding up);
- Appointment of an Examiner (Court Protection).

There are also various provisions for appointment of inspectors etc. but in the case of a financial institution, such an appointment would either follow or precipitate the intervention options above. Anyhow, the supervisory powers of the CBFSAI would probably be more relevant and confidential. Company and Banking Law also provide mechanisms for internal reorganisation, transfers of business and mergers, but these are either cumbersome or involve significant time lags. *The Court Protection route seems to offer the most advantageous approach to dealing with a problem financial institution, if intervention at this level is to be considered.*

Appointment of a receiver

2 Receivers are usually appointed by creditors in respect of a charged asset once the conditions (default etc.) specified in the agreement creating the charge for the appointment occur. The receiver's main function is to realise the security for the benefit of the creditor. Such appointments do not need court sanction although the courts also have an implicit power to appoint a receiver e.g. where the security is put in jeopardy or there is a winding up. Where the security relates to all of the assets of the company the receivers powers can extend to the running of the company and the salvage of its viable parts. Appointment of a receiver to a financial institution would immediately erode confidence in its solvency, require supervisory intervention and probably precipitate a request for appointment of either a liquidator or examiner. The CBFSAI does not seem to have explicit powers to appoint a receiver to a credit institution, but receivership per se would not seem to offer any benefits as a form of supervisory intervention. However, some of the powers enjoyed by a receiver might be looked at in the context of any proposal to extend the Bank's supervisory powers to intervene in the direction of a financial institution.

Appointment of a liquidator

3 A liquidator may be appointed for the winding up of a company by

- The members (voluntary winding up of a solvent company)
- The creditors (voluntary winding up of an insolvent company)
- The Courts (compulsory winding up for insolvency or other reasons).

The functions of a liquidator are to wind up the affairs of the company and realise its assets for distribution (S258 Companies Act (CA) 1963). The appointment generally puts an end to the directors' powers (completely so in the case of a Court appointment). The liquidator has considerable powers over the company's assets etc., but many, particularly in relation to settlement with creditors, must be exercised under supervision of the Company's members, creditors or the Court as appropriate. The winding up commences from the time the resolution is passed or the petition is presented to the court. All three forms of winding up are well publicised to creditors, public and authorities.

Members and creditors voluntary winding up

4 The members (shareholders) may by special resolution appoint a liquidator to wind up a company (S251 CA 1963). In the case of a solvent company the only further formalities

are a statement of solvency by the directors (independently verified), notification of the Registrar of Companies and a public notice. If the company is insolvent, an ordinary resolution is all that is required but there must be a publicly advertised creditors' meeting on the day the resolution is proposed to be voted or the following day. The creditors are entitled to appoint the liquidator and a committee of inspection to fix his remuneration and oversee the winding up. Neither course precludes application to the Court either on specific points of the liquidation or for a compulsory winding up. Ss 49 and 50 Of the Central Bank Act (CBA) 1989 provide that the CBFSAI is entitled to receive any documents etc. which are required to be sent to creditors and to be represented on any committee of inspection in any winding up of a license holder (i.e. bank) or former license holder. S 109 of the Building Societies Act (BSA) 1989 applies the company law and CBFSAI provisions to liquidation of Building Societies.

Compulsory winding up under a Court appointed liquidator

5 The company, any creditor, the M/ETE (following an inspection report) and any member or contributory (a person liable to contribute to the assets in the event of its being wound up) may petition the Court for the winding up of a company (S215 CA 1983). The grounds on which the Court may order a winding up sets out in S213 CA 163 but the most common reason is inability to pay its debts (e.g. Revenue cases). This status is deemed to exist if a judgment order is returned unsatisfied or if a creditor owed more than £1000 is unable to secure payment, security or compounding of the debt within 3 weeks (S 214 CA 1963).

6 The CBFSAI is entitled to prior notice and a hearing in relation to any petition to wind up a bank The Bank may also petition for the winding up of a bank on four grounds i.e. that it may be unable to meet its obligations to creditors, has failed to comply with a direction under S21 of the CBA 1971, has ceased to carry on banking, or in the interests of depositors. Where a bank is being wound up voluntarily the Bank may also apply on these grounds to have it wound up by the Court (S48 CBA 1989). The Bank has similar powers in relation to Building Societies (S 1 09 BSA 1989).

7 The court has wide powers in relation to the appointment of a liquidator and may terminate or vary the appointment and appoint a provisional liquidator (to secure the assets pending liquidation). The official liquidator is an officer of the Court and has extensive powers (subject to Court control). Usually the Court directs him to call a creditors meeting and to set a timetable for various phases of the winding up process. The appointment does not prevent the appointment of a receiver in respect of charged assets but it restricts the receiver's powers to manage the business or enter into contracts binding the company.

8 From a practical point of view a liquidation has a number of important effects:

- It freezes the assets and the transactions of the company;
- It freezes all actions against the company;
- It terminates all contracts of employment;
- It invokes the fraudulent preference rule in relation to certain payments, floating charges and other securities and transactions effected in the previous 6 months.
- Payments to creditors etc. would generally not commence until the liquidator has established the true state of affairs of the company

9 In the case of a financial institution these practical difficulties would have important implications. There could be delay or uncertainty in relation to repayment of short term commercial deposits and settlement of other payment transactions. The liquidity of the institution would also be affected by the triggering of cross-default clauses in long term debt instruments which would render them immediately repayable, while it would be unable to raise

funds on any commercial basis, thus increasing the level of uncertainty for creditors. This would have knock on effects on liquidity both in the payments system and for commercial transactions (e.g. money held by solicitors and others towards the conclusion of contracts). The value and nature of assets (loans, securities derivatives etc.) and liabilities (e.g. debt instruments) could both be difficult to determine and adversely affected by the appointment of the liquidator. Termination of employment contracts could affect the availability of useful personnel to the liquidator (particularly in the areas of dealing with depositors and collection of assets/loan repayments from creditors).

10 While these adverse implications could be minimised by delaying liquidation until there had been an orderly run down of the business (deposit and lending bases) and/or its reliance on short term deposits, significant funding might have to be provided to replace the volatile commercial deposits. In those circumstances any transfer of property (or security given) in respect of that funding could be rendered void if this took place within the previous six months and the company was insolvent (i.e. unable to meet its liabilities as they arose) at the time (S286 CA 1963). The CBFSAI, as funder would then become an unsecured creditor, whose dividend would depend on the outcome of the winding up. Any decision to provide financial support (other than temporary liquidity to an otherwise very sound institution) would have to have regard to the likely outcome of a liquidation. *In the case of an institution with a strong retail deposit base would an intervention which effectively met 100 per cent of the liabilities of commercial depositors before liquidation either prejudice the use of the deposit protection scheme to meet the liabilities to small depositors, or give them grounds to claim unfair treatment?*

Appointment of an Examiner (court protection)

11 The protection and examination procedure is designed to save all or part of the undertaking and to prevent it being wound up. The Company, its directors, shareholders or creditors may apply to the Court to have an examiner appointed to the Company. However, only the CBFSAI may apply in the case of a credit institution which is supervised by it (this seems to exclude Building Societies). Creditors' rights are restricted from the moment the petition is presented. An application to the Court should:

- be in good faith and factually accurate;
- be supported by good reasons why the examiner should be appointed;
- be supported by a report of an independent accountant (although in exceptional cases the court may postpone this for up to 10 days);
- demonstrate that the company is insolvent or likely to become so (5 tests are provided);
- satisfy the Court that there is a reasonable prospect of ensuring the survival of all or part of the undertaking.

The CBFSAI do not consider that their supervisory data would be detailed enough/suitable to establish viability or to support the independent accountant's report to support its application as it would not reflect the difficulties the institution is experiencing,

12 The immediate effect of court protection is to provide the company with extensive protection against creditors, claims, realization or repossession of assets against which security was given, liquidation and receivership, from the time of application Shareholders and directors may continue to exercise their rights and functions but the Court may give directions in relation to the conduct of the company's business, including restriction of the directors' powers. The granting of protection and the appointment of the examiner must be notified to the Companies Office and the creditors etc. and advertised within specified time limits.

13 The examiner has 2 principal functions:

- To examine the affairs of the company and to report back to the court (within 3 weeks of his appointment), and
- To seek to put together a scheme to ensure the company's survival to report back to the Court (within 6 weeks of his appointment).

The Court may extend the above time limits. Also the Court must be immediately informed of any irregularities in the company's affairs found by the examiner. If the conclusions of the initial report are adverse the Court may make such orders as it sees fit including a winding up order. If the conclusions are that all or part of the company can survive, that a scheme would facilitate this, and that to do so would be more advantageous than a winding up , the examiner prepares his proposed scheme for the survival of the company and presents it to the Court, and then to the various classes of creditors etc. Once the latter have agreed to the scheme the Court confirms it and it may be implemented.

14 In the case of a credit institution Court protection would offer a number of advantages. While it would freeze the company's transactions, the examiner can be given extensive powers to continue its operations pending the putting in place of the final rescue package. Where necessary, in order to secure the survival of the company, the examiner may certify liability in respect of certain transactions, thus making them an expense of the examination which would then have priority over other debts of the company. *These powers could presumably be granted immediately if the Bank's application were able to demonstrate the ultimate viability of the business, the availability of appropriate funding and measures to reduce or control the risks of prejudicing the position of other classes of creditor.* Holders of subordinated debt instruments or long term deposits would remain restricted in relation to demanding immediate repayment e.g. under cross default clauses in their agreements. This could allow the repayment of deposits and the settlement of payments as they fall when due, thus minimising the short term liquidity problems associated with a liquidation.

Appointment of Inspectors or intervention of the Director of Corporate Enforcement

15 The Companies Acts provide for various powers of direct or Court ordered investigations into the affairs of a company. However, their scope is confined to investigation of breaches of Company Law. Obviously, an inspection of this nature could not be ruled out if breaches of Company Law came to light during other interventions to rescue a financial institution. An early intervention of this nature would have the effect of damaging confidence in the institution and offers less scope for dealing with its banking business than a direction by the Bank (under S 21 CBA 1971). Interventions of this nature would not help directly in a rescue or salvage of a credit institution, although it may be a necessary accompaniment if public funds were being committed.

Structural Changes to the Company

16 The vast majority of structural changes to a company (e.g. reduction or issue of share capital, mergers, change of purpose and often sale of major assets require as a minimum the prior approval of the shareholders by special resolution. In the case of a credit institution which is a publicly quoted company the time scale for effecting such a change, and the need to obtain it to shareholder approval on both sides (or legislative authority in the case of the State), would to limit the scope for use of such mechanisms to restore confidence in its solvency, or to effect

urgent changes in its operations. Similarly, these requirements would seem to preclude an arrangement with whereby rescue funding would be provided (by the State or another company) in exchange for share capital.

17 The situation in the case of an unquoted or subsidiary company would be slightly better. The directors or owners could presumably take some remedial actions before the need for them became public. In some circumstances this might require a direction from the CBFSAI. In the case of subsidiary company, sale to a third party could also be agreed if it were within the powers of both sides (i.e. directors of the companies involved) or in the expectation of subsequent shareholder sanction. This course would not be without risk to the survival/reputation of the parent company, particularly if a clean break were not possible or a liquidation by the new owners followed immediately. It would still be dependent on a clear plan for dealing with the problems of the affected institution, and a contingency plan to support the parent if it were a financial institution

18 The course outlined at par 17 was followed when the State acquired the insolvent ICI from AIB in 1985 and put it into administration under the Insurance Acts, with funding effectively provided by AIB and the banking system under parallel and subsequent agreements. (Shareholder and legislative cover was given retrospectively.) Similarly, the State acquired a share holding in Irish Life in 1939 by facilitating the merger of a number of insolvent life companies and making up the deficit on policyholders funds (The Insurance Act 1939 provided for the Minister's holding and confirmed the arrangement) However, the relevance of these models to a credit institution is limited. Insurance liabilities are generally long term while most credit institutions are heavily dependent on short term deposits. Also, unlike non-repayment of deposits, delays in or partial settlement of insurance claims would have little or no systematic effects on payment systems or liquidity in the banking system.

Stock Exchange considerations

19 In the case of a listed institution, the Stock Exchange would have to be informed, by the affected company, of any development which would have a material impact on its share price. This greatly complicates any effort to rescue the institution from its difficulties. Any solvency or structural liquidity problems affecting the credit rating or borrowing terms of a credit institution would presumably have implications for the share price of the institution (or its parent in the case of a subsidiary) and would certainly have to be reported. While it is not clear if liquidity support alone would need to be reported, this is probably academic as the underlying problem (e.g. balance sheet exposure, management change) would still have to be reported. The 24 hours time limit for reporting these development would effectively set the time frame for putting in place support/remedial measures *While it might be possible to empower the CBFSAI to override or grant an exemption from this reporting requirement, this would seem undesirable. The side effects could include downgrading the overall standing of CBFSAI shares relative to other companies, placing the CBFSAI in an awkward position as supervisor of the Stock Exchange, and accusations of providing excessive comfort for credit institutions. The current position of leaving it to the company to balance the risk of not reporting against the risk of prejudicing remedial measures may be the lesser evil.*

Some Tentative Assumptions and Conclusions

- *Intervention should only be considered where difficulties for the banking and/or payment systems are foreseen arising from serious problems likely to affect the long term liquidity or the balance sheet of a credit institution.*

- *Where the institution is substantially viable (or has a significant "goodwill value') a market solution (takeover or merger) may be the preferred option or the target of any short term intervention.*

- *Company law intervention would of its nature only from part of any package to assist a troubled financial institution, and would probably accompany or follow measures to support its liquidity.*

- *The Court Protection (Examinership) procedure seems to offer the least difficulties and most advantages of all the procedures except possibly in the case of dire insolvency.*

- *If Court Protection is recognised as the most useful of the tools available there may be scope for fine tuning aspects of the legislation governing the initiation of the process (e.g. use of CBFSAI data) to render it more user friendly.*

- *It is doubtful if an effective form of support or supervisory action (intermediate between short term liquidity support and company law intervention) could be devised which would enable a credit institution to continue trading in a normal or near normal manner.*

- *There is a need to explore further the nature of deposits as liabilities of a credit institution and the related question of when or if a liquidity problem affecting their repayment on time would constitute insolvency (as in unable to meet liabilities as they fall due).*

Goodhart approach to deposit protection

Charles Goodhart, Emeritus Professor of Banking and Finance, LSE, has recently advocated an alternative approach to the protection of depositors than the deposit protection schemes currently in place in the US and elsewhere. He argues that on receipt of evidence that a bank cannot meet its due commitments, or can do so only by persistent recourse to the Bank of England for Lender of Last Resort support, and on receipt of a letter from the Governor of the Bank of England to the effect that failure of that bank would probably have contagious consequences, the Chancellor should have the power to nationalise the bank on a temporary basis (with a maximum horizon of perhaps two years).

Once it is nationalised, the Chancellor would be expected, but not obligated, to dismiss senior management. All deposits, irrespective of currency denomination, location or counterparty would be guaranteed but no dividends or interest on subordinated debt would be paid during the temporary nationalisation.

At, or before, the two-year horizon, the Chancellor would be required to hold an open auction to sell the bank back to the private sector, although some potential bidders might have to be prevented on competition grounds. With the auction proceeds, the Government would first be repaid for any losses in making good on the guarantees and then the remaining creditors, debt and equity holders would be paid off in strict order of seniority.

An advantage of this approach would be that no additional deposit insurance or extra regulation would be required. Crucially the scheme would penalise those who make the poor decisions: the bank managers and their shareholders. Professor Goodhart acknowledges the difficulty for governments in penalising shareholders for managerial errors, since they include charities, pensioners, voters and other worthy people.

25/JAN/99

Draft Material for use by Government Senators in Seanad Debate – 8 October 2008

Government Decision to safeguard the Irish Banking System

The Guarantee arrangements:

- The Government, following the advice of the Central Bank and Financial Regulator, decided to guarantee the retail, wholesale, dated term debt, secured borrowings and interbank deposits of the six domestic credit institutions (AIB, BoI, Anglo-Irish, Irish Life and Permanent, Irish Nationwide, EBS).

- In taking this action the Government is acting first and foremost in the interest of the stability of the Irish economy and the long term interest of the taxpayer. A secure and stable financial sector is essential for the Irish economy and it is in the best interests of the Irish people.

- It is important to note that this guarantee is intended to secure the funding of these institutions. Equity investors and those holding junior debt will take first charge on the risk of any losses in these institutions over time under the guarantee provided by the State is not intended to insulate them from the risks that they have taken on.

- The measure is being taken as a response to the severe dislocation in the international credit markets, which has impacted worldwide.

- Since the onset of the current period of turmoil in 2007, the Government has stressed its commitment to the stability of the Irish financial system. The Minister has highlighted in recent weeks that money placed with an Irish credit institution would not be placed at risk.

Legislation

The President signed the Credit Institutions (Financial Services) Bill to give effect to the Government decision last Thursday after it was debated in the Dáil and amended in this House.

Extent of financial exposure of taxpayers

- It is important to stress that the risk of any potential financial exposure is significantly mitigated by a very substantial buffer made up of the equity and near-equity (high yielding subordinated debt). There is, therefore, a significant buffer before there is any question of credit impairments impacting on the Exchequer on foot of the guarantee.

- The asset quality in our financial institutions is good with a strong concentration in residential mortgages with a relatively low loan-to-value ratio (LTV) on average. While Ireland along with all developed economies has experienced a sharp decline in its property market there is very significant capacity within the institutions to absorb any losses.

Protections in place for Irish Taxpayers:

- Firstly, I would stress that this guarantee was not given lightly. It was informed by the strong advice of the Central Bank and Financial Regulator that on account of unprecedented disruption in international financial markets the system-wide State guarantee was required to
  - ensure that Irish financial institutions has access to the normal liquidity and funding to effectively operate their day-to-day business
  - provide confidence to depositors and wholesale lenders that they should continue to transact their business as usual with the institutions concerned.

- The interests of taxpayers will be very firmly safeguarded from any risk of loss form the very substantial warranty that the State is now providing.

- The scheme which is to be brought forward to implement the Act will set out the specific terms and conditions, including fees, in relation to a guarantee provided.

- On foot of a Seanad amendment brought forward by the Minister for Finance, the draft scheme must be approved by a resolution of the Houses under section 6(5) of the Act.

- The intensified scrutiny and oversight of financial institutions which has been put in place since the onset of the current turmoil will be maintained and strengthened further to ensure that high regulatory standards are achieved in Ireland and that the quality of corporate governance in these institutions is a bulwark against any risk of loss for the State.

- As far as the question of 'moral hazard' is concerned, it will be a priority for the Government to ensure that the highest regulatory standards and standards of corporate governance apply in all of the institutions concerned including in relation to lending practices to safeguard the interests of taxpayers against any risk of financial loss

Possibility of a return to Taxpayers from this intervention

- This guarantee will not be a free lunch. Legislation which is to be brought forward to underpin this guarantee will provide for specific terms and conditions, including fees, in relation to a guarantee provided.

- In taking this action the Government is acting first and foremost in the interest of the stability of the Irish economy and the long term interest of the taxpayer.

- A secure and stable financial sector is essential for the Irish economy and it is in the best interests of the Irish people.

- The protection of taxpayers' interests is the primary focus of this measure.

- If the guarantee is not called upon, the Exchequer will benefit to the extent of the charges received from the institutions.

Benefits to the Government for the guarantee:

- The first and most important point to be made is that the measure helps secure the stability of the Irish banking system. As is clear from the impact of the international credit crunch on the Irish economy, the financial system overall plays a central role in the economy and in the day-to-day lives of ordinary people.

- So the Government's objective for the guarantee is to stabilise the Irish financial system as much as possible against the backdrop of the very uncertain and volatile international environment at present so that individuals and businesses can transact their normal financial business in a normal way.

- The Government's announcement makes clear that the guarantee will be provided at a charge to the institutions concerned and will be subject to specific terms and conditions so that the taxpayers' interest can be safeguarded.

- The Minister of Finance will be drawing on the advice of the Central Bank and NTMA to put a fee mechanism in place to pay for the guarantee taking into account such factors as the possibility of increased funding costs for the Exchequer, the economic value for the institutions and need to support the investor confidence in the Irish financial system overall.

- In current highly abnormal market conditions it is not considered useful to speculate on what might be described as commercial rates for the guarantee. It is important to be clear that it is only the State that could provide such a warranty; no market mechanism would of course provide it.

- The State in its approach to costing the guarantee will wish to take all relevant factors into account including to ensure that in the medium-term the Irish economy supports a strong and viable banking system, the benefit and value it creates for the financial sector and above all else that the Exchequer suffers no financial loss from having provided it.

(5)

International Economic Consultants

Indecon

Strictly Personal and Confidential
Addressee Only

STRICTLY CONFIDENTIAL

Mr. Kevin Cardiff,
Second Secretary,
Department of Finance,
Government Buildings,
Upper Merrion Street,
Dublin 2.

20th October, 2008

RE: Risk Management and Exit Strategy Re Government Guarantee

Dear Kevin,

I know that having just prepared the terms of the Scheme underpinning the Government Guarantee it is hard to have to now focus on starting the effective risk management for the Guarantee and the exit strategy. However, as I know you are aware, the day we give a time limited guarantee is the day we need to plan for exiting.

To that end I have been thinking fundamentally about what are the key elements of this risk management strategy. (These are in addition to the ongoing regulatory process issues of effective monitoring, assessment, quantification and control of conduct). In this context I think it is worthwhile to consider what strategies may or may not be needed and in this context it is useful to consider three different possible strategies, namely:

- Actions to increase the capitalisation of the Irish institutions
- Actions to reduce capital requirements by increasing availability of liquidity
- Actions to reduce capital requirements by reduced lending in certain institutions.

I attach my thoughts on the specifics of each of these which I have sent to John Hurley and Jim Farrell but I thought you should see these on a confidential basis. (I have also sent these on a personal basis to David Doyle).

It is important to stress that these actions may to some extent be alternatives and for example the need for any additional capital will depend on the level of lending, the level of liquidity and how the loan books perform. Some of these actions might also not be needed if the world's markets returned to one whereby corporate and inter bank funding was readily available to the Irish banks but my judgement is that this is unlikely and cannot be basis for prudent planning.

I hope this is of help.

Kind personal regards,

Yours sincerely,

Alan

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Managing Partner

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POSSIBLE OPTIONS RE RISK MANAGEMENT AND EXIT STRATEGY RE GOVERNMENT GUARANTEE

1. INCREASES CAPITAL IN IRISH INSTITUTIONS

	Options	*Comments*
1.1	Facilitate or incentivise sale of specific institutions to either international or Irish institutions who have greater levels of capital or better access to retail or inter bank funding	Smaller institutions in particular should be actively encouraged to consider this option although it is accepted that this is a very difficult time to foster such transactions but this merits ongoing priority.
1.2	Restrictions on Dividends	Appropriate for certain institutions but will impact on share values. The benefits of the Guarantee in terms of potentially lower funding costs could increase profits greater than would have been the case. This with dividend restrictions will result in some increase in capital in the banks.
1.3	Sale of Selected Parts of Bank Businesses including Consideration of Sale of International Operations	Should be actively encouraged in certain institutions.
1.4	Rights issue by Irish Banks	Should be pursued in discussion with banks but likely to be very difficult.
1.5	Partial State capital injection from NPRF or other sources in exchange for preference equity shares	May or may not ultimately be needed but this needs careful consideration. May be worth thinking of merits or otherwise of a joint state-private sector preference share injection. Detailed planning needed.
1.6	Nationalisation and State Capital Injection	Believe this is least beneficial option but may ultimately be required as a last resort.

2. REDUCE CAPITAL REQUIREMENTS BY INCREASING AVAILABILITY OF LIQUIDITY

	Options	*Comments*
2.1	Changes in ECB Eligibility Criteria	Liquidity problem is now a global issue and ECB responses merit renewed attention.
2.2	Packaging of Assets to Meet ECB Eligibility Criteria	This will take time and require ratings which may be difficult. Not all assets will be eligible but this should be pursued.
2.3	Improve Perceptions of Future Loan Deficits	This could potentially be achieved by increasing provisions but this has risks although some increases in provisions will be needed. Better information available to the market may also be desirable. However, mistake to think this on its own will solve the problem.
2.4	Facilitating Banks to Convert Lending to Commercial Developers into Residential Mortgages which are ECB eligible	This would increase liquidity and also has merits in reducing risk. Innovative ways of facilitating this should be considered.
2.5	Wider EU Action to Increase Availability of Liquidity	Merits increased attention at EU level.
2.6	Increase in the Levels of Deposits of €100,000 or less in Irish institutions	This should be actively pursued by Banks and facilitated by regulations as the funding guarantee will remain on deposits below €100,000 and so these funds are less mobile.

3. REDUCE CAPITAL REQUIREMENTS BY REDUCING LEVELS OF LENDING

	Options	*Comments*
3.1	Restrictions on Future Lending	If increased capital or increased liquidity is not secured such restrictions may be necessary but this will impact on wider economy.
3.2	Active Management to Reduce Loan Book	This is essential and should be carefully monitored.
3.3	Incentivise Selected Large Commercial Borrowers of Banks to Repay Loans at Discounted Levels	Some commercial borrowers may have credit lines internationally or may have options to sell assets to repay loans but may not have any incentive to do so. It might be appropriate for certain banks to offer discounts for early repayment of loans including reductions on the principal amounts.
3.4	Sale of Parts of Loan Book to Other Institutions	This may not be feasible in certain cases but requires active management.

19

SCENARIO

"PROTECTION"

CONTROL

GOING CONCERN BASIS

PROPERTY RIGHTS ADDRESSED

LEGISLATION REQUIRED

RECALL DAIL AND SEANAD

3 STAGES DAIL
SAME SEANAD
URGENCY MOTION
PRES SIGNS

interim stage.

CAN BE FAST, BUT THERE IS A TIME FRAME

PHASES OF ACTION

need for ELA - tipping point
what cash level = trigger?

DISTRESS PHASE 1 DAY ----- ?

pressure on liquidity
on mgt
preparatory activity
ACTION ON LIQUIDITY
ACTION ON COMMS
ACTION WITH MGT\STAFF
ACTION\PREP RE OTHER INSTITUTIONS
WORK ON OTHER\BETTER OUTCOMES

"RED BUTTON" PHASE (E.G FRI ---- MONDAY)

DECISION TO GO - Minister, Government, CBFSAI, NTMA.
INVOKE PLANS AND ADHUST AS REQ.
TAKE CONTROL INCL. Subs. - need enough control to cover risk.
START LEG PROCESS (incl recall Dail, Seanad
COMMUNICATE DECISIONS

- public
- depositors
- corporate and interbank
- mgt and staff
- EU bodies
- MOU counterparts

-need statement of intention from Minister before mkts open.

- 5 'c's - message needs to be
- coherent

- can't trade if known to be insolvent.

Co. aw power ...

: need to
: worried about book values in other institution

- comprehensive
- credible
- consistent
- coming from all rescue parties - FR bank Min GIS Taois NTMA and, v. important, INBS consistent with everyone else's message
-
- internet
- mass media
- PR firms
- usual investor channels
- direct contact - phones, branches email

significant risk to public finds both ways

~~[illegible]~~

v. importa.

REGULATOR CONTROL PHASE -- DAYS?
Cbfsai POWERS AND INFLUENCE DIRECT ALL ACTIVITY THROUGH A TEAM PUT IN AND DIRECLY (esp if resistance) - what powers available?

ACTION CONTINUES ON COMMS AND LIQUIDITY
ACTION TO PROTECT ASSETS IF NEEDED - business as usual but don't what lose assets
ACTION TO REASSURE MGT AND STAFF
LEG PROCESS IN TRAIN

NEED TO PLAN ALSO AGAINST CONTAGION - other institutions implications

MINISTERIAL PROTECTION PHASE STARTS - President sign
TEAM ALREADY IN SITU - put in place by FR/CB - same team ~~[illegible]~~ by minister
VERY CLOSE COOPERATION WITH CB\FR\NTMA\MIN
COMMS\LIQUIDITY\REASSURANCE CONTINUES
ANTI-CONTAGIN ACTIVITY
EXAMINATION OF STATUS\STOCKTAKING

CONSOLIDATE AND DIG-IN AGAINST "BACKLASH"
KEEP MESSAGES POSITIVE

could legislation be easily adapted to [illegible])

CHECKLIST
GROUPS - bullet points then details
WORKPLAN
REPORT BACK

- contagion -> pricing of book digger -> contagion
-> could be positive contagion if do well.

/ guarantee on of deposits
↓ will have to able to [illegible]

- equity reason to keep money in will be gone
() liquidity needs will have to account of this

heat map

Timing critical - need triggers

Workstreams for Nationalisation Contingency

1. Legislation	2. Governance	3. Press/PR/Consumer	4. Market and Investor Relations	5. ECB and EU	6. Liquidity	7. Supervision post nationalisation
Advise on drafting of legislation How will the legislation be triggered? How will compensation (if any) be determined?	Identify potential candidates to chair inst With Chair, identify management needed and potential candidates Identify any changes required in existing management arrangements	Prepare Statements and Information packs for media & Consumers Handle calls Design media strategy	Identify external advisors on how to present to market Identify key information to be made available on request. Identify market expectations of information to be provided/covenants to be addressed	Identify potential areas of EU law that need to be addressed Identify obligations in respect of ECB	Identify liquidity requirements for initial business plan Identify sources of contingent liquidity to provide support as required What expertise is required within the institution to manage liquidity? What collateral can be generated for market transactions?	Identify which supervisory requireme should be applied to nationalised entity Identify any legislative amendments required Identify any administrative notices affected/directions required Identify any foreign supervisors that would need to be informed

Each team will be shadowed by an Authority Director
Each stream will require administrative support for file searching, typing and photocopying/faxing

13/09/08

What is /who is
the Isle of Man management???
Control of INBS' website

Checklist

1. Legislation in place
2. Deposit maturity profile - daily
3. Debt Maturity Profile - daily
4. Take full possession of all assets – J.V.s + nominee companies
   Fingleton says does not have right control of bk. subsidiaries

   operational + not given away / sold cheap
5. Press Statement to cover

   - Management – new CEO > informed by Bill
   - New Board (s)
   - Depositors
   - Debt holders
   - Future of INBS
   - State Guarantee of INBS Liabilities
   - ~~Nationalisation~~ Protection
   - Profit\Losses – sharing of risk
   - Legal Advisors
   - Staff of INBS
   - IFSRA\Central Bank
   - Setup Hotline and arrange PR Agency

6. Contact major depositors in advance of media announcement?
7. Accountants KPMG - what do they know
8. Credit Ratings of INBS – advise CRA's
9. Credit Ratings of Ireland – advise CRA's
10. Appoint Corporate Finance Advisors
11. Power of Attorney & appoint Legal advisors ? [illegible] V. I.
12. Analysis of Assets & Liabilities
13. Overseas subsidiaries/ trusts – can we access all assets\liabilities and information – check subsidiary definition. (question)
14. Use of Loan Book as collateral with Central Bank
15. Refinancing
16. Cash available at Branches
17. Impact on other Financial Institutions, get them to also issue press releases

18. INBS staff – who knows what?

19. Cooperation of current INBS Senior Management

20. Contact ECB

21. Contact European Commission

22. Central Bank support of other Financial Institutions – cash/assurance

23. Role of Central Bank/IFRSA

24. DOF role

25. NTMA role

XFI Protection Bill

- Head 5
  - Appointment of Assessor
  - Minister required to appoint assessor within X months to determine compensation (if any) payable in respect of membership/extinguished rights
  - Assessor to be independent
  - Assessor to be paid such remuneration etc as the Minister shall determine

XFI Protection Bill

- Head 6
  - Determination of compensation as if
    - Society cannot continue as a going concern [to be wound up]
    - No assistance/guarantee by the State
  - Further criteria for determination of fair and reasonable compensation
  - Process for consultation with Minister/those affected
  - Process for advising of outcome

XFI Protection Bill

- Head 7
- Scheme of compensation
  - Calculation of amount payable
  - Process of payment
  - Principles/policies of scheme (Assumptions to be made, rules of procedure)
- Scheme to be laid before Houses of Oireachtas for approval; permanent unless motion annulling passed within 21 days

XFI Protection Bill

- Head 8
  - Power for Minister to mage Guarantee/loan (incl. to do so on commercial terms/fee)
  - Provision for recovery, charging to Central Fund, reporting to Oireachtas

XFI Protection Bill

- Head 9
  - Misc
    - Power for the minister to incur expenses

XFI Protection Bill

- Schedule
  - Powers of Assessor
  - To require giving of evidence and production of documents
  - Conduct of proceedings
  - Proceedings in private
  - Offence of failing to appear
  - Offence of refusing to answer
  - Protection of those appearing before Assessor

Xfi Protection Bill

12 September, 2008

XFI Protection Bill

- Protection of depositors and lenders by taking Xfi into public ownership.
- Maintain Xfi as a going concern
- State as owner to have to have all the powers, rights and obligations of ownership
- Relevant prudential rules and requirements applied by the Financial Regulator to continue to apply
- Ensure that State's capacity to mange isn't inappropriately constrained by procedural rules
- Provision of fair compensation (if any)
- Minister enabled to provide guarantee/loan
- Misc - expenses

XFI Protection Bill

- Head 1
  - Minister given functions under the Bill (after consolation with Governor) where the Minister is of the opinion that
    - There is or would be a serious threat to the stability of the Society if these functions are not exercised and
    - The exercise of those functions is necessary, in the public interest, for maintaining financial stability in the State
  - CBFSAI's functions in relation to the Society continued

XFI Protection Bill

- Head 2
  - Existing shareholdings to become deposits
  - Existing membership rights to be extinguished
  - Minister to become sole member
  - Rights (of lenders or borrower) to acquire shareholding extinguished
  - Procedural aspects of BS Act '89 (as amended) disapplied.
  - Existing Society rules disapplied
  - Ensure sufficient power of BS Act '89 (as amended) are maintained to ensure ordinary business can be carried on post transfer
  - Provide power to amend, repeal rules of the

XFI Protection Bill

- Head 3
  - Power to remove/appoint
    - Directors
    - Chairman
    - CEO
    - Employees
  - Nominees to comply with Ministerial request
- Head 3B
  - Directors to hold office for such duration and on such terms as minister may determine.

XFI Protection Bill

- Head 4
  - Extinguishment of rights to acquire shares (by virtue of being an employee, director, etc.) at a future date
  - Extinguishment of rights to dividend arising out of any shareholding

46

2

Uimhir Thagartha: S180/20/10/0919

CRUINNIÚ RIALTAIS

Dáta: 13/11/2007

Ábhar: Financial Markets Development

An tAire a thionscain: Oifig an Aire Airgeadais

Dáta an Mheabhráin: 13/11/2007

Cinneadh an Rialtais:

Noted the contents of the memorandum for information concerning Financial Markets Developments.

Ard-Rúnaí an Rialtais

Cóip curtha chuig: Oifig an Taoisigh, Oifig an Aire Fiontar, Trádála agus Fostaíochta, Oifig an Aire Comhshaoil, Oidhreachta agus Rialtais Áitiúil, Oifig an Aire Sláinte agus Leanaí

To:
Mr W Beausang – to see
Mr K Cardiff
Tánaiste

RE: Aide Memoire for the Government on Financial Market Developments

The attached Aide Memoire is to update the Government on recent developments in the financial markets as well as outline the key messages of the forthcoming Central Bank Financial Stability Report, which will be published on Wednesday 14 November.

The Aide Memoire is based on the attached report of the Central Bank and Financial Services Authority of Ireland, which outlines the CBFSAI's assessment of current market developments. The report is based on discussions at a meeting of the Domestic Standing Group on Financial Stability on November 2 as well as more recent updates received from the CBFSAI.

The Aide Memoire also outlines the key messages of the CBFSAI's Financial Stability Report. The CBFSAI's overall assessment is that financial stability risks have increased since the publication of last year's report. However their expectation is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

____
Michael Manley
November 2007

cc: Secretary General, Mr. G Steadman

13 November, 2007

Oifig an Aire Airgeadis

Aide Memoire for the Government

Financial Markets Developments

1. Matter-Issue for Information

The Tánaiste is submitting this Aide Memoire, in accordance with his commitment to keep the Government informed of ongoing developments in the financial markets and their possible impact on Ireland. The Aide Memoire is based on the attached report of the Central Bank and Financial Services Authority of Ireland (CBFSAI) made to the recent meeting of the Domestic Standing Group on Financial stability, composed of the Department of Finance, the Central Bank and the Financial Regulator.

2. Background-Reason for Aide Memoire

There have been some improvements in credit market conditions. The actions of international central banks over recent months in providing liquidity to the marketplace and in cutting interest rates (Federal Reserve) or holding back on interest rates increases (ECB) have supported confidence. Disclosures by major financial institutions of their losses have reduced uncertainty. However, confidence remains fragile, financial market conditions remain volatile and the expected normalisation of wholesale lending market conditions has not taken place to date.

At an international level, there are continuing concerns regarding such issues as:

- undisclosed losses and incomplete information (exacerbated by the write-down of almost $8bn by Merrill Lynch in its Q3 results, the CEO having previously announced a write down of $5.5bn and an additional write down of up to $11bn by Citigroup on top of a previous $6.5bn write down)
- the state of the US property market and the lack of a policy response to its deterioration, and
- the slow progress achieved by initiatives to restore confidence (e.g. Superfund proposal by some major investment banks to buy up CDO assets and repackage them for sale to investors).

3. Interbank market

The level of activity on the wholesale interbank lending market remains low and wholesale interest rates that banks rely on significantly to fund their activities remain high. Accessing funding through this market is difficult and the approach of year end will introduce a premium for cash as banks look to close their positions, increasing the cost of liquidity above its already high level.

4. Irish Impacts

To date, these developments have not had any serious affects on the Irish domestic financial system over and above their international impact but a number of areas remain a focus of attention.

Domestic Irish institutions are financially sound with good quality assets and are well regulated. However, the general tightening of access to credit has required careful attention to liquidity management and work on contingency planning is being undertaken by financial institutions (e.g. seeking to restructure asset holdings to ensure these can be used as collateral for credit). At various times of the year, banks 'roll over' their credit positions, leading to a certain 'lumpiness' (i.e. periods when relatively significant portions of debt have to be rolled over). Irish banks face such a period early in the New Year, which may coincide with what some expected to be a 'second-round' of serious funding difficulties in international markets.

Irish banks have a good name internationally and have an asset base that that can be used as collateral to access liquidity within the Eurosystem. However, more generalised concerns about the Irish economy and the exposure of banks to the property sector has resulted in Irish banks having to pay a premium in accessing liquidity, and share prices have been depressed (making them increasingly attractive for takeover). In this context and the current heightened sensitivity of the international financial system, recent reports of wrongdoing by lawyers in relation to borrowing, though the amounts are small in the overall context, have been unhelpful but are of a scale that there is no potential for any significant prudential concerns.

The domestic financial institutions do not have significant direct exposure to sup-prime lending, though a number of Special Purpose Vehicles (SPVs) are registered in Ireland. While the resolution of any difficulties these encounter is a matter for their parent organisations and the supervisory authorities, reputational risks for Ireland remain.

On the longer term economic situation, there has been recognition that global credit difficulties will have an effect beyond the purely financial realm, though it is too early yet to determine the full extent. Increasingly international commentators are factoring in that the increased cost and reduced availability of finance will spillover into lower economic growth internationally in 2008.

5. The Central Bank's Financial Stability Report

The Central Bank's annual Financial Stability Report will be published on Wednesday 14 November 2007. This report is a comprehensive and authoritative assessment of the state of financial stability in Ireland and is likely to give rise to significant public and media attention. The overall assessment of the Report is that financial stability risks have on balance increased since publication of last year's report.

On the positive side, the Report will welcome improvements with respect to some domestic risks. First, the upward momentum in residential property prices has abated, thus reducing the vulnerability posed by the previous substantial increase in house prices. House prices are now about 3.5 per cent lower on a year-to-date basis but this should be assessed against the gains in house prices in recent years. The underlying fundamentals of the residential market continue to appear strong. The central scenario is, therefore, for a soft, rather than a hard, landing. Second, the rate of credit growth has eased and the rate of accumulation of private-sector indebtedness has moderated accordingly. Although the current rate remains high by international comparison and increases the vulnerability of the private sector to income and interest-rate shocks, there are also important mitigating factors such as the sector's overall net worth and the positive outlook for the economy which, when assessed alongside the slowdown in borrowing, reduce this vulnerability somewhat.

On the negative side, issues have arisen with respect to the domestic economy arising from the longer-term deterioration in competitiveness, the moderation in the contribution of residential construction-sector activity to overall growth, and the possible effects of international financial-market turbulence. This turbulence arose as problems in the US subprime mortgage market broadened into a repricing of risk in a number of financial markets, the possible spillover effects from which could be important for financial stability because of the potential impact on the banking sector and on the economy. In this respect, the domestic banks report no significant direct exposures to US subprime mortgages and very limited exposures through investments and credit lines extended to other financial companies or special purpose vehicles. The domestic banks' shock absorption capacity has not been much reduced by these events.

We understand the central expectation of the CBFSAI, based on an assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector and the results of recent in-house stress testing is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

6. Contingency Planning

The Domestic Standing Group on Financial stability is continuing its work in line with EU requirements to strengthen financial stability planning arrangements in Ireland. This comprises part of the Government's Emergency Planning Arrangements generally. The DSG is also examining the lessons for Ireland from developments in Northern Rock in the UK including in relation to the powers available to the CBFSAI and the Minister for Finance to respond to any such situation arising in Ireland, as well as the issues for Ireland arising from the EU review of Deposit Guarantee arrangements.

7. Conclusion

It is important to emphasis that the Irish banking system is strong, liquid and well capitalised. However, should current market conditions continue Irish banks could have difficulties in accessing funding and may even be subject to a hostile takeover bid. It is important to continue to monitor the situation and the Financial Regulator has increased the frequency of its liquidity reporting requirement. In addition the FR will meet with the Treasury Departments of the major banks in Ireland to discuss possible pressure points for funding as well as contingency plans should the interbank market remain tight.

(12)

F9/25/08, D
Record 12

30 September 2008

Attendance: T, BL, AG, DMcC, KC, DD, JM, E McCague, xxxx Burrows Sheehy, Gleeson

Burrows

- Rapidly deteriorating situation everywhere – fully caught up in it
- Situation threatens the stability of our organisations
- Rumour in NYSE that Dublin won't go tomorrow
- Contagion from weaker to strong
- 2 institutions in terminal decline
- Why has INBS not been dealt with? Afraid people will assume INBS & Anglo tied in to the healthier outfits.
- Reminded action: 2 elements (a) guarantee for surviving (b) troubled patients to be taken out
- Can't guarantee that any guarantee will work
- Eventually impartial guarantee should register as good among Centrals Banks around the world – language must be unmistakeable
- Higher difficulty with funding – slight resistance to overnight funding today (heard from Eamonn Hackett, Treasury).

Sheehy

- On positive side, retail guarantee has been very successful – no effect on wholesale depositors.
- Trend has been increasing – more and more difficult "no quote for Dublin".
- People we've been dealing with for decades pulling back – 1 month we will be funding bank overnight. Bad if can't even get that, disaster – bankruptcy.
- Market is saying that Anglo is bust.
- Guarantee in xxxx will not help equity markets, but may help liquidity a bit.
- Want price to be in cash.

Hurley

- Guarantee required tomorrow
- Needs to be priced
- Anglo now asking for 4 bn tomorrow
- Will give them 1 ½ in the morning
- Might be necessary tonight to call in the banks
- Will have to be told that the use of the guarantee requires them to close down their businesses
- If further funds required AIB & Bank should contribute
- If rates for Anglo are significant, give them ELA from Central Bank.

PN &JR

- Guarantee absolutely xxxx
- Price of guarantee 0.25 and 0.5 of a point

- Min asked FR did they agree with AIB/BofI that 2 need to be nationalised first, FR (PN) did not agree.

T

- State guarantee best way to underpin deposits
- Want clarity of what is to be done in light of international events
- Go off and do it – Chairman & CEO

PN

- Will put in significant conditions

Governor

- If provide funding, need conditions – need to reduce risks of State

PN

- Everybody who has had a look at the banks is saying there is value in them over time
- Accepts this is a 'throw of the dice'

00.41 on 30 September 2009

AIB & BofI back in ....

- Use MLF[?] for AIB – 1 ½ billion best can do 4. 6 best do
- Another idea – non eligible assets
- 10bn ABS & AAA – bring to NTMA – give gilts for it – say 8bn assuming a haircut – have to get it back next Monday.

Goggin

- Tomorrow is ½ year end
- So already managing for tomorrow
- Can't get cash xxxx Wed in xxxx
- Very nervous about how own deposits will hold up
- Could produce 4-5bn by Wed if get tender
- Will not use MLF[?]
- Capacity to consider
- Very strong preference not to xxxx
- Prefer to get it back close of business on Friday
- Could not xxxx

Briefing for Taoiseach on Government's Interventions to Protect Irish Banking System

The Government's approach to the unprecedented crisis in global financial markets has been structured and considered. We have sought advice and counsel from various qualified sources and have at all times sought to protect depositors in Irish banks, the Irish financial system and Irish taxpayers.

A. Why was there a need for Government Intervention?

- Unprecedented difficulties in international funding markets have impacted on Irish banks. Concerns about the quality of assets held by banks and possible impairment levels have also focused the attention of international markets on the level of capital that banks hold.
- This is a global problem, and Governments across the world have intervened with little success to attempt to rebuild confidence in financial markets.
- The Irish Government's approach has been based on two broad principles: First, not to let any systemically relevant financial institution fail, this involves protecting depositors and creditors, and secondly, any State involvement in the financial institutions will protect taxpayers' interests.
- In deciding policy approaches regarding the banking sector, the Government has taken advice from and consulted with the Central Bank, the Financial Regulator, the National Treasury Management Agency and its legal and financial advisors.

B. What Action has the Government Taken?

Bank Guarantee Scheme

- The contraction in the availability of funding particularly following the collapse of Lehman Brothers proved challenging for financial systems across the world. Ireland acted decisively to guarantee until September 2010 the liabilities of relevant institutions in order to ensure banks could maintain their normal liquidity position in interbank lending and debt markets.
- The Central Bank, the Government and its advisors continue to closely monitor the liquidity position of all relevant institutions.

- In the context of the six month review of the guarantee Scheme to be completed by mid-April 2009, the Government will examine how the Scheme could be revised, subject to European Commission approval and consistent with EU State aid requirements, to achieve a reduction in risk overall, including by supporting longer-term bond issuance by the covered institutions.

Recapitalisation

- As part of the increased engagement with the banks following the announcement of the guarantee Scheme, and in view of increased market focus on the capital position of banks towards the end of 2008, a detailed assessment of the loan books and capital position of the Irish banks was undertaken.
- The Financial Regulator commissioned PwC to report on the financial position of the six relevant institutions. This report contains an analysis of likely loan impairment rates in these institutions up to 2011 and the impact of various stress tests on capital levels. Work was also undertaken for the Financial Regulator by Jones Lang LaSalle, a firm of independent valuers, to assess elements of the bank's property based loan portfolio and the value of the collateral underlying it.
- This was a structured approach, and following this assessment the Government put forward detailed recapitalisation proposals with regard to our two main banks, Bank of Ireland and Allied Irish Bank.
- The total amount to be invested, €7 billion or €3.5 billion for each bank, was determined following consideration of likely trends in property values and various stress scenarios for the economy and property values. The State's investment will significantly strengthen the Core Tier 1 capital of these banks, bringing it well up in excess of regulatory limits. Existing reserves will be supplemented by ongoing profits and so the banks are more than adequately equipped to deal with the expected losses.
- The Government is also in discussion with other relevant institutions about their capital position.

C What Issues were Factored into the Government's Actions?

Protecting Taxpayers

- The Government's actions have always been guided by the principle of protecting taxpayers.
- The Government's guarantee Scheme includes a charge on the banks for this facility and ensures a significant return for taxpayers. There are significant fees of about €1billion payable by banks on foot of the guarantee.
- Anglo Irish Bank is a major financial institution whose viability is of systemic importance to Ireland. Anglo has a balance sheet of some €100bn with a substantial deposit base which the State is determined to safeguard. The Government's commitment to protecting taxpayers, depositors and creditors was again highlighted when taking this bank into public ownership.
- The investment of €3.5m each into AIB and Bank of Ireland is not unconditional. The investment generates a significant return for the State and includes conditions and obligations that the banks have signed up to.

Ensuring Credit Availability and Helping Bank Customers

- The Government's recapitalisation proposals included various measures on credit supply and requirements on banks in their dealings with customers. The main features are:

Business Lending

- Lending capacity to small to medium enterprises to be increased by 10%
- AIB and Bank of Ireland will both commit a further €15m each to new or existing seed capital funds, in collaboration with Enterprise Irelands Seed and Venture Capital Programme, to further create and develop indigenous enterprise.
- The recapitalised banks agreed to work closely with the IDA, Enterprise Ireland and with State agencies to ensure the supply of appropriate finance to contractors engaged on major projects sponsored by them.
- More generally, the banks have agreed to engage in a 'clearing group' chaired by a Government representative and including representation from business interests and State agencies. The purpose of this group will be to identify specific patterns of events or cases where the flow of credit to viable projects appears to be blocked and to seek to identify credit supply solutions.

- Code of practice for business lending to small and medium enterprises – this was published by the Financial Regulator on 13 February and applies to all banks. The code includes a requirement for banks to offer their business customers annual review meetings, to inform customers of the basis for decisions made and to have written procedures for the proper handling of complaints. Decisions to grant, refuse or alter credit must be taken on a case by case basis. Where a customer gets into difficulty the banks will give the customer reasonable time and seek to agree an approach to resolve problems and to provide appropriate advice. This is a statutory code and Banks will be required to demonstrate compliance.
- The recapitalised banks have agreed to fund an independent review of credit availability which will be managed jointly by the banks, Government and business representatives. The banks have undertaken to co-operate fully with this review and to engage constructively in implementing any recommendations made.
- €100m fund to support environment friendly investment and innovations in clean energy.

<u>Mortgage Lending</u>

- Additional 30% capacity for lending to first time buyers to be made available in 2009. If the extra capacity available for mortgages is not taken up in any quarter, it will be redirected to SMEs in the following quarter.
- Code of practice on Mortgage Arrears: - also published by the Financial Regulator on 13 February. This statutory code applies to all mortgage lending on a customer's principal private residence. A lender may not seek repossession until every reasonable effort has been made to agree an alternative repayment schedule with the borrower. The Code will ensure that mortgage lenders can only commence legal action for repossession six months from the time arrears first arise.
- The recapitalised banks have further agreed that they will not commence court proceedings for repossession of a principal private residence within 12 months of arrears appearing, where the customer maintains contact and cooperates reasonably and honestly with the bank.

Remuneration

- Pay restraint is important not only in the context of the financial supports being provided by the taxpayer to the banking sector. It is also important in the overall context of the economy and the message it sends to ordinary workers who are suffering as a result of the current global crisis.
- Under the guarantee Scheme the remuneration packages of directors and executives, including total salary, bonuses, pension payments and any other benefits are subject to review by Covered Institution Remuneration Oversight Committee (CIROC). CIROC's report is expected shortly.
- As part of the Government's recapitalisation proposals, total remuneration for all senior executives will be reduced by at least 33% and non-executive director fees by at least 25%. No performance bonuses will be paid for these senior executives and no salary increases will be made in relation to 2008 and 2009.
- The Minister for Finance has written to CIROC recommending that an overall cap be introduced for executive pay in banks benefiting from State support.
- It is imperative that this regime is organised in such a way that any rewards in the sector are structured to meet the long-term objectives of both the banking institutions themselves and the overall health of the Irish financial system.

Co-Ordination at EU level

- The Government's interventions in the banking system have sought to reflect agreed principles at EU level such as the European Commission Recapitalisation Communication.
- The Government engaged with the European Commission and the ECB on the development of a common framework on recapitalisation and is contributing to the development of a common approach to bad debt resolution.
- The Government is committed to working with the EU on an ongoing basis to frame a common approach to the issues faced by the financial services sector.

D Anglo Irish Bank

- Matters at Anglo including loans to Directors, certain transactions with Irish Life and Permanent and loans to finance the purchase of shares are under investigation by a number of statutory authorities.

- These ongoing investigations may have a criminal dimension and caution should be exercised to ensure that potential future actions are not prejudiced.
- The Government is keen to ensure that unacceptable practices at Anglo are disclosed and punished appropriately so that the bank can set about re-establishing itself as a reputable financial service provider.
- The Government made clear when bringing the relevant legislation through the Houses of the Oireachtas that Anglo Irish Bank would continue to be run as a going concern, at arms length from Government. To drive this process forward, the new Board is preparing a comprehensive business plan which will be required to demonstrate how the Board will oversee the continued commercial operation of the bank.

E Next Steps

Banking Regulation

- Work has begun on forging a new model to govern the conduct and behaviour of the financial sector both here and internationally. Ireland will play its part internationally and particularly at EU level in seeking to ensure that the re-design of the financial system and in particular of financial regulation is consistent with the objectives that underlie a strong, stable and functioning national banking system.
- Following the implementation of the Credit Institutions (Financial Support) Scheme, the oversight of the banks concerned has been greatly intensified. This new regime provides for a heightened direct engagement with each of the covered institutions and new reporting arrangements including the provision of Scheme compliance certificates by the covered institutions themselves and by their external auditors.
- The Bank Guarantee Scheme requirements and conditions are the first step in a new system of financial regulation and supervision. The joint Boards of the Central Bank and Irish Financial Services Regulatory Authority have submitted to the Minister for Finance a report on reform of the regulatory structures. This report is currently being considered by the Minister.
- In addition, a number of regulatory reviews are underway at an international level. The Minister for Finance proposes to take account of the various reviews that are underway on regulatory reform when all relevant issues have been considered fully, bring my proposals for reform to Government.

Dealing with Impaired Assets

- Much of the concerns over assets quality internationally have revolved around so called toxic assets – structured products related to US subprime lending. By contrast, concerns over asset quality in Irish banks relate to property based lending here and in the UK – generally land and development lending.
- The Government will examine proposals to manage and reduce the risks on these specific exposures, having regard to international developments and ongoing work at ECB-level and in the EU on this issue. Loan insurance and a 'bad bank' approach are among these options.
- Any arrangement on asset risk management would require detailed preparatory work to define the categories of assets covered, and the State's role in managing and reducing risk associated with these assets. The Minister for Finance has appointed Mr Peter Bacon to work in conjunction with the NTMA to report and advise him on the best solutions in this area.
- The Government will ensure that any commitments on the availability of public funds for risk management will contribute to the stability of our financial system and our economy generally.

C3b: Appropriateness of the bank guarantee decision

Information Summary (Section 33AK)

Note: All references are aggregated.

Document category	Time period
Extract of CBFSAI Board minutes	Late September 2008

Extract of CBFSAI Board minutes

In an extract of Board minutes from late September 2008, pre the guarantee decision, it says "… the position of the Irish banks was deteriorating and if the liquidity situation did not improve, the issue for the Authorities would be how to address the whole Irish financial system. The Governor of the Central Bank was keeping in close contact with the ECB and had discussed with President Trichet the difficult situation in Ireland and asked to be kept informed of developments in other countries."

79. It was strongly stated to us by our own regulatory authorities that this was a liquidity problem and not a solvency problem. At no stage was it contemplated then or indeed until the NAMA valuation of loans emerged, that the funding gap for the banks would reach the levels that it did or that the impairments of loans in the banks would be of the horrific nature or magnitude that came to pass.

80. I was coming to the view that given what was potentially at stake whatever we did would have to have an immediate and dramatic impact in stopping the outflow of funds from banks and indeed reversing the trend if possible.

81. Word came into the meeting that the Chairman and CEO of the two main banks were looking to meet with us. I adjourned the meeting for a short break. During this break, I decided to get an external view.

82. Mr Alan Gray, an economist and a Central Bank board member, was someone whose views I respected. I phoned him and asked him what he thought of a guarantee option being used.

83. Mr Gray emphasized that providing a guarantee would obviously give an advantage to those institutions to whom the guarantee would apply vis-à-vis competitors since they would have the backing of the Irish Government.

84. In that respect, it was important to be mindful how other lending institutions would regard it and he stated that compliance with EU state aid rules would be an important factor to bear in mind. In dealing with that issue, it would also be important to be seen to charge a proper fee for the value of that guarantee to those institutions who got the benefit of it.

85. Mr Gray also stated that if we were considering the introduction of a guarantee of any kind, then it should be strictly time limited. This would assist in arguing that it was proportionate to meet the serious situation that was being dealt with. I thanked him for this advice.

86. During this break from the main meeting, the Minister for Finance and I weighed up the options ourselves in my personal office.

87. We reviewed the discussions from the meeting thus far. He was minded to still go the nationalisation route for Anglo and guarantee the rest of them.

88. I explained my reservations about it and reassured him that nationalisation was something that we could not rule out in the future and would remain an option available to us. I also told him that a time limited guarantee seemed to me preferable than giving an open-ended guarantee which a full nationalisation would entail.

THEME: C3

Appropriateness and effectiveness of the Department of Finance actions during crisis

LINE OF INQUIRY: C3c

Effectiveness of reviews of banks' loan books and capital adequacy

John Callinan/EUAFF/DOT
01/10/2008 10:18

To "Lorcan Fullam" <lorcan.fullam@taoiseach.gov.ie>, "Dermot McCarthy" <Dermot.mccarthy@Taoiseach.gov.ie>
cc
bcc
Subject Fw: Points for T discussion with sarkozy

----- Original Message -----
From: "Cardiff, Kevin" [Kevin.Cardiff@finance.gov.ie]
Sent: 01/10/2008 10:17 CET
To: "Hogan, John" <John.Hogan@finance.gov.ie>
Cc: John Callinan; <tony.grimes@centralbank.ie>; <john.hurley@centralbank.ie>; <jhurley@centralbank.ie>
Subject: Points for T discussion with sarkozy

Points for Discussion with Mr Sarkozy.doc

Points for Discussion with Mr Sarkozy: European Implications of Irish Decision and Next Steps

Know there are concerns among some of European partners about our move
'economic' concern about competition
'political' concern about the pressures it puts them under

Background

- ◊ About 12 institutions in trouble around the globe in past 3 weeks alone
- ◊ Huge difficulty in accessing funds for many smaller institutions – and in global terms all the Irish banks are relatively small
- ◊ Small countries having particular difficulties
- ◊ Pressure to 'take out/nationalise' one or two smaller institutions in Ireland – but real risk that speculative pressures and liquidity withdrawals would just move on to the bigger institutions
- ◊ Example of other countries – Fortis followed by Dexia in Belgium, Northern Rock followed by HBOS, B&B in UK, long succession of institutions in US
- ◊ Lehmans messed up the world market, but -
- ◊ Bradford and Bingley created real difficulty for Ireland, given that some Irish institutions have similar, though better quality, UK assets
- ◊ Greatest ever one day decline in Irish Stock Exchange indicated that the market's attach on Irish stocks could easily threaten the whole economic future
- ◊ Each country has been dealing with this crisis on a national basis – unfortunate, but perhaps inevitable - so had to deal with this nationally
- ◊ Our Conclusion – real danger that only a bold and decisive intervention would halt decline in Ireland – no corporate finance solutions (seeking buyers etc) available in the time frame – had to act

Offsetting measures

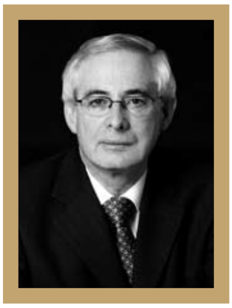
- ◊ Need to let institutions take some deposits to make up for some of the more extreme losses in recent weeks
- ◊ But there will be pricing – this will not come free to institutions
- ◊ We are already looking at the control measures that will be required – and at what restructuring will be necessary to wean these institutions off support

What can Europe do?

- ◊ The competition issues arising from the Irish, UK, Belgian and other Governments support of selected institutions comes direct from the fact that there is no overall European approach
- ◊ Think that an overall European approach on the lines of what we have just done could help – could of course be more sophisticated and deal much better with cross border issues
- ◊ Might need a European vehicle to work with – perhaps an offshoot of EIB or some other institution could act as intermediary for the Union and the Member States?

- In the meanwhile, would be helpful if ECB broadened the base for access to liquidity and perhaps also made longer term funds available – the huge reliance on short term ECB funds can add to instability in the market (though in the absence of the ECB, all of Europe would have been in worse position)
- Commission/member state work on EU responses to the financial crisis has been positive, but perhaps focussed too far into the future – Europe needs a response – definitive and far-reaching, more quickly. We will do our best to help.

Governor's Foreword



Very difficult challenges in world financial markets were the prominent feature of 2007. While global economic growth, at 4.9 per cent, remained strong in general terms, this performance masked a sharp slowdown in momentum in the final months of the year, marked by the financial markets turmoil and sharp increases in food and energy prices.

The euro area economy grew by 2.7 per cent in 2007, which is above its generally agreed sustainable growth rate. Growth was broad based, with contributions from both domestic and external demand, but there was a sharp decline in consumer sentiment towards the end of the year. This pattern appears to have continued into the first half of 2008 and, while exports have continued to hold up, for 2008 as a whole the euro area should see growth of about 1¾ per cent. The US economy experienced a more significant slowdown in the final months of 2007 and growth is expected to be somewhat weaker again in 2008. The risks to the growth outlook are on the downside in both the US and the euro area.

After a long period of extremely buoyant conditions, global financial markets experienced a substantial adjustment in the second half of 2007 and into 2008. The proximate cause for this correction was the downward valuation of securities linked to sub-prime mortgages in the US. Central Banks responded decisively to counteract this with the ECB in particular taking effective action in the light of the pre-existing arrangements that ensured banks had an extensive range of collateral that could be used to access central bank liquidity through the normal tender process.

The Irish financial sector was, of course, impacted like all others by these global developments. Medium- to long-term funding was not as readily available on wholesale markets as had been the case. However, Irish banks have negligible exposure to the sub-prime sector and they remain relatively healthy by the standard measures of capital, profitability and asset quality. This has been confirmed by the stress testing exercises we have carried out with the banks.

Although growth overall remained robust in 2007, increasing by 5.3 per cent GDP (4.5 per cent GNP), the Irish economy slowed towards the end of the year. A modest pick up in export performance was accompanied by a moderation in consumption growth in mid-year and a sharp slowdown in investment expenditure, which became more pronounced by year-end, particularly in the housing sector. There were sharp declines in both housing output and prices, which have continued into 2008.

The prospects for the Irish economy in 2008 are for a significant reduction in output growth, as many of the potential risks to growth that had been identified previously began to materialise. Developments in the construction sector constituted a significant drag on growth. Domestic demand is likely to contract and a sharp slowdown in the overall rate of job creation should see the unemployment rate at close to 6 per cent on average in 2008. Overall, it now seems likely that GNP growth will be less than 1 per cent in 2008. A recovery to about 2 per cent may be seen in 2009 as the domestic housing market bottoms out and some improvement occurs in the external environment, although considerable uncertainty attaches to this outcome.

Turning to the Bank's own activities, a strong focus on financial market issues was the dominant feature in the second half of the year. The institutional arrangements we have in place, where the Central Bank and Financial Regulator operate within the one single organisational structure, enabled us to meet the challenges we faced.

The Bank's profits for 2007 amounted to €228 million, compared with €110 million in 2006. Surplus income of €193 million will be paid to the Exchequer.

I would like to express my appreciation to the Board of Directors for all of their valuable input and support. In particular, I would like to thank Brian Patterson, Roy Donovan and Martin O'Donoghue who retired as members of the Board on 30 April 2008 for their major contribution to the work of the Bank. Brian Patterson also served as the first Chairman of the Financial Regulator and it was a huge pleasure to work alongside him over the past five years. I would like to welcome the new Board members, Jim Farrell, the newly appointed Chairman of the Financial Regulator, who is an ex-offcio member of the Board, Brian Hillery, Dermot O'Brien, and our new Director General, Tony Grimes.

I would like to thank Patrick Neary, Chief Executive of the Financial Regulator and all his team for their ongoing cooperation and support.

Finally, I pay special tribute to all the management and staff of the Central Bank and Financial Services Authority of Ireland for rising to, and meeting, the challenging times we faced in 2007.

John Hurley
Governor

C3c: Effectiveness of reviews of banks loan books and capital adequacy.

Information Summary

Note: All references are aggregated.

Document category	Time period
Extract from Merrill Lynch due diligence report on AIB regarding the potential investment by the NPRF in AIB. DOF05885.	May 2009

Sector concentration; AIB has been in breach of Financial Regulator sector concentrations since March 2006. This breach relates to AIB's exposure to the property sector, which amounted to €48bn at 31 December 2008. Of this exposure, €13bn was to the Building & Construction sector and €34bn to Property companies (36% of loan book in aggregate). We understand that AIB continues to be fully engaged with the Financial Regulator on this topic. AIB also has 33 exposures in excess of the Group Large Exposure Limit of €250m, and AIB's largest loans are bigger than BOI's. For example, AIB's 3 largest land and development loans are between €450 and €800m, while BOI's range from €250m to €300m. The number of exceptions to Group Policy further suggests inadequate risk controls and processes.

51

Lonergan, Ciara

From: Lonergan, Ciara
Sent: 02 October 2007 17:49
To: 'con.horan@financialregulator.ie'; 'tom.oconnell@centralbank.ie'; 'tony.grimes@centralbank.ie'; McKiernan AnneMarie; Beausang, William; Cardiff, Kevin; Nolan, Kevin; Manley, Michael
Subject: Meeting of DSG Wednesday 3 October 2.30 pm

Attachments: List of Issues for DSG meeting - 3 October 2007 v2.doc

Please find attached a list of issues that need further examination / clarification in order to facilitate actions the Dept or the CBFSAI may need to take should a financial institution in Ireland find itself in difficulties, or systemic problems arise in the financial system. This list has been prepared for discussion at DSG meeting on Wednesday.

List of Issues for DSG meeting...

Regards
Ciara Lonergan

Taxation and Financial Services Division
Department of Finance
Government Buildings
Upper Merrion Street
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List of Issues/Questions for DSG meeting 3 October 2007

Domestic Financial Stability Arrangements

- Further clarification of the roles and responsibilities of the Department, the Central Bank and the Financial Regulator as outlined in the Memorandum of Understanding may be required.
- Principles for dealing with cross-border financial crises were set out by the EFC Ad Hoc Working Group on Financial Stability and are due to be formally agreed at the Ecofin meeting of 9 October. Should these principles be incorporated into the domestic financial stability arrangements? (see Annex I for a list of these principles)

Ministerial and CBFSAI powers:

Further clarification and certainty regarding the legal powers of the CBFSAI and the Minister for Finance in relation to the resolution of financial crises may be required. In particular a number of issues require examination:

- A Department assessment suggests that the CBFSAI would appear to have significant powers for assisting a financial institution in trouble. Are there any impediments to the CBFSAI taking actions to maintain financial stability? (eg, cost of providing liquidity, etc; restrictions on types of collateral accepted by the CB; the role of the ECB; and potential conflicts of interest between the CB and the FR if the CB were to invest in a financial institution which is regulated by the FR.)
- At what point must the Government and the Oireachtas be informed of any actions by the CBFSAI and/or the Minister to assist a financial institution in difficulties?
- A Department assessment from 2002 indicates that the Minister has no specific power to intervene or any implicit powers relevant to potential financial crises. Is there a requirement for specific Ministerial powers for dealing with financial crises? Or would such powers reduce the Minister's discretion in the method chosen for dealing with a crisis?
- The legal position regarding a number of potential policy options for the State to provide support to financial institution in difficulty requires further examination. These include:
    - o the legal scope for a "letter of comfort" to be given to the Central Bank in an emergency situation confirming the Minister's intention to approach Dáil Eireann for legislative authority to enable the issuance of a financial guarantee to the Central Bank
    - o the legal scope for resort to the Contingency Fund
    - o provision of liquidity to the Central Bank by increasing the sum held in the Exchequer Account as collateral and to appropriate the increased deposit to the extent necessary to cover any default
    - o the scope for NTMA to place a deposit with a bank
- What impact would EU rules on State Aid have for any actions undertaken by the CBFSAI or the Minister?

Deposit Protection Scheme

To what extend does the Deposit Guarantee Scheme (DGS) require amendment – examination of the following issues is required:

- The appropriate level of compensation for depositors,
- the operations of the DGS, and
- the funding of the DGS.

Company Law

A number of issues arise regarding the interaction between the authorities' ability to act to maintain financial stability actions and the company law framework for insolvent companies. These include:

- What restrictions do the receivership, liquidation and examinership procedures, as laid down in company law, place on the activities of the CBFSAI and the Department in dealing with difficulties at a financial institution?
- How do these procedures affect the return of deposits to financial institutions' customers?
- How could a financial institution trade itself out of difficulties? If it relies on emergency provision of liquidity by the CB and all its assets are used as collateral what happened to the institution?

Other relevant legislation

The potential impact of other legislation on the three authorities' ability to maintain financial stability and to act in a crisis situation has been highlighted by the recent difficulties faced by Northern Rock in the UK. Some issues in this context which bear further examination include:

- The legislation that governs takeovers – takeovers in Ireland are regulated by the Takeover Panel as provided for in the Takeover Panel Act 1997. Does this legislation or the rules made under the Act prevent the takeover of an illiquid or insolvent bank quickly and efficiently?
- Does the concept of a Scheme of Arrangement[1] rather than a takeover have any relevance for dealing with a credit institution in trouble?
- What impact does Market Abuse legislation have on the ability of the CBFSAI to provide covert liquidity support to a credit institution in difficulty, particularly given the requirement of any company listed on a Stock Exchange to report any thing that could affect its share price to the Stock Exchange within 24 hours?

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[1] A scheme of arrangement is a reorganising of a company's capital structure or its debts which is binding on creditors and shareholders. There are two types: a creditors' scheme and a members' or shareholders' scheme. A creditors' scheme is generally used by companies in financial difficulties. creditors may agree to defer payments in the hope of a better eventual return than they would receive if the company were liquidated. A members' scheme is used to effect corporate reorganisations, including mergers. A scheme of arrangement is carried out in three steps:
1.The court is approached to order a meeting of creditors or shareholders directly affected;
2.The scheme must be approved by a vote of more than 50 per cent of the creditors or members present and voting who represent 75 per cent of the total debts or nominal value of the shares of those present and voting at the meeting; and
3. The scheme is referred back to the court for confirmation. (Definition taken from www.anz.com Financial Dictionary)

Annex I: Common Principles for cross-border financial crisis management

Member States agree on a set of common principles to be followed in the management of any cross-border financial crisis, which involves at least one banking group which (i) has substantial cross-border activities and (ii) is facing severe problems which are expected to trigger systemic effects in at least one Member State; and (iii) is assessed to be at risk of becoming insolvent. The common principles are the following:

1. The objective of crisis management is to protect the stability of the financial system in all countries involved and in the EU as a whole and to minimise potential harmful economic impacts at the lowest overall collective cost. The objective is not to prevent bank failures.
2. In a crisis situation, primacy will always be given to private sector solutions which as far as possible will build on the financial situation of a banking group as a whole. The management of an ailing institution will be held accountable, shareholders will not be bailed out and creditors and uninsured depositors should expect to face losses.
3. The use of public money to resolve a crisis can never be taken for granted and will only be considered to remedy a serious disturbance in the economy and when overall social benefits are assessed to exceed the cost of recapitalisation at public expense. The circumstances and the timing of a possible public intervention can not be set in advance. Strict and uniform conditions shall be applied to any use of public money.
4. Managing a cross-border crisis is a matter of common interest for all Member States affected. Where a bank group has significant cross-border activities in different Member States, authorities in these countries will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden. If public resources are involved, direct budgetary net costs are shared among affected Member States on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries' supervisory powers.
5. Arrangements and tools for cross-border crisis management will be designed flexibly to allow for adapting to the specific features of a crisis, individual institutions, balance sheet items and markets. Cross-border arrangements will build on effective national arrangements and cooperation between authorities of different countries. Competent authorities in the Member States affected by a crisis should be in a position to promptly assess the systemic nature of the crisis and its cross-border implications based on common terminology and a common analytical framework.
6. Arrangements for crisis management and crisis resolution will be consistent with the arrangements for supervision and crisis prevention. This consistency particularly refers to the division of responsibilities between authorities and the coordinating role of home country supervisory authorities.
7. Full participation in management and resolution of a crisis will be ensured at an early stage for those Member States that may be affected through individual institutions or infrastructures, taking into account that quick actions may be needed to solve the crisis.
8. Policy actions in the context of crisis management will preserve a level playing field. Especially, any public intervention must comply with EU competition and state-aid rules.
9. The global dimension will be taken into account in financial stability arrangements whenever necessary. Authorities from third countries will be involved where appropriate.

Three scenarios for institutions having difficulties

1. Illiquid but solvent
    - Liquidity can be provided by the Central Bank using eligible collateral. Irish banks in general can use a lots of their assets as collateral as for example Mortgage backed promissory notes.
    - If the institution does not have eligible collateral Emergency Liquidity Assistance (ELA) is provided by the Central Bank, with any ineligible collateral given appropriate haircuts. The ELA may be provided at a penal rate but this is not required. The decision to provide ELA is made by the Central Bank, and the permission of the Department of Finance is not required. In practice the Central Bank would liaise with the Department and the Financial Regulator before providing ELA.
    - When ELA provision becomes necessary, it would be attempted to
    - Following the provision of ELA if the institution fails the assets taken as collateral by the CB are not available to depositors or other creditors of the bank.
2. Nearing insolvency:
    - The CB and the FR have a Crisis Steering Group which would meet in this circumstance.
    - Decision to be made when insolvency is nearing – type of collateral provide for ELA, percentage of assets used as collateral…
    - Examinership may be a possible solution. (see below for further discussion of examinership issue)
    - Nationalising the bank at this point may also be an option. There may be Constitutional issues with nationalising a bank. Also losses by shareholders and cost to the taxpayer may be an issue.
3. Insolvent
    - Once an institution is insolvent the Central Bank cannot provide ELA to the institution. In order for the institution to be assisted the CB would required some form of guarantee from the Government eg a letter of comfort. This would allow the CB to treat the institution as illiquid but solvent. What legal issues arise from such a guarantee –
        - does this need Oireachtas approval?
        - Would this be ex post or ex ante?
        - What are the State Aid rules implications? etc…

Issues that require further examination:

- If the CB provides ELA and makes a loss does the loss appear on the CB's balance sheet or is it recouped from the Government?
- How would examinership affect an institution - would it assist in facilitating the institution in remaining a "going concern". If all assets, etc must be frozen for 90 days what effect will this have on deposits?
- Can the Deposit Protection Scheme be used to pay depositors during an examinership?
- Can the Deposit Protection Scheme be used to bail out institutions?

- Has the UK's provision of a temporary 100% guarantee of deposits with Northern Rock set a floor where by any guarantee less than 100% is not enough to prevent a run?
- Communications will be extremely important should any institutions have difficulties. Whoever speaks to the public first needs to be able to retain customer confidence in the institution if it remains solvent. In the UK, despite the assurances that NR was solvent, once the story , and the queues were publicised, the assurances did not prevent a bank run (the "Sky News effect")
- When would the provision of ELA have to be revealed - what impact does the Market Abuse Directive have – a section in directive states that it shall not apply to transactions concerned with the monetary, exchange rate or public debt policy. When would an institution receiving ELA be required to inform the Stock Exchange – ELA likely to affect share prices.
- The failure of a small institution could have systemic consequences if its problems are likely to effect confidence in other larger institutions eg it has a lot of depositors.
- If there was a shock relating to property this could apply to all banks – this would have implications for any rescue operation.

C3 - Appropriateness and effectiveness of DoF actions during crisis - Crisis management

C3c - Effectiveness of reviews of banks' loan books and capital adequacy

Information Summary (Section 33AK)

Note: All references are aggregated.

Document category	**Time period**
Document prepared by Internal Audit Division, CB, on: "Operation of Exceptional Liquidity Arrangements for Domestic Banks"	H1 2011

- Operation of Exceptional Liquidity Arrangements for Domestic Banks Including follow up on all outstanding issues.

- However a number of incidents of noncompliance (some of which could be significant) with the agreed summary procedure and normal operating procedures were noted, these are detailed below.

- Lack of statements of solvency from credit institutions in receipt of ELA (Exceptional Liquidity Assistance) and other forms of liquidity assistance.

- Verification and classification of certain assets taken as collateral deemed to be inadequate, noting independent collateral assessments were not performed or sought after initial assessment.

- Lack of certain documentation on file in relation to some transactions with Irish financial institutions.

- A subsequent exercise was carried out and the above issues had been satisfactorily addressed and closed.