Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

International Monetary Fund

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IMF Staff Written Statement in Response to Questions from the Joint Committee of Inquiry into the Banking Crisis of the Irish Parliament

1. Outline the degree of independent analysis carried out in the preparation of the Financial System Stability Assessment of Ireland in the IMF Country Report No: 06/292 issued in August 2006?

The Financial Sector Assessment Program (FSAP) is a tool for assessing a member country's financial vulnerabilities and financial sector policies. The factsheet at the following link provides further background: https://www.imf.org/external/np/exr/facts/fsap.htm

FSAP analysis relies in part on the quality and detail of financial information provided by national authorities. Until 2010, the FSAP was an entirely voluntary program and not an instrument of IMF surveillance. The scope and methodology of an assessment was mutually agreed between the FSAP team and the national authorities. In 2010, the assessment of systemically-important financial sectors became mandatory (at present, 29 financial sectors are defined as systemically-important, including Ireland). In addition, the requirements of assessments have been strengthened in recent years.

The 2006 Ireland FSAP followed the practices prevalent at that time. The FSAP team's analysis of vulnerabilities was based on aggregate data provided by the authorities. The authorities did not provide detailed supervisory data as requested by the FSAP team, so the FSAP team could not perform its own stress tests:

- Top-down stress tests were performed by the Central Bank and Financial Supervisory Authority (CBFSAI) using macroeconomic scenarios agreed with the FSAP team. The FSAP team estimated a cross-country provisioning model to conduct a credit risk test. This model allowed the FSAP team to offset what it saw as deficiencies in CBFSAI's macro-econometric model.

- Bottom-up stress tests were carried out by eleven financial institutions in consultation with the FSAP mission. The FSAP team cross-checked the outcomes using published financial data (e.g., end-2005 balance sheet positions and income statements, money and banking statistics, and bank-by-bank balance sheet data from Bankscope).

- The FSAP team also analyzed cross-border contagion risks between banks (including the three large Irish banks) using market-based high-frequency data on distance-to-default. In the absence of granular data, detailed analysis of sectoral vulnerabilities (e.g., construction and commercial property) was not possible.

2a. Comment on the sources relied upon to support the statement on Page 17 of the IMF Country Report No: 06/292 which stated that "Banks are well capitalized, relatively efficient and highly liquid".

The finding that banks were well capitalized and liquid was based on the results of the stress tests described above. It should be noted that stress tests are not forecasting tools. They provide inputs to help form a view of the resilience of financial institutions at a given point in time based on a set of shocks. The FSAP team also highlighted risks that would eventually become the main threats to financial stability in Ireland, namely household credit risks resulting from the house price boom, the rise in household debt, the concentration risk in the banks' books on household credit, and the banking system's heavy reliance on wholesale funding. In the absence of detailed information and given the macroeconomic scenarios agreed with the authorities, these risks were not viewed as posing an imminent systemic threat to the banking system either in terms of solvency or liquidity. With the benefit of hindsight, the Irish authorities and the FSAP team could not fully assess the interconnectedness between sectors (especially exposure of banks to commercial properties) and across countries in part due to limited data availability and in part due to available analytical techniques.

The stress test shock scenarios included a sharp slowdown in world trade (6 percent), a significant appreciation of the euro (25 percent) and a decline in house prices (40 percent), whose magnitude was calibrated to extreme historical values, with an estimated 1 percent joint probability. The combined impact was to lower Irish GDP by 15 percent relative to the growth path in the baseline scenario. Therefore, these assumptions cannot be considered to be inconsistent with good practice in macro prudential stress tests (see 2012 IMF Board paper "Macro financial stress testing – Principles and Practices"). In the event, the declines in GDP (cumulative fall of 7.5 percent in 2008–09 compared with 5.1 percent assumed in 2007–08) and house prices (50 percent over 2007–12) turned out to be worse and over a more prolonged period than the stress test assumptions, in part reflecting the global nature of the financial crisis that occurred.

2b. Does the IMF rely at present on similar sources in its analysis for Country financial system stability assessments?

FSAP requirements have been strengthened in recent years. FSAP analysis now places more emphasis on systemic risk, cross-border exposures and spillovers, macroprudential policies, financial safety nets, and crisis management frameworks. At the same time, global supervisory standards have been improved and a global standard on bank resolution has been adopted. Nonetheless, FSAP teams still rely on national authorities for data and other information.

3. Did the IMF assess the connection between the growth in property lending and the risk to financial stability in the years prior to 2008?

The IMF staff frequently assessed the link between the growth in property lending and financial stability in the years prior to 2008. For example:

- The 2000 Article IV Staff Report includes a discussion of risks associated with the property boom (Box 2 on page 16). It notes that:
  - "It is less clear that fundamentals alone can justify the rapid increase in house prices" and points to the possibility that "sustained rapid price increases may lead to self-fulfilling expectations-driven demand followed by price overshooting".
  - "Cumulative real estate prices increases in Ireland exceed those of several countries, notably the United Kingdom, Sweden, Finland, and Norway that experienced unsustainable property booms in the late-1980s."
  - "…in fact, no industrial country in the last 20 years has experienced price increases on the scale of Ireland without suffering a subsequent fall."
  - "…if Irish real estate prices were to fall, the aggregate demand effects would probably be substantial, given the high rate of house ownership in Ireland. It is not currently considered that such a decline would pose a threat to the Irish banking system. Average household indebtedness is still moderate; falling interest rates have kept the mortgage repayment burden well below that during the UK boom, and Ireland's volume of mortgage debt remains below that observed in other countries at their house price peaks."
  - "Given this, the risks may arise not so much from a price decline now, as from the possibility that rapid price increase may persist, increasing the potential for overshooting and a future price reversal."
- Further discussion is provided in the report, including in:
  - Page 31, paragraph 33: "…The mission stressed the dangers that an unsustainable property boom posed for macroeconomic stability and financial sector. Given these dangers and lags with which most feasible measures operate, the mission called for early consideration of the full range of measures affecting property incentives. In the

mission's view, it was unfortunate that two otherwise desirable measures—a well-designed property tax, and water sewage charges—did not appear to be on the agenda. The authorities since announced additional measures, based on the recommendations of an external consultant, aimed at improving housing supply and discouraging speculative demand."

  - The report also includes the main conclusions of the 2000 Financial Sector Assessment Program (FSAP) in Box 5 on page 33. The FSAP indicated that the financial system has a "high degree of resilience to macroeconomic shocks and a fall in property prices", yet it also recommended that "the CBI's risk-based approach to supervision was fully appropriate but could be further strengthened by increasing the focus on systemic issues through, for example, a deepening of its analysis of macroprudential indicators. Also, the CBI should use its full arsenal of prudential requirements to ensure that smaller mortgage lenders are adequately capitalized and provisioned."

- The 2001 Article IV Staff Report includes an assessment of property prices and related risks:

  - Page 18, paragraph 19: "On real estate prices, the recent gradual cooling of the housing market reduces the risk of a disorderly downward correction in house prices. Nevertheless, the equilibrium relative price of housing is likely to keep rising for some time because of the demand for additional housing spurred by the rapid rate of new household formation–reflecting demographic trends and immigration–and rising real incomes…supervisory vigilance is key to ensuring that should a sharp downturn adjustment in real estate prices occur, it will not pose a systemic risk to the financial sector."

  - In page 28, paragraph 46, staff noted that "the banking sector is well capitalized, and although the overall exposure to the real estate sector remains high, there is no evidence of a significant change in vulnerability since last year's FSAP."

- The 2002 Article IV Staff Report discusses property market developments and the resilience of the financial system to shocks. For example:

  - Page 22, paragraph 25: "There was general consensus on a soft landing in property prices after years of rapid growth."

  - Pages 22–23, paragraph 26: "Banks' greater caution on extending

housing loans in 2000–01 had contributed to the limited adverse effects, thus far, from the recent growth slowdown (Table 6). Stress tests revealed that banks were more vulnerable to increases in unemployment than to a fall in house prices, and thus a possible appreciation of the euro could be a particular risk…Staff observed that banks' exposure to housing and commercial real estate remained high (some 60 percent of loans to the private nonfinancial sector at end-2001) and continued supervisory vigilance was needed if these markets do not recover as expected…"

- The 2003 Article IV Staff Report includes an assessment of whether fundamentals can explain the growth of house prices in Ireland (Annex I) and of risks to the financial sector (Annex II).

    - The analysis in Annex I (page 28) indicated that "the possible existence of a house price bubble depends on whether the change in demand behavior observed in the late 1990s represents a permanent structural adjustment (e.g., to a different economic environment from joining the EMU) or a temporary deviation. In the former case, fundamentals such as real income and real interest rates could largely explain house price growth. However, if behavior itself has been temporarily affected by boom conditions, there is a substantial risk that house prices may be significantly overvalued."

    - Annex II (page 31) indicated that "Credit growth has remained very high for some years, with heavy exposure to the mortgage and real estate market" and that "credit risks within the mortgage portfolio have also risen". Moreover, it noted that "the boom in house prices has led to an increase in borrowers' leverage, resulting in rising equity withdrawal and loans to small investors to acquire rental properties." The analysis suggested that "even if only a small portion of borrowers renege on obligations, execution of corresponding collateral could create a dangerous dynamic if Ireland's small housing market were not able to absorb the additional supply without a further sharp reduction in house prices (particularly in a deepening downturn)."

- The 2004 Article IV Staff Report discusses the developments in property prices and repercussions for the financial system:

    - Page 18, paragraph 18: "Rapidly rising property prices in the face of slow growth have been a feature in many countries recently, but the extent, scale and duration of the boom in Ireland set it apart."

- Page 19, paragraph 20: "There is greater agreement that recent rates of price increase are running above sustainable rates dictated by medium-term growth prospects and the longer they fail to moderate the greater the vulnerability to a possibly disorderly correction."

- Page 20, paragraph 23: "a sharp correction in the housing market could have macroeconomic consequences, although financial stability is likely not a concern."

- The accompanying Selected Issues Paper looked at the drivers of rapid increase in house prices and the consequences of possible adjustment in the property market:

  - Page 35, paragraph 34: "Going forward, house price increases need to moderate. As suggested by the asset valuation of housing, future growth in real house prices should be in line with the medium term prospects for real income growth of 4–5 percent per annum. If house price increases—currently still running in double digits—fail to moderate to these more sustainable rates, the likelihood of a disorderly correction will rise further."

  - Page 35, paragraph 35:

    - "With 50 percent of the banks' loan portfolio concentrated in the property sector, a sharp correction in house prices could lead to cutbacks in lending as the collateral values and banks profitability decline. This, in turn, could result in a protracted period of slow private consumption and investment."

    - "Accounting for over 10 percent of total employment and over 7 percent of GDP, the construction sector in Ireland could suffer sizable output and employment losses as a direct response to an adverse shock from the housing market."

    - "An adjustment in the housing market could affect household consumption in a number of (direct and indirect) ways. Potential employment losses could lead to a protracted slowdown in consumption growth. In principle, consumption growth could also decelerate as a result of the negative wealth and liquidity effects associated with the adjustment in the housing market, although the strength of these channels in Ireland is not well established."

- The 2005 Article IV Staff Report includes a discussion on the level of house prices. For example:

  - Page 5, paragraph 4: "staff analysis suggests that not all of the increase in house prices over the past several years can be attributed to fundamentals and that the estimated house price overvaluation in Ireland is relatively large compared to other countries (though—given the inherent uncertainties in these types of calculations—it is difficult to be precise about the degree of overvaluation)."

  - Page 11, paragraph 10: "The housing market is widely regarded as headed for a soft landing, though the authorities and staff acknowledged the risk of a sharp decline. Survey evidence suggests that expectations of house price appreciation have declined in line with the easing of actual house price appreciation. The authorities argued that the underlying demand for housing is relatively strong, noting that the number of dwellings per capita in Ireland is still low compared to other advanced economies in Europe. Nonetheless, the authorities and staff agreed that house prices are relatively high on a variety of measures, including the price-earnings ratio in the housing market, which is still about double its historical average and one-and-a-half times its 2002 level."

- The 2006 Financial System Stability Assessment (FSSA) Update discusses the link between credit growth and the housing market boom:

  - Page 5, second paragraph: "sustained rapid credit growth, driven largely by the record increases in mortgage credit which have accompanied the extended boom in the housing market, has resulted in household debt to GDP ratios that are now amongst the highest in Europe, raising some concerns about household sector credit risk."

  The FSSA Update also assessed the links between property lending and housing market through various stress tests:

  - Page 5, third paragraph: "The financial system seems well placed to absorb the impact of a downturn in either house prices or growth more generally." And that "…the major domestic lending institutions have adequate capital buffers to cover a range of large but plausible hypothetical shocks…"

- In the 2006 Article IV Staff Report, staff notes that:
  - Page 4, paragraph 2: "Bank credit to property-related sectors has grown rapidly and now accounts for more than half of total bank lending."
  - Page 8, paragraph 5: "House prices are seen as somewhat overvalued by staff, becoming somewhat overvalued by CBI officials, and in line with fundamentals by DOF officials."
  - Page 9, paragraph 9: "…However, rapid credit growth has led not only to a concentration of lending in property-related sectors, but has also increased banks' reliance on wholesale funding as lending growth has exceeded deposit growth."
- The 2007 Article IV Staff Report includes a discussion of the housing market, property lending, and the results of stress tests that were conducted by the central bank:
  - Page 1, third paragraph: "Banks have large exposures to the property market, but stress tests suggest that cushions are adequate to cover a range of shocks."
  - Page 4, paragraph 2: "House prices increased rapidly and the ratios of house prices to rents and to household disposable income rose to historical highs. The construction boom was accompanied by surging bank credit to property-related sectors, strong wage growth and inflationary pressures, and a deterioration in the external current account balance."
  - Page 6, paragraph 7: "With the ratio of house prices to rental income above its historical average, house prices were seen as somewhat overvalued by Central Bank officials and staff, though in line with fundamentals by Department of Environment officials."
  - Page 16, paragraph 21: "Stress tests by the Central Bank indicate that the major lenders have adequate buffers to cover a range of shocks. Even in an extreme scenario, involving a sharp rise in unemployment and a sharp decline in house prices, capital remains adequate at every bank."

4. Did the IMF provide sufficient and timely advice to the Irish Government in the years prior to the Bank Guarantee in 2008?

The IMF's Article IV reports on Ireland prior to 2008 recurrently pointed to the risks of a housing bubble, as outlined in the answer to question 3. Policy advice on reducing these risks was provided, in particular in relation to housing tax incentives (the following extracts include staff views and the responses of the authorities in italics):

- The 2003 Article IV Staff Report, page 16, paragraph 11: "Various tax changes in recent years have sought to achieve a better balance between housing supply and demand…The stamp duty regime has been changed frequently. After measures to cool the housing market contributed to an unexpectedly sharp deceleration in houses prices in 2001, the 2002 budget re-introduced measures that many analysts felt were fuelling the resurgence in house prices. Staff noted that…care would need to be taken that measures do not postpone the adjustment of house prices, given the risk of an even sharper unwinding later on."

- The 2004 Article IV Staff Report, page 26, paragraph 38: "At this conjuncture, public policy should aim to engineer a soft landing in the housing market…The strong preference in Ireland for owning property is a compelling reason for not providing additional incentives in the form of subsidies to home ownership. Removing the interest-deductibility of mortgage payments on primary dwellings and introducing a market-value-based wealth tax on property is therefore important."

- The 2005 Article IV Staff Report, page 15, paragraph 16: "The authorities noted that a review of property related tax reliefs is currently underway, and staff observed that a useful way to curtail these reliefs would be to establish across-the-board limits on allowances. Staff also suggested preserving the nominal ceiling on mortgage interest tax relief (MITR) and introducing a property tax. *The authorities noted that there are no plans at present to raise the MITR ceiling, but that the appetite for a property tax is limited, recalling the short-lived experience with a property tax on high-value homes between 1983 and 1996.*"

- The 2006 Article IV Staff Report, page 13, para 15: "On the revenue side, staff suggested broadening the tax base by phasing out the remaining property based incentive schemes, reducing mortgage interest tax relief, or introducing a property tax. *Officials acknowledged the economic desirability of broadening the tax base, but pointed to popular opposition to increasing property-related taxes.*"

- The 2007 Article IV Staff Report, pages 12–13: "... *On the revenue side, the authorities noted that a Commission on Taxation will be established to review the efficiency and appropriateness of the taxation system*. Staff suggested that the Commission could consider, among the other issues, the nature of taxes on property, with a view to establishing whether revenue neutral adjustments might be made which would encourage mobility while ensuring a dynamic tax base and avoiding distortionary effects. Staff also suggested broadening user fees, for example by fully charging for water supply and sewage treatment and introducing a congestion charge in Dublin. *The authorities pointed to the political sensitivity of property-related taxes and user fees*."

Staff policy advice also focused repeatedly on the broader risks stemming from a pro-cyclical fiscal stance:

- The 2000 Article IV Staff Report included a discussion of risks of fiscal stimulus in the context of an overheating economy:
  - A Box on "Responding to overheating under EMU" (page 23), highlighted the crucial role of fiscal policy in the face of excess demand: "In the absence of monetary policy, adoption of a contractionary fiscal policy is an obvious choice to address excess demand. Certainly, there is no case for a pro-cyclical fiscal stance, and a compelling case exists for taking advantage of strong cyclical conditions to make rapid progress on medium-term structural fiscal goals…It is concluded that the dangers have indeed reached the point where discretionary fiscal tightening is warranted, notwithstanding the fact that the budget is already in surplus…".
  - Staff Appraisal, page 35, paragraph 44: "**Given the overheating risks, fiscal policy should be tightened to restrain excess demand pressures.** For 2000, this suggests that budgeted spending limits should be strictly adhered to, and any excess tax receipts should be saved. For 2001, some increase in the fiscal surplus would be preferable, thereby ensuring an improvement in the structural primary balance. This would imply a significantly tighter stance than implied by the target in the Stability Program."
- The 2001 Article IV Staff Report contained similar advice:
  - Page 20, paragraph 21: "…even if fiscal policy had limited effect on tradable prices, it would still affect the relative price of non tradables—both labor and assets such as houses. It would thus be important to avoid a pro-cyclical stance."

- Page 27, paragraph 43: "**The fiscal stance in 2001 should have been neutral rather than expansionary, and it will be important to prevent a further fiscal impulse in 2002**….Although mid-year fiscal measures are not warranted in 2001 given slowing growth, public expenditures should be held tightly to budgeted levels and any underspending saved to mitigate the fiscal easing. For 2002, any procyclical effects of improvements to the structure of taxes or expenditure should be curtailed through offsetting measures elsewhere in the budget."

- As did the 2002 Article IV Staff Report, page 25, paragraph 36: **"In the short-term, fiscal policy should be broadly neutral**. ….Given such concerns and the already expansionary stance in 2002…, it will be critical to hold general government spending firmly to budgeted amounts this year. Fiscal policy should, at minimum, be neutral in 2003, barring any large economic shocks."

- The 2004 Article IV Staff Report, page 26, paragraph 39: "…**cyclical considerations argue for frontloading the remaining necessary longer-run consolidation.**… Political pressures to spend the improvement in the public finances should be resisted as such an easing would be procyclical, raise inflation, hurt competitiveness, and limit the value for money from such expenditures."

- The 2005 Article IV Staff Report :

  - Page 3: "While public finances are strong, the 2005 budget implies sizable fiscal stimulus, which is ill-advised for an economy close to full employment. There was agreement that fiscal tightening would be desirable to dampen aggregate demand in the short term and to build a cushion in the event that downside risks materialize in the medium term."

  - Box 1, page 8, featured a review of past Fund Policy Recommendations and Implementation: "…the fiscal stance has tended to be procyclical, contrary to Fund recommendations."

  - Page 14, paragraph 14: "Staff suggested that, given Ireland's cyclically advanced position and accommodative euro area monetary policy, fiscal tightening would be desirable."

  - Page 23, paragraph 33: "The key priorities for fiscal policy are to help relieve potential overheating and to build a cushion in the event that

downside risks materialize. Public debt is low and fiscal positions have been generally prudent, but the 2005 budget is imparting considerable fiscal stimulus, which is adding to pressures on capacity constraints."

- The 2006 Article IV Staff Report, page 16, paragraph 22: "Given the strength of domestic demand, the risk of a hard landing, and the need to prepare for population aging, fiscal stimulus in 2007 would be unwarranted and modest tightening would be desirable."

- The 2007 Article IV Staff Report cautioned against fiscal stimulus:

    - Page 11, paragraph 14: **"The budget for 2007 implies substantial fiscal stimulus at a time when the economy may be operating at or above capacity**… Staff noted that, given inflationary pressures, eroding competitiveness, and a widening current account deficit, substantial fiscal stimulus in 2007 is unfortunate, but the authorities pointed to the need to achieve social objectives."

    - Staff also noted downside risks from the housing market and external economic developments, page 12, paragraph 15: "However, a faster-than-expected cooling of the housing market could result in a much sharper fall in the fiscal balance, reflecting lower property-related revenues, lower income tax and VAT revenues, and higher spending on unemployment benefits. If external shocks were to occur at the same time, the deterioration in the government balance could be even larger, as illustrated by the large deterioration in the fiscal balance (almost 5 percentage points of GDP) between 2000–02."

    - The report concluded, page 20, paragraph 29: "In 2008, on unchanged policies, some weakening of the fiscal position due to the cooling housing market is likely. Given the uncertainty about the size of the decline in revenue from the cooling housing market, this is the time to preserve a strong underlying fiscal position by restraining current spending increases to nominal GDP growth and avoiding tax cuts. Over the medium term, fiscal policy should focus on improving the quality of spending and modernizing property-related taxes."

On the financial sector, advice included:

- The 2000 Article IV Staff Report, page 36, paragraph 48, urged that: "**The sustained rapid growth in private sector lending calls for extreme vigilance, and supervisors should use all tools at their disposal to ensure that financial system remains sound.** The growing complexity of the

financial sector will pose increasing regulatory and supervisory challenges in coming years. Early resolution of the issue of a single supervisor would be desirable, and developments in this regard should not be allowed to disrupt the effectiveness of financial sector oversight."

- The 2007 Article IV Staff Report noted on page 20, paragraph 31: "**The key challenge for the financial authorities is to maintain the soundness of the financial system**. Banks have large exposures to the property market, but stress tests suggest that cushions are adequate to cover a range of shocks. The Financial Regulator's general approach—which aims to prioritize supervisory resources across sectors based on risk profile—is appropriate. The introduction of a new liquidity management framework for banks and the improvement in the capacity for insurance supervision are important steps forward. Looking ahead, continued careful monitoring of banks' risk management practices, including for commercial property lending, is essential. The envisaged upgrading of the stress-testing framework and the commitment to continue to improve supervision are welcome."

Although these extracts indicate the IMF provided relevant advice, subsequent reports have acknowledged weaknesses in IMF surveillance ahead of the crisis:

- The Article IV 2012 Staff Report (page 4, paragraph 2): " Regulators—and the IMF, in its surveillance role—failed to issue proper warnings as a vast commercial and residential property bubble inflated and bank assets grew to some 500 percent of GDP."

- Staff conducts an Ex Post Evaluation following all IMF supported programs with exceptional amounts of lending. The Ex Post Evaluation for Ireland's EFF was published on January 19, 2015. It notes that (page 6, paragraph 6): "Ireland's long history of economic success may have contributed to the fact that risks were largely not recognized or downplayed, both by domestic and foreign observers. This also applied in general to Fund surveillance prior to 2008, although staff reports noted that the "impressive" economic performance of Ireland was "increasingly reliant on house building."… The 2006 Financial Sector Stability Assessment (FSSA), while highlighting vulnerabilities, did not raise significant flags."

The IMF's Independent Evaluation Office (IEO) is conducting a review of "The IMF and The Euro Area Crisis" that will include a fuller evaluation of the IMF's surveillance of Ireland before the crisis.

5. Comment on whether the IMF should have changed the methodology for estimating the CAB (Cyclically Adjusted Budget) prior to 2009 and whether such a change would have materially changed its advice to the lrish authorities prior to 2009.

The IMF's calculations of the structural fiscal balance for Ireland ahead of the crisis used a similar approach to those used by the OECD and the European Commission:

- An output gap was calculated based on a Cobb-Douglas production function.
- Revenues were adjusted for cyclical factors using an aggregate elasticity of revenue with respect to the output gap.
- Expenditures were cyclically adjusted by replacing actual unemployment benefit spending with an estimate of spending if unemployment was at trend (NAIRU), which was estimated by statistical filtering of the headline unemployment rate.

This approach failed to recognize the temporary factors boosting revenues:

- The credit-fueled property boom had pushed output, especially in the construction sector, well above a level that could be sustained with more normal lending.
- It also failed to diagnose the high elasticity of revenues to the property boom, such as stamp duties, together with the broader impact of rising asset prices on domestic demand, and hence VAT and income taxes.

IMF staff have worked to improve the reliability of structural fiscal balance calculations:

- IMF Working Paper No. 10/57 on "Asset Booms and Structural Fiscal Positions: The Case of Ireland" published in March 2010 extended the standard estimation of structural balances by explicitly accounting for asset prices, the housing bubble, and changes to the composition of national income. It highlighted how the changing sectoral composition of GDP bolstered revenues unsustainably, supporting an expenditure relaxation that weakened public finances considerably ahead of the crisis.
- The June 2012 Staff Report for the 6th review of the EFF described the methodological changes adopted by staff to cyclically adjust fiscal balances. Using deviations of real output, house and equity prices, and unemployment from their fundamental trends staff estimated that the cyclically adjusted primary balance stood at -8.7 percent of GDP in 2007.

- The IMF Multi-Country Report "Housing Recoveries: Cluster Report on Denmark, Ireland, Kingdom of the Netherlands—the Netherlands, and Spain" published in January 2015 also featured an alternative approach to calculating the output gap based on a multivariate filter taking into account asset prices and other financial variables.

- More recently, the 2015 Selected Issue Paper proposed a further enhancement to the calculation of Ireland's cyclical position by excluding the impact of large swings in the value added of multinational enterprises.

Earlier changes to the methodology used to estimate structural fiscal balances would have highlighted the extent to which asset prices were impacting revenues. They may not have fully captured the temporary element of revenues, which would have required a fuller appreciation of the extent to which activity was inflated by lending and also of the sensitivity of revenues to property turnover. Nonetheless, the assessment would have been that the underlying fiscal position was inadequate relative to the strength of economic activity, reinforcing the case that staff made for a stronger fiscal stance (see response to question 4). Such a policy could have helped moderate the boom-bust cycle, yet it would have been more important to strengthen macroprudential regulation.

6a. Did the IMF raise any concerns with the Department of Finance, the Central Bank or the Financial Regulator regarding risks in the property and banking sector prior to 2008?

6b. If yes, with whom were the concerns raised and outline the responses provided?

In reports prior to the crisis, staff considered the rapid credit growth and the large credit exposure of banks to the property market a concern, pointed to the risk of a possible property downturn, and recommended a range of policy actions. Before they are published, such reports are provided to the IMF's Executive Board and also to the Irish authorities (the main counterparts being the Department of Finance, the Central Bank of Ireland, and the Irish Financial Services Regulatory Authority while it was in place). The following extracts include staff views and the responses of the authorities in italics:

- The 2000 Article IV Staff Report presents the IMF staff and the authorities' views about the risks:

    - Page 36, paragraph 48: "The sustained rapid growth in private sector lending calls for extreme vigilance, and supervisors should use all tools at their disposal to ensure that financial system remains sound."

    - Page 36, paragraph 49: "Recent moves to promote better balance in the property market are timely, as international experience suggests that

economic costs of allowing an unsustainable property boom to develop can be very large. While the focus on alleviating supply-side constraints is appropriate, however, it is unclear whether the latest measures on the demand side go far enough in reducing expectations-driven demand."

- Page 34, paragraph 37: "*the central bank authorities were fully cognizant of the risks posed by current developments, and had been active in working with credit institutions to develop and refine stress tests that assessed the impact on their portfolios of a weakening in macroeconomic conditions. These tests suggested a high degree of resilience to macroeconomic shocks and to a fall in property prices. The authorities would continue to monitor the situation closely and would not hesitate to ask individual institutions to raise their solvency ratios if they felt this was warranted*."

- The 2001 Article IV Staff Report presents IMF staff and the authorities' views about the property market and financial sector's soundness:

    - Page 28, paragraph 46: "*The authorities' judgment that the present slowdown will not pose significant systemic difficulties for the banking system* seems broadly appropriate, but vigilance is always essential on this score. The banking sector is well capitalized, and although the overall exposure to the real estate sector remains high, there is no evidence of a significant change in vulnerability since last year's FSAP."

    - Box 2 in page 32 provides a summary of the 2000 FSAP conclusions and recommendations, noting that "the CBI should continue to pay particular attention to the smaller mortgage lenders. While not individually systemically important, the sectoral concentration in loan portfolio of these institutions, along with their likely lower resilience, could lead to problems in case of an economic downturn which might be aggravated by a loss of reputation."

- The 2002 Article IV Staff Report presents IMF staff and the authorities' views on the property market's risks and soundness of the financial system:

    - Pages 22–23, paragraph 26: "*The authorities considered the financial system to be well capitalized and sound. Banks' greater caution on extending housing loans in 2000–01 had contributed to the limited adverse effects, thus far, from the recent growth slowdown (Table 6). Stress tests revealed that banks were more vulnerable to increases in*

unemployment than to a fall in house prices, and thus a possible appreciation of the euro could be a particular risk…Staff observed that banks' exposure to housing and commercial real estate remained high (some 60 percent of loans to the private nonfinancial sector at end-2001) and continued supervisory vigilance was needed if these markets do not recover as expected…"

- Page 26, paragraph 43: "The level of capitalization of the banking system appears to provide an adequate buffer against moderate risks to asset quality. Nevertheless, continued supervisory vigilance is required to ensure that capital and provisions remain adequate in the event of any unexpectedly large increases in unemployment or ICT-related bankruptcies, or deterioration in property prices."

- The 2003 Article IV Staff Report presents IMF staff and the authorities' views on property market risks—including commercial property—and the soundness of the financial system:

  - Page 14, paragraph 8: "The spectacular increase in house prices and credit to households over the past several years inevitably raises the risk that prices may unwind, possibly abruptly, especially if unemployment were to rise further."

  - Pages 15–16, paragraph 10: "*Many officials and analysts felt that house prices were not out of line with fundamentals… With income growth and rents slowing and supply increasing, they expected house price inflation to moderate considerably, without a significant risk of a crash. But others cautioned that a bubble was likely since house prices had been outstripping rents and were inflated by speculative activity as investors had been shifting out of the stock market*."

  - Page 16, paragraph 12: "*The authorities were concerned about risks to banks from rapid price and credit growth, but noted that high levels of capitalization and profits provided an adequate cushion to absorb the effects of potential shocks without systemic distress*….Staff agreed with the authorities' concerns about risks in mortgage lending, particularly from possible rise in unemployment and from differential credit risks within mortgage loan portfolios. Staff also noted that the concentration of large exposures to commercial property loans as well as insurance industry risks merit close attention."

  - Pages 25–26, paragraph 35, staff stressed that "continued supervisory vigilance will be needed to ensure the stability of the financial system,

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given risks from slower growth, higher unemployment, and a potentially abrupt unwinding of house prices." Staff also argued that "while high levels of capitalization and profitability have fortified banks' capacity to absorb the effects of potential macroeconomic shocks without systemic distress, some issues merit close attention. These include differential credit risk within mortgage loan portfolios; the vulnerability of debt service payments to sharp increases in unemployment; the concentration of large exposure to commercial property loans among few institutions; and the health of the insurance industry."

- In the 2004 Article IV Staff Report staff warned against a disorderly correction in the property market. For example:

  - Page 3, third paragraph: "House-price inflation continues to run well above sustainable rates and the longer it takes for them to moderate the greater the risk of a disorderly correction."

  - Page 14, paragraph 10: "Staff emphasized and the authorities acknowledged the risks to growth from the potential unwinding of the spectacular booms in house prices and construction."

  - Page 20, paragraph 23: "A sharp correction in the housing market could have macroeconomic consequences, although financial stability is likely not a concern."

  - On page 26, paragraph 38, staff stressed that "public policy should aim to engineer a soft landing in the housing market" and argued that "there is thus a strong case for removing the interest-deductibility of mortgage payments on primary dwellings and for introducing a market-value-based wealth tax on property."

  - Staff's view on the capacity of the banking system to withstand shocks is presented on page 20, paragraph 22: "High profitability and capitalization levels have bolstered the capacity of the domestic banking system to withstand shocks without creating systemic stress."

- The 2005 Article IV Staff Report mentions IMF staff and the authorities' views of the risks emanating from the housing market:

  - Page 11, paragraph 10: "The housing market is widely regarded as headed for a soft landing, *though the authorities and staff acknowledged the risk of a sharp decline….The authorities and staff agreed that house prices are relatively high on a variety of measures, including the price-earnings ratio in the housing market, which is still*

about double its historical average and one-and-a-half times its 2002 level."

And a discussion of the financial system's soundness and capacity to absorb shocks is presented:

- Page 18, paragraph 23: "Banking system profitability and capitalization are strong, but vulnerabilities exist (Table 6). Credit growth—while slowing—remains high, property-related lending accounts for more than half of the stock of bank lending, and net interest margins have declined as reliance on more expensive wholesale funding has increased. Household debt has risen sharply and now exceeds 110 percent of disposable income. *The authorities argued that efforts to increase awareness of risks—including the central bank's public warnings about the eventual rise in interest rates and the more recent roundtable discussions with heads of financial institutions organized by the central bank and financial regulator—have helped to cool the housing market. They said that a drop in house prices remains a possibility, but the banking system could withstand a considerable fall, as shown by the scenario analysis in the September 2004 Financial Stability Report. They added that only one tenth of households have debt service burdens greater than 23 percent of disposable income. The authorities observed that the international diversification of banks' assets is increasing*, but staff noted that much of this lending is also property-related. *The central bank and financial regulator have established a financial stability committee, which recently conducted a crisis simulation exercise. The authorities noted that asset-covered securities provide relatively inexpensive funding for mortgage lenders*."

- Page 24, paragraph 38: "In the financial sector, continued efforts are needed to maintain financial stability. While banking system profitability and capitalization are strong, vulnerabilities exist, and the authorities' efforts to increase awareness of risks are thus welcome. Looking ahead, continued supervisory efforts are essential to limit excessive risk-taking by lenders and borrowers: stress-testing could be enhanced and conducted more frequently, credit standards could be strengthened, and it is understood that an interim update on financial stability issues to complement the Financial Stability Report is currently being planned."

- The 2006 FSSA Update flags a number of risks related to the rapid credit growth and the booming housing market:

- Page 5, second paragraph: "sustained rapid credit growth, driven largely by the record increases in mortgage credit which have accompanied the extended boom in the housing market, has resulted in household debt to GDP ratios that are now amongst the highest in Europe, raising some concerns about household sector credit risk."

- Page 11, paragraph 7: "Further, while international diversification of bank's assets is increasing, with the two largest banks each having an almost equal amount of domestic and foreign assets, a significant part of the foreign assets are also property-related. These banks are therefore exposed to any general downturn in world property prices that might occur."

- Page 13, paragraph 14: "While much of the growth in housing construction, and the extended boom in house prices, can be explained by fundamental factors of catch-up and immigration, there are concerns that house prices are now becoming overvalued; real estate prices have risen by about 10 percent per year on average since 2000, consistently faster than household average income (Figures 4 and 5). The central expectation is for an orderly slowing in the housing market. A sharp correction cannot be ruled out, however, and would have adverse consequences for employment and growth, and thus for debt servicing capacities for both households and the corporate sector."

However, based on the stress tests, IMF staff noted that:

- Page 5, third paragraph: "The financial system seems well placed to absorb the impact of a downturn in either house prices or growth more generally."

- Page 20, paragraph 36: "The TD test on house price declines shows that the banking sector has enough profit and capital buffers to withstand severe shocks on combinations of house price declines and default rates. The test shows that the current value of provisions set aside for mortgage lending would cover a scenario of a 25 percent fall in house prices. Even if the mortgage NPL ratio were to increase from the currently low 0.45 percent to 5 percent after a 40 percent fall in house prices, the banks' existing capital buffer would adequately absorb the resulting loss."

- In the 2006 Article IV Staff Report staff underlines financial sector risks stemming from rapid credit growth and a possible correction in the housing

market:

- Page 15, paragraph 20: "Bank credit is expected to continue to expand rapidly, exacerbating financial sector risks….A contraction of the construction sector to a more sustainable size over the medium term is likely to be smooth, but an abrupt correction cannot be ruled out."

- Additionally, staff stressed on page 15, paragraph 21 that the: "Financial Regulator should continue to monitor banks' risk management practices, including for commercial property lending."

- The authorities' response was presented on page 10, paragraph 10, with a caution by staff about uncertainties around the authorities stress tests: "*Central Bank officials noted that recent stress tests indicate that the major lenders have adequate buffers to cover a range of shocks. The results suggest that, even in an extreme scenario involving a sharp rise in unemployment and a sharp decline in house prices, capital remains adequate in every bank. In addition, even a substantial withdrawal of private sector deposits would not exhaust the stock of liquid assets at any major lender, given banks' ample liquidity.* Staff welcomed these favorable results, but observed that the long period of strong economic performance limits the ability to quantify the relationship between macroeconomic variables and credit risk."

- The 2007 Article IV Staff Report presents the risks from housing market and the vulnerabilities from rapid credit growth:

  - Pages 7–8, paragraph 11: "The risks to the short-term outlook are tilted to the downside. The housing market could cool more sharply than expected or the external environment could deteriorate (or both). If realized, these risks would further dampen economic growth, reduce government revenue, and increase financial sector stress:

  - **"Housing market:** The prospect of lower capital gains could scare investors in buy-to-let properties. The 2006 census shows that 15 percent of dwellings are unoccupied, though this is in line with the EU average. Another transmission channel is through private consumption, as housing market developments could undermine consumer confidence. A third transmission channel is through the financial sector. The end of rapid house price appreciation could trigger a reassessment of the risks associated with mortgage lending, possibly leading to a tightening of lending standards, which in turn could affect domestic demand. Cross-country, historical evidence

presented in the April 2003 *WEO* suggests that sharp increases in house prices are followed by sharp declines about 40 percent of the time."

- Page 14, paragraph 20: "The banking system continues to perform well, but rapid credit growth has led to vulnerabilities.'

- Page 20, paragraph 28: "Rising euro area interest rates have prompted a welcome cooling of the housing market, which will help to rebalance growth, though there is a risk of a sharper slowdown." In addition, "…risks to growth from the housing market and the global economy are tilted to the downside. If these risks crystallize, growth could slow more sharply, with potentially adverse effects on government revenue and the financial sector."

- Page 20, paragraph 31: "the key challenge for the financial authorities is to maintain the soundness of the financial system", and that "the authorities and staff shared the view that continued careful monitoring of banks' risk management practices is essential."

- The authorities' views on the housing market are presented on page 7, paragraph 8: "*The authorities saw a soft landing of the housing market as likely. The shared view is that any overvaluation of house prices would likely diminish gradually over time as rental income and other fundamentals grow more quickly than house prices*."

7. Outline the views of the IMF on the extent to which domestic and or international factors caused the financial crisis in Ireland and if possible rank the factors.

As highlighted in the 2012 Article IV Staff Report (pages 4 to 6, paragraphs 1 to 5) and the Ex-Post Evaluation (pages 5 to 8, paragraphs 4 to 10) a complex combination of domestic and international factors was at play in Ireland.

8. What are the views of the IMF on the business models adopted by the Irish Banks prior to the financial crisis in 2008?

9. What are the views of the IMF on the property related lending strategies and risk appetite adopted by the Irish Banks prior to the crisis?

10. What are the views of the IMF on the funding sources, mix, maturity profiles and costs adopted by the Irish Banks prior to the crisis?

The 2006 FSSA Update makes the following points related to the business model of the Irish banks, including on property lending and funding:

- Paragraph 6 noted the banks' high loan concentration on the property sector**: "Banking system profitability and capitalization are strong and NPLs are low, but credit growth remains concentrated in the real estate sector**. As expected by the 2000 FSAP team, competition has strengthened, tending to compress interest margins and reduce fees. Banks have reacted to these trends with significant cost cutting. However, they have also benefited from the record increases in mortgage credit which have accompanied the Irish housing boom, with the result that Irish banking sector profits are currently amongst the highest in western Europe. The increase in mortgage credit has also meant that assets are concentrated in property-related lending; taking commercial property lending into account, total property-related lending accounts for more than half the current stock of bank lending.[3]

  [3] As at December 2005, residential mortgages comprised 37 percent, commercial property 17 percent, and construction 5 percent, respectively, of total bank lending."

- Paragraph 7 added that foreign exposure also included property lending and hence exposure to global property prices**: "Further, while international diversification of bank's assets is increasing, with the two largest banks each having an almost equal amount of domestic and foreign assets, a significant part of the foreign assets are also property-related**. These banks are therefore exposed to any general downturn in world property prices that might occur."

- Paragraph 19 drew attention to risky mortgage lending practices**: "Some banks have recently started to offer innovative mortgage products, such as 100 percent LTV and interest-only mortgages.** This reflects increased competition in the mortgage market, especially from new entrants seeking to gain market share. Most of these products are reportedly offered only to a limited range of bank customers, for example, borrowers with particularly high earning potential. Indeed, the maximum debt service to income ratios imposed by most banks on their clients mean that the majority of borrowers are ineligible for 100 percent LTV loans. Further mitigating risks, NPLs for mortgages are currently extremely low—at 0.45 percent, the ratio is amongst the lowest internationally.[7] That said, these innovative mortgage products are of higher risk to banks and the move by the authorities to require Irish banks to assign higher risk weights to mortgage loans with loan-to-value ratios above 80 percent from May 2006 onwards is therefore welcome.

[7] One reason for the very low NPLs is the prolonged expansionary phase of the business cycle in Ireland. Consequently, NPLs would be expected to rise somewhat when the expansion slows."

- Paragraph 8 noted high reliance on wholesale funding and consequent liquidity risks**: "Banking system lending growth has exceeded deposit growth for some time.** European Central Bank (ECB) data indicate that Irish banks had the lowest customer deposits-to-assets ratio of all western European Union (EU) member countries as at end-2004. As a result, a growing share of banks' funding has been from other financial institutions, including from off-shore; heavy reliance on wholesale funding potentially increases liquidity risk. As shown in Figure 1, however, the off-shore funding is diversified."

The vulnerabilities of the banks' business model prior to the crisis were also discussed in the 2009 Article IV Staff Report, page 13, paragraph 18:

- "…Domestic vulnerabilities are revealed in the sharp decline in the stock prices of Irish banks relative to the overall stock index, the pronounced degree of this fall differentiating Ireland from other eurozone banks (Figure 1). Three key features of the financial system have been central to the strains they are facing:

    - The domestic loan portfolio is heavily concentrated in residential mortgages, construction, real estate development, and commercial property (Table 5). The sharp correction in property prices lies at the heart of the losses that banks face. Residential mortgage servicing has held up, but arrears have been growing and will likely increase as the unemployment rate rises. Some Irish banks are also exposed to risks from their substantial property and home mortgage lending in the U.K.

    - Irish interest margins were low by international standards. As the crisis has unfolded, margins have been under further pressure with the sharp decline in lending rates (especially for mortgages, which are predominantly on variable rate terms).

    - In the past, profitability was maintained through large lending volumes. But since domestic deposit growth did not keep up with the lending targets, reliance on wholesale funding increased, reflected in the rise of the loan-to-deposit ratio. With the recent downturn, market funding pressures have been compounded by lack of growth in deposits."

And in the 2012 Article IV Staff Report, page 4, paragraph 2:

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- **"**The boom years stored up immense problems. Following a decade of export- and FDI led growth supported by broad-based productivity gains, from about 2003 on the Irish economy embarked on a domestic boom underpinned by lax lending. Stiff competition for market share from foreign-owned as well as domestic banks pushed underwriting standards lower, and the feedback effect of rising collateral values fuelled the leveraging process. Rapidly rising property prices also drove high fixed investment in commercial and residential property, and a positive wealth effect fed private consumption, raising incomes and employment. Wages and prices rose, eroding competitiveness and compressing real interest rates. The integration of the Irish financial system into the broader euro area financial landscape, as well as the apparently strong fiscal position of the sovereign, gave Irish banks unfettered access to wholesale funding that turbocharged their asset expansion. In the five years to mid-2008 the net foreign liabilities of the Irish banking system jumped from about 20 percent to about 70 percent of GDP, and wholesale funding rose to 55 percent of assets."

11a. Did the IMF give any advice to the lrish government on dealing with the fiscal banking or Liquidity position in the 6 months prior to the Guarantee in September 20008?

11b. lf Yes, outline the advice given?

IMF staff are not aware of any specific advice given to the Irish government by the IMF on these matters in the six months prior to the September 2008 guarantee.

12a. Outline the views of the IMF on the Government decision on the 30th September 2008, to provide a blanket guarantee to the depositors and creditors of 6 domestic banks?

12b. Comment on the scope of the Guarantee which covered all retail and corporate deposits, interbank deposits, covered bonds (including asset covered securities) senior unsecured debt and dated subordinated debt.

The 2009 Article IV Staff Report noted:

- Page 15, paragraph 18 that the: "The government's guarantee to depositors and creditors and the capital injections have helped banks obtain market funding, and access to ECB facilities has been an important stabilizing factor."

- Page 16, paragraph 19: "**The authorities' extensive and ongoing support**

has been vital to maintain financial stability. On September 30, 2008, following the failure of Lehman Brothers, the government provided a blanket guarantee to the depositors and creditors of six domestic banks.[4] The guarantee, covering over 200 percent of Irish GDP, is much larger than in other countries.

[4] The guarantee covered all retail and corporate deposits, interbank deposits, covered bonds (including asset covered securities), senior unsecured debt and dated subordinated debt."

The IMF's Ex Post Evaluation of Exceptional Access Under the 2010 Extended Arrangement, however, concluded that the government's decision to provide a blanket guarantee limited the policy options for the Fund-supported program (page 9, paragraph 13):

- "Some steps taken during this period would limit subsequent policy options for the Fund-supported program. These included the blanket guarantees extended to bank creditors, which provided some bank creditors time to exit and with banking sector burden sharing covering only a relatively modest amount of subordinated debt, these steps intensified the nexus between the banking and the public sector. Moreover, the state support for the banking sector contributed to a large increase in public debt to close to 100 percent of GDP (not counting the cost of further bank recapitalization), before the Fund-supported program went underway. As a result, the fiscal space for maneuver was severely limited under the Fund-supported program."

As part of the lessons from the crisis, the IMF's Ex Post Evaluation of Exceptional Access Under the 2010 Extended Arrangement noted that unsecured and non-guaranteed creditors of failed banks should be bailed in (page 37, paragraph 64):

- "Unsecured and non-guaranteed creditors of failed institutions should be bailed in, accompanied by a strategy to ring fence potential risks when needed. Market participants generally anticipated a bail-in of unsecured creditors in failed Irish financial institutions. Moral hazard considerations, the need to contain public debt, and experience outside the euro area also argued for this approach, at least in failed institutions that required public support, and that it should have covered not only subordinated debt holders but also senior bond holders. While this approach would have broken new ground in the euro area at a time of area-wide fragility, negative spillover effects to other parts of the area, to the extent that they might have occurred despite the anticipation by market participants, should have been ring fenced at the euro area level."

13. Outline the chronology of contacts, if any, and the advice given to the Irish Government following the decision to guarantee the banks and prior to the official request by the Irish Government for a programme of assistance in 2010?

The frequency of contacts between authorities and IMF staff increased over the 2009–10 period. The following focuses on the main contacts made and policy recommendations:

- **February 2009**: There was an IMF staff visit to Dublin ahead of the annual Article IV consultation mission in April. Staff enquired whether a Fund-supported arrangement could be useful in helping smooth the necessary adjustment.

- **June 2009:** The 2009 Article IV mission took place in a deteriorating external and domestic environment in April-May. At that time, IMF staff raised again with the authorities the possibility of Ireland requesting a precautionary arrangement. The Article IV Staff Report published in June 2009 contained the following policy recommendations:

  "**43. The Irish economy is in the midst of an unprecedented economic correction.** The stress exceeds that being faced currently by any other advanced economy and matches episodes of the most severe economic distress in post-World War II history. Banks face extensive losses and double-digit fiscal deficits over the next three years will imply a run up in public debt. The short-term dislocations come on top of a sharp decline in potential growth, implying a modest pace of recovery.

  44. The risks remain significant. Market sentiment has improved and Irish sovereign spreads have come down from their highs. The reduction in public sector wages has been accompanied by a decline in private wages, which if sustained would help competitiveness in the medium term. But the recent research is clear. Financial crises generate deeper and more prolonged downturns, and more so if the crisis is globally synchronized. In a weakened Irish economy, adverse global economic and financial events would be disruptive.

  45. On the two fronts that matter most, the authorities have moved in the right direction. Most recently, the proposed establishment of NAMA offers the prospect of extracting distressed assets from the banks, a precondition for their return to healthy functionality. They have also laid out a multi-year plan to contain the fiscal deficit.

  46. But the task ahead is formidable and determined execution of these initiatives will be needed. The challenge is severe because unwinding the large macroeconomic imbalances entails difficult policy

trade-offs, which, in turn, are associated with considerable political sensitivities. Communicating clear objectives, allowing for contingencies, and creating benchmarks for transparent assessment will help maintain political legitimacy.

47. **With regard to NAMA, risk-sharing structures should be considered to address the well-known pricing problem**. The pricing of distressed assets is complex and can slow down the transfer of assets from the troubled bank. Risk-sharing can potentially create better incentives for managing the bad assets and they guard against the risk that the taxpayer does not bear a disproportionate burden of the costs cleaning up the banks.

48. **It is particularly important to incorporate flexibility in NAMA's design.** While an early focus on removing property-development loans from the financial system may be appropriate, the economic downturn will cause impairment of other asset classes as the latest trends are already indicating. The option of relieving banks of those additional assets within a year or so will continue the process of "cleaning" up the banks. Absent that option, banks may remain hobbled.

49. **Where a bank has been rendered economically insolvent, the only real option would be its temporary nationalization.** In that case, NAMA would continue to act in its capacity as an agency managing bad assets. An advantage would be that prices at which these assets are transferred would become less of an issue. Nationalization could also be used as a step towards mergers and, hence, sectoral restructuring. But it would be necessary to ensure that the banks are operated transparently, with commercial objectives, and that they receive the same regulatory and supervisory treatment as private banks. Finally, a clear exit strategy to return the banks to private operation would be needed.

50. **Accompanying these immediate crisis management tasks are several supportive crisis prevention measures.** These can and should be guided by evolving European Union guidelines. However, inevitably, they will need to be tailored to domestic circumstances.

- A broader tool kit would allow for more speedy resolution of banks. This would be supported by the authorities' ongoing enhancements of the deposit protection program.

- The supervisory challenges include intensification of surveillance for systemic risks beyond the six guaranteed banks, further safeguards against related-party lending, and continued development of a macro-prudential regulatory and supervisory process.

51. **The authorities have laid out an ambitious fiscal consolidation plan.** While the initial reliance on increases in personal income tax rates was appropriate to minimize the contractionary effect of the consolidation, a greater focus on reductions in current expenditure will be needed in the coming years.

52. **Steps should be taken to sustain the execution of the planned fiscal consolidation.** The following principles could be used as a guide:

- More targeting of the vulnerable (as proposed for child benefits) and greater reliance on incentives for efficient use of public resources.

- Further ratcheting down of the public pay structure and employment levels.

- Broadening the tax base.

- A fiscal rule, backed by a medium-term expenditure plan that details the intended measures over the full horizon."

June 2010: The 2010 Article IV mission raised again the possibility of a precautionary agreement with the Irish authorities. The 2010 Article IV Staff Report policy advice published in July contained some of the key policy elements of the program (restructuring the banking system, resolving impaired loans, strengthening supervisory powers, establishing a special bank resolution regime, and strengthening the fiscal framework). Staff Appraisal, page 26, paragraphs 43 to 48:

"43. **Ireland is emerging from a deep slump into a modestly-paced recovery.** Helped by active policy stabilization measures and, increasingly, by the improved global outlook, GDP is expected to resume growing this year. However, because GDP fell steeply and through much of last year, the 2010 real GDP is expected to be about ½ percent lower than in 2009. As the crisis-related dislocations are corrected, GDP growth should increase gradually to about 3½ percent by 2015, while unemployment should decline from a peak of about 13¾ percent this year to still high 9½ percent.

44. **A continuation of vigorous policy efforts is required with an emphasis on risk management.** The challenge is to wean the banking sector from public support and stabilize public debt in a testing environment of gradual domestic economic recovery and episodic international market tensions. Mindful, therefore, that unforeseen fiscal shocks and, at times, heavily bunched banks' funding needs could constrain policy options along the narrow path to stability and recovery, active risk management should guide policy priorities. This will require a continued visible demonstration of commitment to the goals set. But with limited fiscal space, the commitment will need to be backed increasingly by mechanisms for accountability and oversight to anticipate and contain slippages and surprises.

45. **To address the fallout from the crisis, three restructuring priorities deserve attention.** Having acquired risky assets, NAMA's task would include restoring the commercial property market through an orderly schedule of market transactions. Economically vulnerable homeowners will likely need narrowly targeted support, including through banks that have been recapitalized by the state. And, following the stabilization effort through bank-by-bank restructuring, a strategic, market-oriented view should help reshape the banking sector.

46. **Much progress has been made on the financial stability agenda, but a special bank resolution scheme remains an important gap.** The de facto combination of the Central Bank and the Financial Regulator is being formalized. The new assertive, risk-based supervisory approach is welcome and needs to be backed by further resources and enforcement powers. The establishment of special bank resolution regime, which has been recognized internationally as a key stability tool, requires immediate attention.

47. **In their 2010 budget, the authorities have stayed on course towards their consolidation goals, but much remains to be done.** The authorities' consolidation target and path remain appropriate. The plan also strikes the right balance with its central reliance on expenditure reduction complemented by necessary revenue enhancement through a broader tax base. However, in a tense market environment for sovereign debt, the authorities should be prepared with additional measures to meet their targets in case of unexpected fiscal demands. The commitment to the consolidation path will be reinforced by greater specificity on the measures foreseen.

48. **This is also a good moment to establish a stronger fiscal framework.** A medium term fiscal framework incorporating expenditure ceilings is a valuable management tool that will help create greater transparency of fiscal priorities and reduce fiscal volatility. Recognizing their limits, a fiscal rule would be a helpful public metric of fiscal prudence and a technocratic fiscal council would help dampen fiscal risks."

Late 2010: As market conditions for Irish sovereign bonds deteriorated and banks' reliance on ECB liquidity support rose, a set of informal meetings were held in Brussels among the EC, ECB and IMF staff. These talks, starting in late-September, culminated on November 14 with a two-day meeting involving teams from all three institutions and a delegation of Irish officials. These meetings focused on some of key policy issues such as fiscal adjustment and the financial sector strategy.

November 18, 2010: The Irish authorities announced the arrival of negotiation teams from the EC, ECB, and IMF in Dublin, and shortly thereafter their intention to negotiate a comprehensive program that would form the basis for a request for assistance.

14. In a witness statement to the Banking lnquiry, Mr. Kevin Cardiff, Former Secretary General of the Department of Finance, stated, in relation to senior bank bondholders sharing the burden of bank failure:- "At the time, we were led to believe that Dominique Strauss-Kahn, Head of the IMF, was not only in favour of this approach, but believed he could persuade other major players in world finance, including the major European Governments, the Americans and the ECB to go along. Strauss-Kahn was to and did convene a conference call to pursue this arrangement. There had even been early indications of a positive hearing from U.S. Treasury Secretary Geithner. We heard back, however, via the IMF team in Dublin that instead of a positive response, there had been a strong negative reaction from the ECB and from Geithner and others and that the programme would not go ahead if senior bond holder burden sharing was contemplated. This was confirmed by European Commission and ECB negotiators in Dublin and the IMF negotiators despondently confirmed that this was now also the official position of the IMF."

14a. Does the statement by Mr. Cardiff accurately reflect the views of Mr. Strauss-Kahn and the IMF?
14b. Did Mr. Strauss-Khan convene a conference call on the issue?
14c. If such a conference call took place, is the statement by Mr. Cardiff accurate in outlining the views expressed by the ECB, Mr. Geithner and others?

Regarding questions 14a, 14b, and 14c, we consider that these issues are confidential and therefore cannot provide a response.

14d. What was the final position of the IMF on the proposal that senior bondholders would share the burden of bank failure?

The final position was for the Managing Director to propose a program to the Executive Board that did not specifically include burden sharing by senior bondholders. The Executive Board approved the proposed program. Nonetheless, the possibility for burden sharing with senior bondholders was not excluded, as reflected in paragraph 28 of the staff report for the Request for an Extended Arrangement:

> "**The sovereign's obligations will also be lower if the debt owed by banks is restructured**. For Anglo Irish, which is a nationalized bank, a debt exchange at a discount of about 80 percent is ongoing. This operation reflects the view that subordinated debt is designed to be loss absorbing and where a bank has lost substantial value—and, indeed, insolvent—the debt holders should share in the losses. Further such action is contemplated for banks that have received substantial state assistance, and would help reduce the need for fresh injections of capital by the government. Both the authorities and the staff noted that the decision to share losses with creditors should, in principle, be based on the extent of the banks' overall losses and the need to return the bank to a more stable funding structure, while keeping in view the knock-on effects on others."

15a. Comment on the implementation of institutional reform in Ireland to address weaknesses that led to the crisis.

The Staff Report for the 12th Review of the EFF summarized the key institutional reforms implemented under the program. As regards supervisory and financial regulation reforms (page 6, paragraph 2, 5th bullet point):

> "**Financial regulation and supervision have developed further and improvements continue.** In October 2011 a special resolution regime for banks and credit unions was enacted and in July 2013 the supervisory powers of the CBI were strengthened.[3] In December 2012 the new Personal Insolvency Act established three new essentially nonjudicial procedures for debt resolution and modernized the Bankruptcy Act 1988.[4] In May 2013 the CBI reinforced its Impairment Provisioning and Disclosure Guidelines, including clauses on loan modification and evergreening practices. The Credit Reporting Bill, though delayed, is expected to be enacted by December 2013 to provide for a statutory Central Credit Register system operated by the CBI. The CBI has been strengthening banking supervision by increasing resources and operationalizing its new risk based supervisory approach. Reports on Ireland's

observance of the Basel Committee Core Principles for Effective Banking Supervision and the IOSCO Objectives and Principles of Securities Regulation are due to be completed shortly, and the authorities are committed to continue making improvements in regulation and supervision.

[3] On the resolution regime, see Box 2 in Ireland: First and Second Reviews Under the Extended Arrangement.
[4] See Annex II, Ireland—Ninth Review Under the Extended Arrangement."

The two reports were subsequently released:

- Ireland: Detailed Assessment of Observance of IOSCO Objectives and Principles of Securities Regulation

- Ireland: Report on Observance of Standards and Codes (ROSC)

As regards the reform of the fiscal framework (page 6, paragraph 2, 3rd bullet point):

"**The fiscal framework has been strengthened.** A general government budget balance rule and a general government debt rule were adopted as part of the Fiscal Responsibility Act 2012, consistent with the Stability and Growth Pact (SGP). Budget 2012 introduced three-year aggregate and ministerial level expenditure ceilings, put on a statutory basis in the recently approved Ministers and Secretaries (Amendment) Bill 2013. The Fiscal Responsibility Act also provides for the independence and adequate funding of the Irish Fiscal Advisory Council (IFAC). The Council is responsible for providing an ex ante endorsement of the macroeconomic forecasts underpinning the budget and for assessing the soundness of the government's budgetary projections and fiscal stance. Measures to enhance transparency include the authorities' action plan on fiscal reporting, forecasting and risk analysis (guided by the Fund's fiscal transparency assessment) and the launch of a quarterly Government Finance Statistics publication."

15b. Identify any residual reforms deemed necessary by the IMF to protect Ireland in the event of further domestic or international turbulence.

Further steps are needed to complete the Banking Union in a manner that the bank-sovereign feedback linkages will be fully severed. As mentioned in the 2015 Article IV Staff Report for the euro area (page 18, paragraph 23):

"Further steps to establish a common backstop would help sever the bank-sovereign link. The resolution framework and bail-in regime under the Bank Recovery and Resolution Directive (BRRD) are expected to be operational from 2016. In addition, more work is needed in the following areas:

- Resolution: The financial capacity of the Single Resolution Fund (SRF) is limited (€55 billion) relative to the size of the euro area banking sector (€22 trillion).To ensure that funding is indeed available to resolve large banks in a crisis, the schedule for SRF funding and the mutualization of "national components" should be accelerated from the current eight-year transition period and its capacity expanded.

- Direct recapitalization: The current preconditions for ESM direct recapitalization of banks—bail-in of at least 8 percent of bank liabilities, followed by a sovereign recapitalization (if necessary) to raise common equity tier 1 to 4.5 percent of liabilities—are too high and should be relaxed. Consideration should also be given to raising the €60 billion ceiling on the ESM direct recapitalization capacity.

- Deposit guarantees: Deposit guarantee schemes (DGSs) across the euro area have been harmonized under the recent DGS Directive, but still fall short of a pan-European DGS. To discourage liquidity "ring-fencing" within national jurisdictions, a pan-European DGS should be established. Since such a pan-European DGS will take time, consideration should be given now to developing a common fiscal backstop to national DGSs, perhaps through the ESM."

More specifically on Ireland, the recent 2015 Article IV Staff Report highlighted a number of policy actions that are needed to enhance the financial sector's resilience, temper property price cycles, and contain bank exposures to the property market:

- Page 19, paragraph 38: "Bank resilience to commercial real estate risks must be protected, especially given the international search for yield. Losses on commercial property accounted for over half of bank capital needs in the crisis. The current upwards pressure on commercial property prices may continue for some time given the low yields available on many assets and the ECB's quantitative easing, raising the eventual prospect of a renewed price slump. Supervision should therefore focus closely on banks' risk management, underwriting standards, and valuations in this sector. Deployment of macro-prudential tools to contain bank's commercial property exposures, such as loan-to-value limits and capital add-ons, should be biased to being ahead of the curve, especially given the availability of nonbank and international financing sources for this sector."

More generally, the 2015 Article IV report saw scope to alleviate supply bottlenecks in the housing market and develop rental market to moderate property prices to reduce household exposure to house price fluctuations:

- Page 19, paragraph 39: "Addressing the weakness in housing construction will

help dampen price increases over time. While house price rises are beginning to promote a construction supply response, it has been weaker than in past experience. High construction costs are a key factor, including local building codes that are stricter than national standards and development levies. In addition, developers have been reluctant to use external equity as required given that banks now apply more prudent LTV limits to construction loans. Incentives to complete developments should be strengthened through use-it-or-lose-it building permits and a vacant site levy. Timely implementation of other Construction 2020 actions, including a streamlining and modernization of planning procedures, would also enhance the performance of this sector."

- Page 19, paragraph 40: "A more developed rental market would support labor mobility, help moderate property cycles, and reduce household exposure to house price fluctuations. Rented properties are a low share of Irish housing. Although Ireland rates favorably on indicators such as rent control, indicators related to landlord-tenant relationships suggest room for improvement. For example, the large role of small scale buy-to-let investors in providing rental housing militates against security of tenure for renters, as this undermines the liquidity of the investors' property. The framework for rental property should be reviewed with the aim of attracting professional investment and management into the sector, which could in time expand the supply and quality of rental property and moderate rents."

Staff also sees a need to address capital quality issues:

- Page 17, paragraph 32: "Early steps by banks to restructure their capital base and build high quality loss absorbing capital before the new capital rules become binding is preferable to relying primarily on the internal capital generation that is emerging across the sector."

16. Comment on the implementation by the Irish Government of recommendations by the Irish Fiscal Advisory Council established on an interim basis in July 2011 and put on a statutory footing in December 2012 by the Fiscal Responsibility Act.

The IMF supported the establishment of the Irish Fiscal Advisory Council (IFAC). This was an element of the IMF policy advice before the program:

- 2005 Article IV 2005 Staff Report, page 16, paragraph 19: "**Given pressures to raise spending and the softening of the SGP, staff saw a role for broader third-party assessment of fiscal policy, but the authorities were not convinced of the merits**….This could be done by building on existing institutions, such as the National Economic and Social Council (which consists of the social partners and provides the background analysis for the

national wage agreements), or by establishing a new body such as a fiscal council."

- Article IV 2010 Staff Report, page 10, paragraph 48: "This is also a good moment to establish a stronger fiscal framework… a fiscal rule would be a helpful public metric of fiscal prudence and a technocratic fiscal council would help dampen fiscal risks."

IMF research finds that well designed fiscal councils are associated with stronger fiscal performance and better macroeconomic and budgetary forecasts ("Strengthening Post-Crisis Fiscal Credibility—Fiscal Councils on the Rise", Debrun et al. April 2014).

Ireland continues to face high public debt and other fiscal challenges. The IFAC is providing a high quality analysis of Ireland's fiscal policy, which contributes to a healthy public debate in Ireland. As an advisory body, it is not expected that the government will implement all recommendations made by the IFAC. Fiscal councils in other countries also make recommendations that are not always implemented. In addition to the advisory role, objective analysis, independent monitoring of fiscal performance compared to rules, and forecast assessments are also vital for a healthy debate on fiscal policy. Overall, the IMF continues to see the establishment of the IFAC as making a valuable contribution to the soundness of Irish fiscal policy over time.

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