# TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

An tAcht um Thithe an Oireachtais
(Fiosrúcháin, Pribhléidí agus Nósanna Imeachta), 2013

# 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**

## Central Bank
## CB: Core Book 12

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Appropriateness and effective utilisation of the expert advice

## LINE OF INQUIRY: R4a

Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used

countries' fiscal accounts, thereby ensuring greater uniformity of reporting across the membership over time. With regard to the treatment of public enterprises in fiscal indicators, Directors noted that hardly any public enterprises met the criteria for commercial orientation proposed in the staff paper considered by the Board in April 2004. They broadly endorsed the proposed revised approach, which focused more on the fiscal risks posed by the operations of public enterprises. Most Directors also agreed that testing the revised criteria in a sample of upcoming Article IV consultations could inform the design of a strategy. A few Directors felt that it would not be appropriate to allow for greater case-by-case flexibility in making decisions on integrating public enterprises in fiscal indicators and targets in a Fund-supported program context and noted the difficulties of assessing fiscal risks posed by individual enterprises. These Directors called for the development of a more standardized approach.

Public-private partnerships (PPPs) offer a potential avenue to increase infrastructure investment, provided they are appropriately structured and the institutional framework is well developed. Directors agreed with the view that PPPs should be undertaken with the goal of increasing efficiency by attracting private capital. Directors strongly cautioned against pursuing PPPs because of a desire to move investment spending off budget. Furthermore, the government should ensure that the risk associated with PPPs was appropriately shared with the private sector, with the risk borne by the government reflected in the fiscal accounts. Directors endorsed the view that high priority should be given to strengthening the institutional framework for PPPs—including the establishment of a sound legal framework and the preparation of a public sector comparator—and called on the multilateral development banks to take the lead on these issues.

Directors saw the lack of an internationally accepted accounting and reporting standard for PPPs as a possible obstacle to the development of efficient PPPs and endorsed continued staff work with the relevant accounting bodies to promote the preparation of such a standard. In the meantime, they generally endorsed the proposed disclosure and reporting requirements for PPPs, noting the importance of valuing the contingent liabilities associated with guarantees. They saw merit in the staff's proposed approach to incorporating PPPs in debt sustainability analysis, which involves counting committed payments by the government under PPP contracts and expected payments arising from the calling of guarantees as future primary spending. A few Directors called for caution in factoring implicit contingent liabilities related to PPPs into debt sustainability analyses. Most Directors agreed that the issue of setting caps on expected costs arising from PPPs, including in Fund program design, should be determined on a case-by-case

## Ireland

Ireland's economy has performed impressively over the past decade. Real GNP growth averaged about 7 percent a year during 1995–2004, bringing income per capita up to the average of the EU-15; the unemployment rate declined sharply and is now one of the lowest in the industrial countries; and inflation stabilized close to the euro area average. This remarkable performance owed much to sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and social partnership agreements that contributed to wage moderation.

Economic performance continues to be strong. In 2005, real GNP growth reached 5½ percent, driven by domestic demand; unemployment was close to the natural rate; and the general government recorded a surplus of 1 percent of GDP. Labor force growth, fueled by increased participation and immigration, has helped dampen wage pressures. House price appreciation, which had eased through mid-2005, has picked up again against the backdrop of rapid credit growth. In response to a reported relaxation of lending standards, the authorities have increased the risk weighting on residential mortgages.

In March 2006, an IMF team visited Dublin to update the 2000 Financial Sector Assessment Program (FSAP). The team found that Ireland's financial system remained robust but recommended some improvements to the supervisory framework, including upgrading stress testing, strengthening on-site supervision of insurers, and enhancing public disclosure requirements for insurers.

**Ireland-IMF activities during FY2006**

| | |
|---|---|
| May 2005 | Discussions on 2005 Article IV consultation |
| October 2005 | Completion of 2005 Article IV consultation |
| March 2006 | Mission to update the 2000 FSAP |

# THEME: R4

Appropriateness and effective utilisation of the expert advice

# LINE OF INQUIRY: R4b

Impact of the reliance placed upon information and reporting from statutory auditors of the banks

## R4 – Appropriateness and effective utilisation of expert advice

## R4b – Impact of reliance placed upon information and reporting from statutory auditors of banks

### Information Summary (Section 33AK)

**Note: All references are aggregated.**

<table>
<tr><td colspan="2">Document category</td></tr>
<tr><td colspan="2"><ul><li>Correspondence from Statutory Auditors to IFSRA in respect of issues uncovered in financial institutions during the course of the statutory audit: 2003-2004</li></ul></td></tr>
<tr><td>Time period</td><td>Summary</td></tr>
<tr><td>2003<br><br>For year ending 31/12/2002</td><td>In respect of Institution X following items were noted:<ul><li>“no detailed procedures manuals “ were in place</li><li>“no formalised controls in place covering the introduction of new products”</li><li>Inadequacies in the monitoring of “moratorium accounts”</li><li>Insufficient attendance at credit committee meetings</li><li>Lack of documentation supporting provisions</li><li>Lack of overall review of credit portfolio</li></ul></td></tr>
<tr><td>2003<br><br>For year ending 31/12/2002</td><td>In respect of Institution Y following items were noted:<ul><li>Errors in annual facility review process</li><li>Errors in recent Capital Adequacy Return</li><li>High pace of growth in institution implies “management of resources and controls in this expanding environment is essential.”</li></ul></td></tr>
<tr><td>2004<br><br>For year ending 31/12/2003</td><td>In respect of Institution X following items were noted:<ul><li>“understatement of non-performing assets”</li><li>Error in Large Exposure Return for March 2003</li><li>Error in Large Exposure Return for September 2003</li><li>Large exposures to 2 particular sectors noted in sectoral return for 2003</li></ul></td></tr>
</table>

# THEME: R4

Appropriateness and effective utilisation of the expert advice

# LINE OF INQUIRY: R4c

Analysis and consideration of the response to contrarian views (internal and external)

**Tánaiste**,
from John McCarthy

## ESRI Summer 2007 Quarterly Economic Commentary

The ESRI Summer 2007 Quarterly Economic Commentary (QEC) will be published tomorrow. The ESRI are forecasting GDP growth of 4.9 per cent (4.8 per cent in GNP terms) this year. These figures do not take into account quarterly national accounts data which will be published by the CSO tomorrow morning. The rate of growth is projected to moderate to 3.7 per cent in both GDP and GNP terms next year. The ESRI's view of prospects for this year and next is broadly in line with our own current internal view.

**Macro-Economic Forecasts** (per cent growth rates unless otherwise stated)

| | **ESRI** (Summer QEC) | | **Dept of Finance** (Budget day) | |
|---|---|---|---|---|
| | 2007 | 2008 | 2007 | 2008 |
| GDP | 4.9 | 3.7 | 5.3 | 4.6 |
| GNP | 4.8 | 3.7 | 5.3 | 4.6 |
| Employment | 2.8 | 1.2 | 3.5 | 2.1 |
| Unemployment (rate) | 4.7 | 5.0 | 4.4 | 4.5 |
| CPI | 4.9 | 3.0 | 4.1 | 2.4 |
| GGB (per cent of GDP) | 1.1 | 1.2 | 1.2 | 0.9 |

While the ESRI see the slowdown as being moderate, the possibility of a sharper slowdown is not ruled out. In particular, the risk that the current high rate of inflation begins to feed into wage demands is identified as a cause for concern, particularly in an environment in which productivity growth has been modest. While acknowledging that the labour market in Ireland is reasonably flexible, the ESRI also argue that policy responses to tackle wage inflation are limited in the short term. However, it is suggested that policy can exert an influence on wages through limiting benchmarking increases under the next round. In addition, the Government is urged to adopt a cautious approach to calls for a renegotiation of the national wage agreement.

An article contained in the QEC (by UCD Professor Morgan Kelly) will argue that **real house prices in Ireland could decline substantially**. It should be noted that this paper is nothing new – a version of the paper received considerable media attention in recent months. The analysis considers house price developments in OECD countries since 1970, and finds a strong relationship between the size of the initial increase in prices and the subsequent fall. If this same relationship was to hold for Ireland, then real house prices would decline by 40 – 60 per cent over a period of 8 – 9 years. It is also argued that policy will not be able to address any decline in house prices; in particular, it is argued that stamp duty cuts will not change buyers' self-fulfilling incentive to wait and see if prices fall further.

CC. Secretary General, Mr. O'Brien, Mr. McNally, Mr. McGrath, Mr. Gallagher, Press Office, Mr. Steadman

## Speaking Points (if required)

Growth prospects

- I note the ESRI's view of economic trends this year, with GDP growth of 4.9 per cent (GNP of 4.8 per cent) being projected. At Budget time, my own Department's forecasts were for GDP and GNP growth of 5.3 per cent. Either way, growth of this magnitude is good and we must be careful not to talk down the economy.

- At this stage, it is fair to say that the prospects for next year are less benign, mainly reflecting an easing in domestic demand. However, growth is likely to remain strong by international standards.

- Our economic fortunes in the coming years will increasingly depend on achieving an improved export performance. This is why we need to improve our cost competitiveness.

Housing market (in response to the Morgan Kelly paper)

- We must be careful that we do not over-react to the current easing from the very high levels of activity.

- House prices have fallen back slightly in recent months, although prices still remain above their levels this time last year.

- I share the view of most commentators that house price increases in recent years have been underpinned by many factors including a strong economy, increases in employment and earnings, reductions in taxation and lower interest rates resulting from participation in monetary union.

Mr McNally,
from John McCarthy

**Each 10,000 drop in new house completions: Macroeconomic Impact**

Under a paper produced by BED earlier this year, the following results were identified:

| | GDP | employment | unemployment | deficit |
|---|---|---|---|---|
| Year 1 | - [½-1] | - [½-1] | + ½ | - €600 million |

i.e., each 10,000 decline in house completions reduces growth in GDP by around ½ - 1 percentage points.

Note that the increase in unemployment is lower than the assumed loss in employment growth, due to assumed outward migration of recent immigrants in the construction sector.

Everything else being equal, there would be little impact in year 2, although the level of GDP and employment would be lower than baseline due to lower growth in output and employment in the previous year. However, if confidence were to be adversely affected, there could be an impact in the second year.

Under the situation in which housing output falls back by 10,000 each year to reach medium term demand levels (about 45,000-50,000 units), there would be an impact on the growth rates each year. These annual impacts would be similar to those above.

# Executive Summary

## Introduction and Background

Indecon International Economic Consultants were appointed by the Department of Finance to conduct an independent review of certain property-based tax incentive schemes in operation in Ireland. This report examines each of the tax incentive schemes, evaluates the success of these schemes in terms of their economic impact and provides recommendations on policy options for the Government. The main findings of this study are summarised in this Executive Summary.

## Our Approach to the Review

Our approach to this study has been to evaluate the contribution that each tax incentive scheme has made to its sector by use of a cost-benefit analysis. We examine the total capital expenditure under each scheme and the associated cost to the Exchequer and economic benefits. The study also identifies changes which could be considered to the ongoing schemes and, should it arise, in any new tax-based incentive schemes. Major information deficiencies existed in relation to many of the schemes. These have been addressed by Indecon as part of this study by utilising extensive new survey evidence and other rigorous approaches. For the first time, detailed estimates of the costs of these schemes have been prepared. In general the estimated costs relate to projects undertaken over a five year period except in the case of more recent schemes.

In our estimates of tax costs we take account of the fact that allowances are claimed over time and allowances on capital expenditure incurred will arise only when the allowances are claimed. Future estimates of allowances are therefore included in our estimate and an NPV based on discounted values at 5% per annum is utilised. While there is uncertainty concerning future take-up in some sectors, this does not, in general, impact on the cost-benefit ratios or on the merits of continuing or ending the incentives.

## Review of Construction Sector

We have presented an analysis of the importance of the construction sector to the Irish economy. It accounts for over 19% of GDP and nearly 16% of employment. There has been an increase in construction activity over the past number of years, and while an immediate cessation of all the property tax incentive schemes would , on its own, not cause a decline in the sector, it could contribute to an acceleration of any decline. While the property-based tax incentives have led to increases in site prices and financial returns to promoters, they have also resulted in significant increased investment in projects. Indecon believes that the timing of changes to these schemes may have important implications for inflationary pressures in the construction sector.

## Review of Capital Allowances for Hotels and Holiday Camps

The hotel sector has experienced considerable growth since the introduction of the tax incentive, with a large increase in the number of rooms available. This has been accompanied by a renewal and modernisation of hotel accommodation and an increase in the average size of hotels. Since 2000, however, there has been a fall in utilization rates. The existence of the tax incentive has improved both the quality and quantity of supply and the levels of investment experienced since 1997 would not have occurred in the absence of the incentive. The incentive has also increased site prices and construction costs. In total, the level of capital investment associated with

projects availing of this incentive has amounted to €664m and the gross Exchequer costs are estimated to be €196m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight. Future significant capital expenditure of €651m to €1,302m is predicted under this scheme.

**Hotels & Holiday Camps: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 664 |
| Gross Tax Costs of Allowances | - 196 |
| Indirect Exchequer Tax Revenues | 71 |
| Economic Benefit | 42 |
| Net Tax Foregone | -125 |
| Capital Expenditure on likely Future Projects | 651 - 1,302 |

## Review of Capital Allowances for Registered Holiday Cottages

The tax incentive for holiday cottages has had a lower level of uptake than the hotel scheme. However, the existence of the incentive had a large positive impact on supply in the sector. The significant increase in supply of holiday cottages would not have occurred in the absence of the incentive. There is evidence of emerging oversupply in the sector and capital spend on projects which have proceeded amounted to €103m with an estimate of future spend of €38m. We estimate the gross net cost of the tax incentive to the Exchequer, in terms of tax revenue foregone, to be of the order of €38 million. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight.

**Group-Registered Holiday Cottages: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 103 |
| Gross Tax Costs of Allowances | - 38 |
| Indirect Exchequer Tax Revenues | 11 |
| Economic Benefit | 6 |
| Net Tax Foregone | - 27 |
| Capital Expenditure on likely Future Projects | 38 |

## Review of Capital Allowances for Private Hospitals

While there has not yet been a high level of investment in private hospitals under the tax incentive scheme for this sector, there are plans for a large number of these facilities coming online. Existing investment would not have occurred in the absence of the tax incentive. There is still a significant shortage of beds in the combined public and private health sector and the incentives have the potential to contribute to the challenges facing the health sector. We estimate capital expenditure on current projects of €154 million with future spend likely of the order of €454m. The gross Exchequer costs are estimated at €37m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight.

**Private Hospitals: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 154 |
| Gross Tax Costs of Allowances | - 37 |
| Indirect Exchequer Tax Revenues | 14 |
| Economic Benefit | 29 |
| Net Tax Foregone | - 23 |
| Capital Expenditure on likely Future Projects | 454 |

## Review of Capital Allowances for Sports Injury Clinics

There is limited data available on investment in sports injury clinics and very little uptake of the incentives. Most operators either did not know about the existence of the incentive or were unsure of its details. The existing incentives do not address any causes of market failure and if utilised would be likely to be characterised by high levels of deadweight.

## Review of Capital Allowances for Nursing Homes

Our analysis of nursing homes indicates that there are high levels of regional heterogeneity in the supply of beds, as well as in costs and average occupancy rate. Operators in this sector, as well as others consulted, widely believe that the tax incentive has been effective in increasing the level of supply of nursing home spaces and that this increase would not have occurred in the absence of the incentive. There is still a significant shortage in supply of nursing home spaces. The weekly cost of places has increased over the last few years. Capital investment is estimated to have been €171 million and our estimate for future capital investment is €30m. We estimate the gross cost of this incentive scheme to the Exchequer to be of the order of €55 million. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight.

**Nursing Homes: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 171 |
| Gross Tax Costs of Allowances | - 55 |
| Indirect Exchequer Tax Revenues | 16 |
| Economic Benefit | 43 |
| Net Tax Foregone | - 38 |
| Capital Expenditure on likely Future Projects | 30 |

## Review of Capital Allowances for Third Level Educational Buildings

There is broad support for the tax incentive for third level educational buildings among institutions that have benefited from it, although many indicated a preference for public expenditure alternatives. Indecon's analysis indicates that the incentive has facilitated investment in research and led to the development of new R&D facilities as well as an improvement in existing ones. Much of the recent investment in third level educational buildings would either not have gone ahead in the absence of the tax incentive or would have taken longer to come on-line. The incentive however represents a very expensive form of borrowing for the state and much lower cost public expenditure options are available. There is a need for on-going investment in the third level sector. Estimated capital expenditure on projects is estimated to be €348m with a gross Exchequer cost of €87m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight.

**Third level Educational Buildings: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 348 |
| Gross Tax Costs of Allowances | - 87 |
| Indirect Exchequer Tax Revenues | 34 |
| Economic Benefit * | 22 |
| Net Tax Foregone | - 54 |
| Capital Expenditure on likely Future Projects | 79 |

** Refers only to macroeconomic benefit and not the impact of the spend*

## Review of Section 23 Relief for Student Accommodation

Since the creation of the tax incentive for student accommodation in 1999, 15,000 new student bedspaces have been created. The extent of investment in this sector has transformed the availability of high quality student accommodation. This has occurred at time of significant improvements in the wider stock of private rented accommodation. Estimated capital spend is €510m and the gross Exchequer costs are estimated to be €214m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight. We estimate capital spend on likely future projects to be €936m.

**Student Accommodation: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 510 |
| Gross Tax Costs of Allowances | - 214 |
| Indirect Exchequer Tax Revenues | 55 |
| Economic Benefit | 32 |
| Net Tax Foregone | - 159 |
| Capital Expenditure on likely Future Projects | 936 |

## Review of Capital Allowances for Childcare Facilities

There has been a significant increase in the number places in the childcare sector over recent years. However supply has not been sufficient to meet the growth in demand and childcare costs have increased significantly. The market for childcare facilities is characterised by a significant supply shortage. Most of the recent investment in childcare facilities either would not have proceeded in the absence of the tax incentive or would have taken longer to complete. We have estimated capital expenditure of €31 million with estimate of capital expenditure on future projects of €21m. The gross Exchequer costs have amounted to €9m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight.

**Childcare Facilities: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 31 |
| Gross Tax Costs of Allowances | - 9 |
| Indirect Exchequer Tax Revenues | 3 |
| Economic Benefit | 8 |
| Net Tax Foregone | - 6 |
| Capital Expenditure on likely Future Projects | 21 |

## Review of Capital Allowances and Other Reliefs for Park & Ride Facilities

There has been a limited uptake of the tax incentive for park and ride facilities since the creation of the scheme. Only 2 schemes have gone ahead since 1999. There is currently a significant shortage of park and ride facilities and these have significant economic benefits in terms of reduced congestion costs. We estimate capital spend of €16m and spend on future projects of €25m. The gross Exchequer costs of projects are estimated to be €5.8m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight.

**Park & Ride Facilities: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 16 |
| Gross Tax Costs of Allowances | - 6 |
| Indirect Exchequer Tax Revenues | 2 |
| Economic Benefit | 2 |
| Net Tax Foregone | - 4 |
| Capital Expenditure on likely Future Projects | 25 |

## Review of Capital Allowances for Investment in Multi-storey Car Parks

Available evidence on the tax incentive for multi-storey car parks indicates that there has been a high level of uptake on the scheme. The incentive has been successful in increasing the supply of multi-storey car-parks but we do not see an economic case for government intervention in this sector. Capital spend on projects which have proceeded is estimated to be €61m at a gross Exchequer cost of €23m. The Indirect Exchequer Tax Revenues and the Net Tax Foregone estimates are adjusted for opportunity cost and deadweight. Future spend is estimated to be €13m.

**Multi-Storey Car Parks: Summary of Indecon Estimates**

| Estimate | € million |
|---|---|
| Capital Expenditure on Projects that have Proceeded | 61 |
| Gross Tax Costs of Allowances | - 23 |
| Indirect Exchequer Tax Revenues | 6 |
| Economic Benefit | 4 |
| Net Tax Foregone | - 17 |
| Capital Expenditure on likely Future Projects | 13 |

## Review of Relief for the Refurbishment of Certain Rented Residential Properties

Indecon also reviewed the property-based tax incentive on certain types of rented residential accommodation. There is very little awareness regarding the availability of these incentives and we believe usage has been very limited.

## High Income Earners

Our analysis indicates that nearly all of the property tax incentives reviewed have been used primarily by high income earners. Structural features of the incentives including the restriction to rental income have had the unintended impact of facilitating this outcome. There is no doubt that the incentives have been a key mechanism for high income earners to reduce their tax liabilities. An assessment of the extent to which the individual tax allowances have been claimed by high earners is examined in the individual chapters dealing with each of the incentives.

## Recommendations

Our general recommendations, applicable across all incentive schemes, are contained in the table overleaf.

**General Recommendations on Property-based Tax Incentive Schemes**

1. All tax incentives schemes should require full disclosures of key information to the Exchequer by investors/promoters via a certification scheme or other mechanism to enable the full cost and impact of the schemes to be monitored.
2. The decision to introduce any new tax incentives should be informed by a formal assessment of the likely costs and benefits.
3. Where there is justification for government incentives the option of direct public expenditure as an alternative to tax incentives should be considered.
4. Any tax incentive schemes which are introduced should have a defined lifespan of a maximum of 3 years and extensions should only be considered after evaluation of the results of a formal cost-benefit appraisal.
5. Developers/investors in any tax incentive scheme should be responsible for securing independent certification that the conditions of the schemes have been met.
6. On equity and cost efficiency grounds restrictions on capital allowances which focus exclusively on shelters on rental income rather than on personal income should be refocused.
7. Consideration should be given to introducing a cap on total annual allowances which can be claimed by any individual.
8. Differential allowances in any tax incentive scheme should be introduced depending on whether these allowances are being claimed at corporate or personal tax rates.

Indecon has also made recommendations specific to each incentive scheme. Our specific recommendations are contained in the table overleaf. In many cases while the schemes have had a benefit our analysis suggests they have served their purpose and there is absolutely no case for future government incentives. Continuing to approve new projects would contribute to oversupply and represent a clear waste of scarce public resources.

In a number of cases on-going government support for the activity is needed (for example in case of third level buildings) but the tax incentives are an extremely high cost and wasteful mechanism to achieve the objectives. In a limited number of cases (hospitals, nursing homes and childcare facilities) increased private sector investment is needed to address the economic and social needs in these sectors and would reduce demands on the public sector and have significant economic benefits.

For the incentives which we believe should not continue there is an important issue of the timing of projects which have already secured approval. We see little or no merit in requiring all of these projects to be completed in a very short timeframe. Such an approach would damage the construction sector and increase inflationary pressures. Permitting a much longer timeframe with an associated adjustment in allowable capital expenditure could reduce Exchequer costs and have other economic efficiency benefits.

**Specific Recommendations for each Property-based Tax Incentive Scheme**

1. There should be no further extension of capital allowances for hotels and holiday camps for projects which have not lodged a full and valid planning application before 31 December 2004.
2. There should be no further extension of capital allowances for registered holiday cottages which have not lodged a full and valid planning application before 31 December 2004.
3. The capital allowances scheme for sports injury clinics should be ended with immediate effect at the earliest feasible date.
4. There should be no extension of the capital allowances for third level education buildings for projects which have not secured Ministerial certificate of approval.
5. Additional public expenditure resources for third level education buildings should be provided.
6. There should be no extension of the capital allowances for student accommodation for projects which had not lodged full planning applications by December 2004.
7. The tax relief to lessors in respect of the expenditure incurred on the refurbishment of certain rented residential accommodation should be ended with immediate effect.
8. There should be no further extension to the capital allowances for investment in multi-storey car parks for projects which had not incurred at least 15 per cent of costs by 30 September 2003.
9. The capital allowance scheme for associated commercial or residential investments with park and ride facilities should be ended with immediate effect. We would support continuation of the incentive for specific investment in park and ride facilities.

10 Public expenditure to support park and ride facilities should be provided.

11. Capital allowances for childcare facilities should continue subject to certain amendments.

12 Capital allowances for private hospitals should continue subject to certain amendments.

13. Capital allowances for private nursing homes should continue subject to certain amendments.
14. For projects under the hotel, holiday cottages, third level buildings, student accommodation and multi-storey car parks, which have already met the requirements for planning and/or Ministerial or other approvals a five year extension to the timescale for completion of the projects should be introduced but the level of all capital allowances claimed should be restricted to 50%.

# MISJUDGING RISK: CAUSES OF THE SYSTEMIC BANKING CRISIS IN IRELAND

## REPORT OF THE COMMISSION OF INVESTIGATION INTO THE BANKING SECTOR IN IRELAND

**MARCH 2011**

was sufficient information to have allowed the authorities to take more decisive action than was the case.

Surprisingly, since the FR saw itself as regularly meeting with the banks, interviewed bank management and board members could not recall any meaningful engagement with the FR on prudential issues (except technically, as part of the Basel II process).[4] According to bank management, prudential issues were tick-the-box checks that formal procedures were in place, not checks on how they worked in practice. On the contrary, when prudential sector concentration ratios were exceeded, the FR did nothing to demand any limitation in risk exposure despite being fully informed. The FR's passiveness with regard to sanctioning, as a matter of urgency, the weaknesses in governance and risk management in Anglo and INBS has been set out above. Consumer issues were exhaustively, publicly and actively dealt with by the FR, however.

The DoF and the Minister for Finance were regularly provided with a Financial Stability Report, officially jointly written by the CB and the FR. In practice, the FR appears to have participated primarily at board level.[5] The report occasionally made reference to the frothiness of the Irish property market but did not explicitly infer serious risks to the banks from this emerging bubble. The banking sector considered the overall tenor of the report to have been benign and comforting. Being conscious and supportive of the independence of both the CB and the FR, the DoF provided very little comment or input to this process,[6] nor did it assess how they fulfilled their duties until very late in the Period.

Neither the CB nor the DoF seem to have considered the implications of a possible interruption in the flow of foreign funding. If such a scenario had been considered, the link between such funding, property market developments and bank solvency could perhaps have been uncovered.

Generally, international organisations (IMF, EU, and OECD) were, at most, modestly critical and often complimentary regarding Irish developments and institutions. This gave the authorities and the banks additional reason to assume that all really was well. Domestic doubters were few, late and usually low-key, possibly because it was thought that expressing contrarian views risked sanction; in addition, a long period of good times had reduced the numbers of those willing to continue to go against the prevailing and apparently proven consensus.

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[4] Given that the FR did send post-inspection letters to banks requiring serious action, this view is difficult to explain. In one late case, it appears that the letter was not distributed to the Board. In other cases, it may be that FR contacts were made by "too low-level" officials or that the issues were seen as technical rather than strategic in importance. Finally, it may be that issues that the senior FR officials considered substantive in a prudential sense were seen by bankers as formal or technical only.

[5] This was explained to the Commission as the combined result of *inter alia* bad relations at times between leadership and staff in the two institutions, time constraints by regulatory staff, the lack of economics skills in the FR and difficulties in achieving mutual comprehension (the different professional languages of economists and accountants). To the Commission it seems that this lack of cooperation is stemmed largely from lack of leadership at various levels in both institutions. Cooperation problems may have been compounded by a solid lack of understanding of stability issues at most management levels.

[6] The Secretary General would provide comments as a member of the Board of the CB. His membership could, for its part, possibly also reassure DoF staff that the CB and, to the extent that stability issues were raised by the FR at the CB Board, that also the FR was doing an adequate job.

4.3.4 This inactivity had serious consequences for the banking sector. For example, in the case of INBS, the main theme of correspondence between the bank and the FR over the length of the Period was governance and internal control – business decisions were left to the institution itself with little regard to actually limiting the risk exposures that the unique structures, unsound for licensed banks, continuously were generating.[98] Despite the fact that the FR detected numerous governance and process issues in INBS throughout and, indeed, prior to the Period, it remained hesitant to take effective action even when the engagement with INBS resulted in little material change. As a result, the very significant risks inherent in INBS's business model described above, had time to develop essentially undisturbed.

4.3.5 In the same vein, inspection reports on Anglo during the Period (both in 2004 and 2007) correctly identified a number of the more important problems in the bank at the time. However, there is no indication that these internal reports led to either a reconsideration of supervisory practices or serious consideration of regulatory action. Had the FR rigorously enforced its recommendations to improve structures and process, it is possible that Anglo would have grown its property lending in a more prudent manner. Moreover, determined public action by the FR early in the Period could possibly have meant that other banks' prudential standards would not have deteriorated to such an extent over the Period.

*Willingness and Ability to take Action*

4.3.6 While acknowledging that the Banking Supervision Division of the FR may have been under-resourced, the Commission does not consider that this accounts sufficiently for the lack of action. As noted in Chapter 2, the essential information was readily available in the banks' regulatory returns and (publicly available) in annual reports. Also, as noted above, the serious governance and procedural problems in INBS, and to a lesser extent in Anglo, were known to the FR for years. Furthermore, there are no signs of the FR requesting increased resources.[99] What unfortunately seems to have been lacking is professional scepticism or suspicion on the part of the FR that all things might not be as well as they seemed on the surface.[100]

4.3.7 It has been argued that even were the FR to have recognised the existence of a major problem it would have been difficult to intervene effectively. The Commission does not share such a

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[98] This approach is captured in a letter from the FR to INBS in December 2004. It states that the FR's overall concern at that time was the significant shift in the risk profile of INBS's overall loan portfolio in a relatively short period of time. While the letter notes that it was a matter for a credit institutions' Board and management to decide upon the business activities it engages in, it was considered essential that there were appropriate policies, procedures, resources, internal controls and reporting structures in place commensurate with the risk arising from these activities which would be sufficient to effectively manage, monitor and control that risk.

[99] The Banking Supervision Division of the FR may have been under-staffed and sought additional resources. However, there is no evidence that the FR requested authorisation for substantial increase in prudential staff from the DoF which was responsible for approving the FR's budget. Nor is there evidence to suggest that the FR's very strong emphasis on consumer protection issues was at the expense of the consideration of prudential issues (in terms of either time spent, e.g., at FR meetings, or resource usage).

[100] This unsceptical approach seems to have widely prevailed in the FR though with a small number of exceptions at the level of the Regulatory Authority.

no financial stability problem serious enough to warrant action at the time. While it is possible that a warning from the FR would have changed the CB's view, this is by no means certain.

4.3.12 Finally, the IMF Financial Sector Assessment Programme (FSAP) report on the Irish financial system in 2006 rated the performance of the FR highly. It did not call for any significant changes in its overall approach or methods. It also concluded that the Irish banking system was basically sound.[107] The FSAP methodology itself suffered from weaknesses, especially a concentration on process rather than substance. The positive FSAP report also served to reinforce the confidence in the soundness of the banking system being expressed by the CB/FR in their Financial Stability Report.

## 4.4 The Central Bank Pre-Crisis (2003 to mid-2007)

4.4.1 As in the case of the FR, there was a major domestic policy failure at the CB in respect of the maintenance of financial stability. Not only did the CB (with a small number of contrarians at board level) seriously underestimate the nature and extent of the risks in the Irish financial system but it was content to express only nuanced and somewhat indirect concerns on possible risks rather than study contingent worst-case scenarios. Had it done so, it might have issued stronger warnings (at least confidentially to the Government) or even taken appropriate action.

*Willingness and Ability to take Action*

4.4.2 At the outset, it is important to note that a view was expressed to the Commission that it was not the primary responsibility of the CB to evaluate possible problems in domestic financial markets emanating from the behaviour of individual institutions. CB legislation provides that while the CB was charged with overall financial stability matters, the FR was responsible for identifying and bringing to the attention of the CB any bank-specific/prudential matters of potential system-wide significance. Therefore, according to this view, the CB should not question, or be seen as questioning, the FR's activities. As the FR did not raise any such concerns with the CB, the CB could therefore not have been expected to detect existing or emerging problems. Indeed, it was even suggested that detailed enquiries by the CB regarding the basis for the FR's assessments could have been regarded as an unacceptable intrusion into the autonomous status of the FR.

4.4.3 Such a narrow interpretation of the CB's role is not shared by the Commission. When combined with the static[108] approach of the FR in assessing individual institutions, it could – and did – create a situation where financial stability problems could not be addressed or prevented. Financial stability should be the overriding objective and the CB (as well as other responsible authorities) should do whatever is reasonably necessary to maintain it.

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[107] These views were also broadly reflected in various IMF Article IV Consultation reports during this period. It may be noted that the Independent Evaluation Office of the IMF in its report of 10.1.2011 *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07* paints a bleak picture of the ability of the organisation to detect the financial stability problems arising internationally and particularly in a number of developed countries.

[108] The FR had a static or backward-looking approach to assessing the financial health of institutions (i.e. whether they met certain prudential ratios at the last filing date).

4.4.8 The Commission has also noted evidence of a tendency to ensure that the FSRs should not convey a negative message even when some internal contrarian information, analysis or view argued for a less benign tone.[113] There are clear indications that little attention was paid to such material or that it was only included after toning down in redrafting. This approach risked creating an internal intellectual climate that discouraged less senior staff from offering their best professional assessments. It also encouraged staff to focus their research work in areas with less relevance for financial stability but where publication would not be subject to such pressures. While it is one thing to tone down external messages, the Commission has difficulty in understanding the apparent lack of interest in fostering critical debate within the confidential confines of the CB on stability issues. There are signs that, reinforced by the relatively hierarchical structure of the CB, a climate of self-censorship had become prevalent in CB policy work.

4.4.9 The Commission accepts the view that it may not be in the best interests of financial stability to publish alarmist views in the FSRs. Given the traditionally fine-tuned nature of CB statements, any sudden or major change in the degree of stated optimism could, in principle, be interpreted by markets as a sign of a looming problem. On the other hand, if official publications are seen as not addressing relevant concerns, there is also the risk of reducing public credibility. Nevertheless, if the CB had had greater concerns there was nothing preventing them from confidentially voicing these concerns to the Government while keeping its public messages benign. However, the Commission has found no evidence that this was done.

*Insufficient Contingency Work*

4.4.10 The Commission notes that the CB did not choose to confidentially study worst-case contingency scenarios. The CB could have commissioned its staff to assess both what the macroeconomic consequences would be if major identified risks were realised and what could be done to avoid a worst-case situation. Such scenarios could have made use of international as well as domestic information, thus providing some estimate of the extent of the economic risks. While it is impossible to assess how such a study might have affected the judgments of the CB, such an exercise would have been useful in many indirect ways. More information and analysis would have been available; staff would have become sensitive to stability issues; the FR might have been inspired to look more closely at the banks; and the CB would have been better prepared when the financial crisis deepened in 2008.

4.4.11 Although action taken by any authority that dampened down the rapid economic growth would have been seen as "spoiling the party", an independent and effective CB must be willing to take unpopular actions. Even in the unavoidable presence of uncertainty, such actions are essential in order to avoid far greater future costs that might (and, in Ireland's case, did) lie ahead. Of course, a CB must first take the steps necessary to ensure that it has an accurate

[113] For example, an internal study estimating that house prices were overvalued by up to 39% in 2007 was not published in that year's FSR.

# Chapter 5 – Findings & Final Considerations

## 5.1 Findings – General

5.1.1 The Report concentrates, as its Terms of Reference require, on explaining the reasons specifically for the Irish banking crisis. However, it is useful to keep in mind that this crisis cannot be seen in isolation from what was happening elsewhere. It appears, at least on the face of it, that many of the problems and failings in Irish banks and public institutions were quite similar to those in other countries.

5.1.2 For instance, Irish banks compared their policies and achievements with peer groups containing well regarded banks in the UK and the EU. Risk management systems and remuneration practices were often adopted from abroad. Judging from results, similar problems, as in Ireland, arose in implementing them in a manner consistent with prudent credit policies. The relatively greater losses seen in Ireland may thus be seen as a consequence of somewhat greater abandon in accessing wholesale funding and in lending to domestic property than in other countries. Thus, there is a difference in degree rather than in concept.

5.1.3 Similarly, central banks and regulators abroad generally were almost as unsuspecting of growing financial fragility as their Irish counterparts. The method of regulation or the number of available macroeconomists does not generally seem to have made a great deal of difference. The same seems true of auditors, rating agencies, analysts and investors, most of whom remained calm and optimistic until the crisis actually broke. Internal investigations in the IMF also indicate a widespread lack of understanding and clear communication of the accumulating risks by that organisation. There were incentives to conform with prevailing views, even in cases where proper analysis would have identified growing risk.

5.1.4 The fact that Ireland was not special does not, of course, account for or diminish the failures in the performance of the people in private and public positions responsible for financial stability and prudent banking. It does, however, put the many undoubted failings found by the Commission into perspective. Regardless, it indicates that the problems experienced in Ireland in the 2000's have a wider relevance, as do any suggestions on how to prevent similar things from easily happening again.

## 5.2 Findings - Banks

*Business Models & Strategies*

5.2.1 Responding to increased competition and pressure for increased earnings, banks set aggressive targets for profit growth. In many cases, this drive for growth really implied a partial change in business model and strategy without the corresponding necessary strengthening of governance, procedures and practices. This was accepted partly because future economic developments were trusted to remain benign in Ireland as they already had been for several years. Comfort was also taken from peer bank practices and the lack of concern among authorities, market

5.3.4 It seems remarkable that the FR in practice accepted the severe governance problems in INBS. Allowing this bank to continue operations without major reforms or sanctions must, on the part of the FR, have reflected either a reluctance to pursue legal action or a profound trust in bank management and the board. Similarly, the rapid and concentrated lending growth in Anglo, and later in other banks, did not lead to regulatory action, with reliance being placed on management assurances that all was basically well. The FR continued to accept these assurances, even after the Guarantee decision in late 2008.

5.3.5 The Commission is aware of the view that the FR did not have sufficient powers to intervene. This view is not persuasive given that the FR could have acted in concert with the Central Bank (CB) and, ideally though perhaps unrealistically, with Government support. The real problem was not lack of powers but lack of scepticism and the appetite to prosecute challenges.

*The Central Bank*

5.3.6 The CB chose to rely on the FR appropriately handling individual bank stability issues, much as the FR in turn chose to trust bank leadership. By implication, unless there were problems in the individual banks, there could not be major stability issues in the system as a whole. The Financial Stability Report (FSR) was constrained to present benign conclusions with a number of almost routine warnings voiced in the text itself. Simultaneously, macro-economic data signalling the emergence of the two key risks – growing dependence on foreign funding and the concentration of bank lending in the property sector – did not appear to have caused acute concern.

5.3.7 At least at policy level, the CB seems not to have sufficiently appreciated the possibility that, while each bank was following a strategy that made sense, in the aggregate, when followed by all banks, this strategy could have serious consequences for overall financial stability. This was a classic macroeconomic fallacy that must have been recognised in the CB and it remains unclear why it was not appreciated at senior levels there. However, there are signs that a hierarchical culture, with elements of self-censorship at various levels, developed in the CB. Of course, this eventually made it even harder to address the increasing instabilities in the financial market.

5.3.8 The Commission is aware of but disagrees with the view that the CB would not have been entitled to intervene to address stability issues concerning individual banks. If the CB management had identified or given sufficient weight to macro-economic vulnerabilities, it could and should have initiated discussions with the FR to ensure a deeper analysis of individual banks' regulatory returns. However, as neither institution suspected any significant problems this does not appear to have been done.

*The Department of Finance*

5.3.9 The Department of Finance (DoF) did not, despite its mandate, see itself as concretely involved in financial stability issues; it also did not have the requisite professional staff for this. There were regular formal contacts with the FR (via the approval process for its budget) and

Indeed, overlapping interest is not necessarily a bad thing as long as responsibilities remain clearly differentiated.

5.5.9 Fourthly, adhering to either formal or traditional, often voluntary, constraints and limits on banking and finance, does not seem to have been greatly valued in Ireland during the Period. The wide acceptance of the new financial paradigm may have amplified any such tendency as it applies to the banking sector. The consequences for financial stability are, in any case, severe in the longer term.

5.5.10 Regulations, rules, procedures, constraints and sanctions exist primarily to prevent management and staff from going overboard during good times. The better and longer the good times are, the more important it is that these safeguards exist and are adhered to. If they do not exist, or are ignored, exposures can grow dramatically as confidence grows and risk is underestimated. The risk of systemic disturbances therefore increases greatly if political leaders and public institutions do not insist on these safeguards being consistently and efficiently followed. Therefore, any greater than average lack of willingness in Ireland to follow rules and constraints is likely to make for a more fragile financial system than elsewhere in the long run.

5.5.11 The Commission considers that it cannot have remained a secret from banking and audit professionals that time-honoured prudential limits and procedures were gradually falling into disuse, particularly in some banks. Examples and indications of serious governance and prudential problems were clearly available to professional observers, including the FR. Increases in credit concentration, loan size and volumes, as well as changes in funding structures, were not concealed. They could also have been inferred from macro-economic data. Information about ongoing and accelerating property speculation was common in everyday Irish life.

5.5.12 The Commission accepts that the new, widespread paradigm, as well as the mania in the Irish property market, could create strong pressures for conformity in all the institutions discussed in this Report. However, while this could explain such behaviour, it does not provide an excuse for those who conformed. Only a naïve and opportunistic interpretation of the paradigm, together with a lack of either relevant experience, training or historical knowledge, could possibly have argued for a major dismantling of the traditional prudential safeguards. History is replete with examples of what happens when bankers, authorities and others come to believe that “this time it’s different”.[157]

5.5.13 The Commission therefore has reluctantly come to the conclusion that at least some of the financial market professionals at the time must have entertained private, undisclosed doubts on the sustainability of banks’ lending and funding policies. However, for various reasons “the dance had to go on”. Similarly, it seems likely that the public and private watchdogs remained

[157] For those arguing that the crisis in Ireland or elsewhere was unique and impossible to foresee, see Carmen Reinhart & Kenneth Rogoff; *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

# Quarterly Economic Commentary

## Summer 2007

**Alan Barrett**
**Ide Kearney**
**Martin O'Brien**

*The forecasts in this Commentary are based on data available by mid-June 2007*

Special Articles

**On the Likely Extent of Falls in Irish House Prices**
by
Morgan Kelly

**Valuing Ireland's Pension System**
by
Shane Whelan

# On the Likely Extent of Falls in Irish House Prices

*Morgan Kelly*[*]

**Abstract**

Looking at house price cycles across the OECD since 1970, we find a strong relationship between the size of the initial rise in price and its subsequent fall. Were this relationship to hold for Ireland, it would predict falls of real house prices of 40 to 60 per cent over a period of 8 to 9 years. The unusually large size of the Irish house building industry suggest that any significant house price fall that does occur could impose a difficult adjustment on the economy.

## 1. Introduction

The purpose of this paper is to look at the likely behaviour of Irish house prices based on the experience of economies that have gone through similar booms. Looking at nearly 40 booms and busts in OECD economies since 1970, we find that the size of the initial boom is a strong predictor of the size and duration of the subsequent bust.

Typically, real house prices give up 70 per cent of what they gained in a boom during the bust that follows. This is a remarkably robust relationship, holding across very different OECD housing markets over more than 30 years.

Were this relationship to hold for Ireland, it would predict a fall in real house prices of around 40 to 60 per cent, over a period of 8 or 9 years. Assuming an inflation rate of 2 per cent, this would translate into an annual fall of average selling prices of 6 to 7 per cent.

Falls of this magnitude and duration are not unprecedented internationally. For example, the real price of Dutch houses fell by around half during the 1980s, as did those in Finland during the early 1990s. However, other large housing busts occurred in

[*]I would like to thank Christophe Andre for providing the OECD house price database used here, and to a referee for detailed and constructive criticisms of the submitted draft. All interpretations and errors are mine.
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economies with high rates of housing occupancy and relatively slowly growing stocks of houses. In Ireland, by contrast, housing stock has been growing at around 5 per cent per year, with about 15 per cent of the housing stock lying empty, increasing the potential for larger price falls than in previous OECD housing busts.

Our estimate is in contrast with existing studies that measure over-valuation by the size of a regression residual and find over-valuation of around 20 per cent. We demonstrate below, however, that unless based on very long run time series, such regressions are effectively meaningless.

The principal macroeconomic reason for being concerned about a fall in Irish house prices is its impact on residential investment. Typically, an industrialised economy gets around 5 per cent of its income from building new houses, around the same that it gets from household spending on recreation. Ireland currently derives nearly three times this amount from building and selling houses. Any sudden fall of residential investment to normal international, and national historical, levels, could have a substantial impact on national income, government finances, and unemployment: fewer than 15 per cent of construction workers are immigrants.

Falls in residential investment, moreover, can be sudden as the example of Arizona shows. Until late 2005, Arizona was experiencing a house price and construction boom similar to Ireland's. Then, as sales of new houses stalled around the start of 2006, building fell suddenly: from around 8,000 starts in May 2006 (similar to Irish levels last year) to around 3,000 in November.

The stagnation of the housing market even below the stamp duty threshold makes it evident that the reduction or elimination of stamp duty will not alter the basic dynamics of the housing market. Markets like housing are driven by fear of offering less than other bidders and ending up with nothing. With a large inventory of unsold houses, the *permanent-tsb* house price index showing monthly falls, and the irishpropertywatch.com tracking site showing that cuts in asking prices of €50,000 are now commonplace, potential buyers have an incentive to wait and see if prices will fall further. At the same time, rents are likely to fall as discouraged vendors attempt to let out empty properties.

The rest of this paper is as follows. Section 2 rehearses the relevant economic theory of rational frenzies in asset markets. Section 3 looks at the nearly 40 cases since 1970 where OECD economies have experienced house price rises followed by falls, and shows that the magnitude of the boom is a strong predictor of the size and duration of the subsequent bust. Section 4 shows how the stagnation of rents since 2000 while house prices doubled means that the Irish housing market has not been driven by strong fundamental demand. Section 5 looks at the possible magnitude and duration of house price falls, and their potential macroeconomic effects.

## 2. Economic Theory

The familiar efficient markets hypothesis predicts that changes in asset prices are unpredictable. The price reflects individuals' information about asset's present value and changes as this information changes. Agents with good information buy, driving up the price, and those with bad information sell, driving it down.

However, instantaneous revelation of information through trade is not possible in house markets due to the very large transaction costs involved. In addition, the market lacks means for individuals to convey negative information through short sales.

As a result, housing markets are better modelled as information cascades: the actions of other agents signal their private information and can cause individuals to ignore their own signals and follow the herd (Bikchandani, Hirshleifer and Welch, 1992). Two models in the cascade literature are particularly useful for understanding the dynamics of housing markets: the rational frenzies model of Bulow and Klemperer (1994) and the wisdom after the fact model of Caplin and Leahy (1994).

Bulow and Klemperer (1994) model rational frenzies in auctions where participants reveal their valuations by bidding. Suppose that there are $k$ items available. If individual reservation prices were known with certainty, everyone would wait until the price fell to just above the reservation price of the $k + 1$-th highest person, and then all buy together. In practice, only the probability distribution of reservation values is known, and by bidding, or failing to bid, individuals reveal information about their valuations, allowing all participants to update their estimates about the value of the $k + 1$-th highest reservation price.

As a result, bidders with very different valuations have very similar willingness to pay. Price drops until one person bids. The information this reveals about the true distribution of willingness to pay can set off a bidding frenzy among the other bidders, driving up price again until it becomes clear that price is again above willingness to pay. Bidding then stops, causing prices to collapse until another bidding frenzy starts.

As well as being volatile, Bulow-Klemperer predict that the relationship of house prices to fundamentals such as income and interest rates need not be straightforward. To the extent that individuals depart from Bayesian rationality, altering reservation values in response to observed trends in prices, these effects will be amplified.

Caplin and Leahy (1994) look at investment where individuals have Gaussian signals. If the true state is bad, individuals continue to invest, driven by the dominating effect of past actions. Eventually, however, because signals are not bounded, a few agents get sufficiently bad signals to induce them to stop investing, causing priors rapidly to move to a belief that the state is bad, leading to a market crash and "wisdom after the fact".

## 3. Mean Reversion in House Prices

Economic theory predicts that house prices should not follow a random walk, but should be a mean-reverting process of booms and crashes around a slowly increasing trend reflecting the growth of household income. This is what the international data show.

Large falls in real house prices in the aftermath of housing booms are common internationally. Table 1 shows the 18 cases since 1970 where OECD economies have experienced falls in real house prices of at least 20 per cent, along with the previous price rise, and the duration of the fall. It can be seen that, in contrast to stock or currency markets, falls are prolonged, usually lasting 5 to 7 years, with the Netherlands, Switzerland, and Japan all experiencing more than a decade of falls. This reflects the reluctance of sellers to cut nominal prices, meaning that inflation does most of the work in reducing real prices.[1]

**Table 1: Magnitude and Duration of Falls in Real House Prices**

| | Peak Year | % Fall | Previous Rise | Duration of Fall |
|---|---|---|---|---|
| Netherlands | 1978 | 50 | 98 | 7 |
| Finland | 1989 | -48 | 109 | 6 |
| Switzerland | 1989 | -39 | 70 | 10 |
| Norway | 1987 | -39 | 53 | 6 |
| Denmark | 1978 | -36 | 22 | 4 |
| New Zealand | 1975 | -35 | 57 | 5 |
| Sweden | 1979 | -35 | 26 | 6 |
| Spain | 1977 | -33 | 24 | 4 |
| Denmark | 1986 | -32 | 52 | 6 |
| Japan | 1974 | -31 | 56 | 4 |
| Italy | 1982 | -30 | 84 | 4 |
| Finland | 1974 | -30 | 22 | 5 |
| Japan | 1991 | -27 | 78 | 10 |
| Sweden | 1990 | -27 | 38 | 6 |
| Italy | 1992 | -26 | 65 | 6 |
| Switzerland | 1973 | -26 | 34 | 4 |
| Ireland | 1981 | -22 | 53 | 5 |
| Canada | 1981 | -20 | 6 | 4 |

Shiller (2006) looks at three long series of real house prices: Amsterdam from 1628 to 1973, Norway from 1819 to 1989, and the United States from 1890 to 2005. In all cases he finds that although there are substantial and long lasting peaks and troughs, there is scarcely any upward long-run trend in prices.

Figure 1 shows the same pattern for smaller OECD economies: the Nordic countries, the Netherlands, and New Zealand, since 1970. The diagram shows the ratio of average house prices to disposable income but real house prices show a very similar pattern. Again, as economic theory predicts, there is considerable volatility and no sign of long-run trends. In contrast to stock price data, the tendency of prices to return to their long-run average means that

[1]The referee observes the one small economy that is notably absent from the list of booms and busts is Belgium. It would be useful to identify the sources of this stability, and whether they could be adapted to reduce future volatility in the Irish market.

the size of price falls can be predicted from the size of the price rise that preceded them.

**Figure 1: House Prices Relative to Disposable Income in Smaller OECD Economies Since 1970. Index: 2000 equals 100**

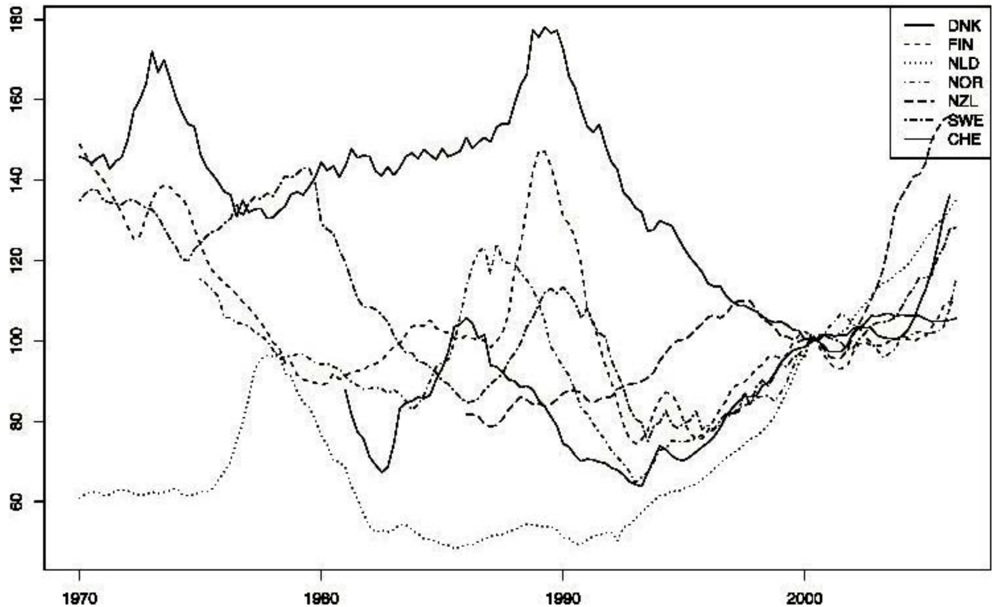



Figure 2 plots the size of increase in house prices for 17 OECD economies, against its subsequent fall.[2] For clarity, we exclude other variables such as interest rates that other studies find to have limited explanatory power for house prices: we are focusing on weak form efficiency of housing markets.

To estimate the peaks and troughs in each series for each country, we first calculated percentage changes for each quarter. A Friedman supersmoother (implemented in the R statistics package) was then applied to the percentage changes to eliminate short-run fluctuations. Peaks and troughs were then identified as the end of runs of positive or negative changes in the smoothed series, and actual price changes calculated between these points.

Percentage rises and subsequent falls are calculated relative to different values: troughs and peaks respectively. Remember that a rise of $p$ per cent only needs a fall of $p/(1 + p)$ per cent to reverse it. To eliminate this complication, all rises in Figure 2 and subsequent regressions are expressed as a percentage of peak values: for example a rise from 50 to 100 is treated as a 50 per cent rise, rather than a 100 per cent one.

[2]These economies are Denmark; Finland; Ireland; Netherlands; Norway; New Zealand; Sweden; Switzerland; United States; Japan; Germany; France; Italy; Britain; Canada; Australia and Spain.

Figure 2 shows that there is a strong linkage between rises in real house prices and subsequent falls. There is one evident outlier corresponding to a dip in house prices in Spain that occurred in the early 1990s in an otherwise continuously up-ward trend that saw real prices quadruple between the mid-1980s and the present.

**Figure 2: Percentage Rises in Real House Prices (Expressed as a Percentage of Peak Values), and Subsequent Falls for OECD Economies Since 1970**

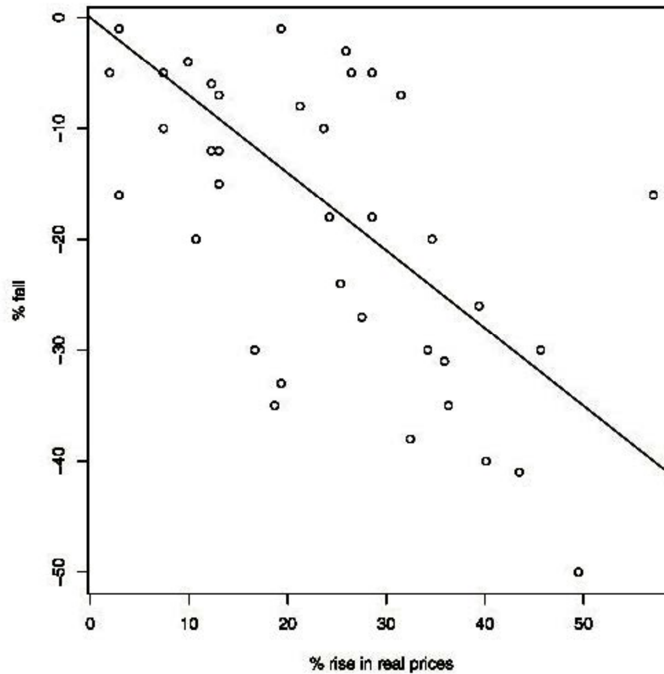



Table 2 shows a regression of the percentage fall in house prices against their previous rise, both including and excluding the Spanish early-1990s outlier, for real house prices and the house price to income ratio. The slope of -0.7 for real house price means that 70 per cent of the rise during a boom (expressed relative to the peak value) is lost during the subsequent bust.

It is worth emphasising that these regressions are simply a summary of data. Beyond being a standard test of weak form efficiency of the housing market, they do not purport to test any model. In particular, the approach here can convey no information about the timing and magnitude of peaks preceding troughs.

By comparison Glaeser and Gyourko (2006) find weaker mean-reversion in house prices in US metropolitan areas: a one dollar rise over five years is typically followed by a fall of 30 cents over the following five years.

**Table 2: Predictability of House Price Falls from Preceding House Price Rises**

| | Intercept | Initial Rise | SER | $R_2$ | BP | N |
|---|---|---|---|---|---|---|
| | | | **Real House Prices** | | | |
| All | -0.0489<br>(0.0363) | -0.5746**<br>(0.131) | 0.1085 | 0.3548 | 0.022 | 37 |
| Excl. Spain | -0.0252<br>(0.0356) | -0.7025**<br>(0.1347) | 0.1021 | 0.4445 | 0.483 | 36 |
| | | | **House Prices Relative to Disposable Income** | | | |
| All | -0.1168**<br>(0.0389) | -0.6115**<br>(0.1899) | 0.1275 | 0.219 | 0.187 | 39 |
| Excl. Spain | -0.104**<br>(0.0395) | -0.713**<br>(0.2013) | 0.1259 | 0.2584 | 0.428 | 38 |

OLS regression of percentage falls in real house prices and house prices relative to income on preceding rises for 17 OECD economies from 1970 to the present. Standard errors in parentheses. *denotes significance at 5 per cent, ** at 1 per cent. BP is p-value of studentised Breusch-Pagan test for heteroskedasticity.

What is notable about the diagram and regressions is how strong the relationship between price rises and falls is. Across very different housing markets in very different economies over a period of more than 30 years, there is a common relationship between the magnitude of booms and subsequent busts. Rent-price series show similar mean reversion but because of the small size of the rented sector in many economies, and the presence of rent controls in part of the period, the data are not as reliable as the real price and price-income series.

As always, national averages conceal substantial variations across regions and types of property. During the last British housing crash, for example, while selling prices nationally fell on average by 10 per cent, they fell in East Anglia by 40 per cent; while models such as Glaeser and Gyourko (2006) predict that the upper end of the market should be the most volatile.

As Table 1 suggests, there is a relationship between the magnitude of real price falls and their duration. Table 3 gives the results of a regression of the average annual rate of house price falls on their magnitude, and shows the two to be closely related. If $p$ is the proportionate price fall, so prices fall from 1 to $1 - p$ over $t$ years, it follows that $r = \ln(1 - p)/t$ is the average rate of decline. Table 3 gives the results of a regression of $r$ on $p$. For every 10 per cent extra decline in real prices, the annual rate of decline rises by 1.5 percentage points.

**Figure 3: Rate Versus Magnitude of Falls in Real House Prices for 17 OECD Economies Since 1970**

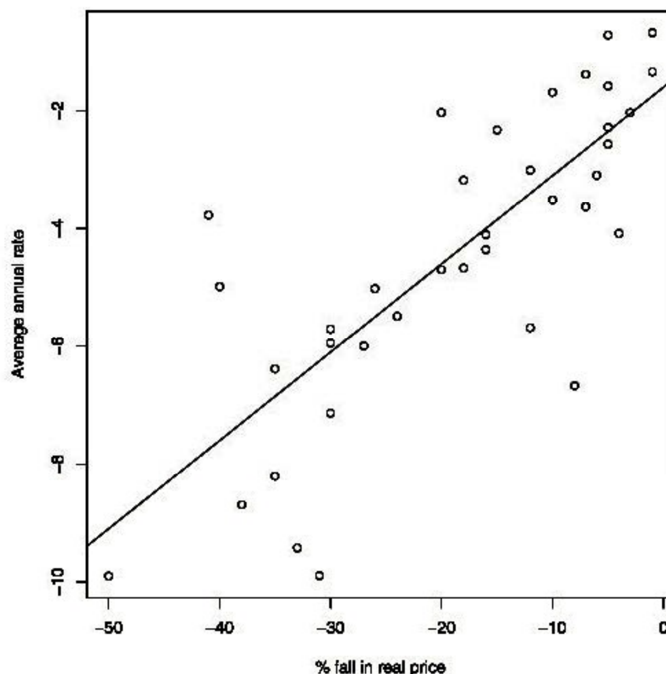



**Table 3: Connection Between Annual Rate of Decline and Magnitude of House Price Falls**

| Intercept | Price Fall | SER | $R_2$ | BP | N |
|---|---|---|---|---|---|
| -1.6784** (0.4709) | 0.1494** (0.0206) | 1.6434 | 0.6014 | 0.121 | 37 |

OLS regression of average rate of fall of real house prices on percentage fall for 17 OECD economies from 1970 to the present. Standard errors in parentheses. *denotes significance at 5 per cent, ** at 1 per cent. BP is p-value of studentised Breusch-Pagan test for heteroskedasticity.

## 4. The Irish Housing Bubble, Causes and Consequences

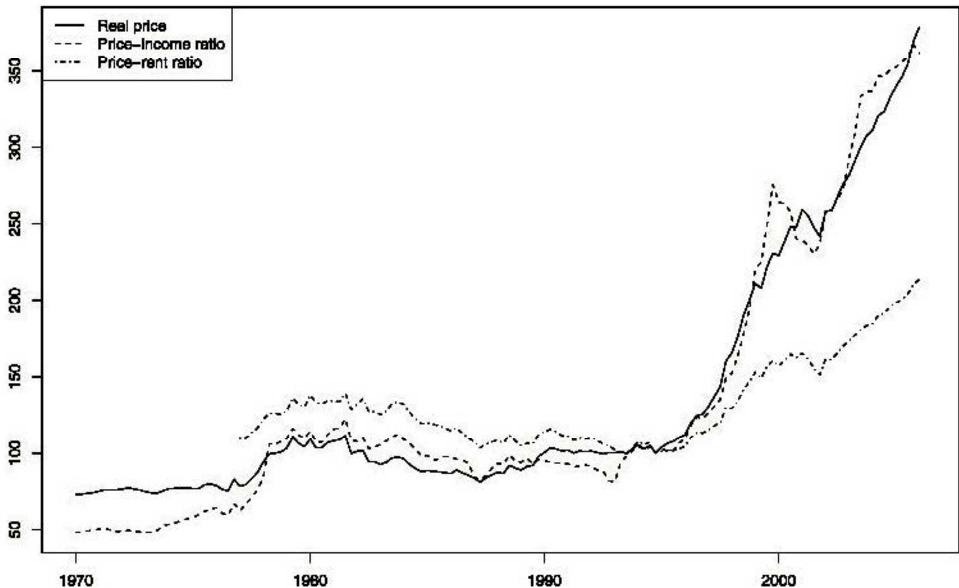
The evidence of nearly 40 cycles in house prices for 17 OECD economies since 1970 shows that real house prices typically give up about 70 per cent of their rise in the subsequent fall, and that these falls occur slowly.

Before looking at what these numbers may imply for Ireland, it is necessary to dispose of the idea that Irish house prices merely reflect strong fundamentals: rising income and increased household formation due to the age structure of the population, declining household size, rising employment, and immigration.

This argument is hard to sustain. If the rise in house prices were due to increased income and more people needing somewhere to live, we would have observed rents rising alongside house prices. Figure 4 shows how house prices have risen far faster than either

rents or income. In fact, while rents doubled relative to income between 1995 and 2000, the ratio has remained unchanged since. The failure of rents to rise, along with the number of recently built units that have been bought but are lying empty (FitzGerald, 2005), suggests that the Irish housing market has left the dull world of fundamental values far behind it.

**Figure 4: Irish House Prices Since 1970 in Real Terms, Relative to Income, and Relative to Rent. Index: 1995 Equals 100**




A back of envelope calculation of the fundamental price of housing is the following. Abstracting from maintenance costs (which typically run around one month's rent) suppose that housing generates an annual rent of *n*. This is a fraction $\nu$ of disposable income $y$ which is expected to grow through time at rate $g$. The present value of this infinite income stream is then

$$p = \frac{\nu y}{r - g}$$

where r is the discount rate. As Figures 1 and 2 and Table 1 show, housing is not a risk-free asset, and this discount rate needs to exceed the risk-free rate by an amount reflecting the fundamental risk of the asset. For housing, fundamental risk is large: housing is the largest item by far in most people's asset portfolio and price changes are strongly correlated with income growth. To be conservative, however, we can assign a value of r of 8 per cent, equal to the long run real return on equities.

The ratio of fundamental price to rent is $1/(r - g)$. To explain why Irish house prices have doubled relative to rent since 2000 we need to ask if there is any reason to suppose that new information has arrived causing long run estimates of $(r - g)$ to be rationally halved.

Ireland's stagnant exports, diminishing competitiveness, and the increasing structural problems of sectors such as IT and pharmaceuticals, would suggest that estimates of long-run income growth for the Irish economy $g$ should have fallen in this period. While it may be the case that increased international demand for quality assets may be driving down equilibrium returns (Caballero, 2006), there is no reason to believe that long-run expected returns on risky assets $r$ have halved in the past 7 years.

As White (2006) has observed, there is considerable variation in price-rent ratios within Dublin, with values in the range 80-100 at the top of the market. These values recall the peaks of the dotcom bubble and can be rationalised, with a discount rate $r \approx 0.08$, only with real long-run growth of income of 6 to 7 per cent, equivalent to a doubling of real income every 10-12 years. This is the rate achieved by Korea during its transition from effectively the stone age to an industrial economy but has not been remotely approached by any rich economy. Alternatively, assuming an equilibrium price-rent ratio in the region of 15, it suggests that large falls in prices, of the order of 85 per cent, might be needed for the top of the market to return to fundamental value.

Again it is worth reminding ourselves that, just as in stock markets, fundamental measures such as price-earnings ratios have limited explanatory power for price changes in the short run.

While other parts of the market appear less over-valued, they are still expensive by international standards. The Global Property Guide website reports that the average Dublin apartment rents for around 4 per cent of its purchase price. Only Madrid among major cities has a lower ratio. By comparison, London apartments return nearly 6 per cent, and Amsterdam and Paris over 8 per cent.

## 5. International Perspectives on the Irish Housing Bubble

Were Ireland to experience the same housing dynamics as every other OECD economy, except Spain in the early 1990s, what sort of price changes might be expected? Recall that Table 2 predicts a 7 per cent fall for every 10 per cent rise (relative to peak values) of real prices from their trough level, with a standard error of 10 per cent.

Since the mid-1990s, real house prices have risen from an index level of 100 to around 350, and increase in terms of peak value of 70 per cent. If 70 per cent of this rise were to be subsequently lost – as occurred during our previous bust in the early 1980s – the predicted fall in real house prices would be 50 per cent with a standard error of 10 per cent. In other words, a 68 per cent confidence interval for price falls would be in the range of 40 to 60 per cent. There would be one chance in eight of a price fall of only 30 to 40 per cent, just as there is a predicted one chance in eight of a fall of 60 to 70 per cent.

Similarly, Table 2 predicts, given an approximately 70 per cent rise in the price income ratio, that the price income ratio will fall by around 60 per cent, with a standard error of around 12.5 per cent.

It must be emphasised that these estimates are extrapolations: no economy in our sample of busts following booms experienced a rise as large as Ireland's. A fall in real prices of 50 per cent from Table 3, implies a predicted annual rate of decline of around 9 per cent, with a standard error of approximately 1.5 per cent. This translates into a decline of around 8 years, of the same order of magnitude as that experienced in the Netherlands in the 1980s or Britain in the 1950s. Assuming an inflation rate of 2 per cent, this implies an annual fall in selling prices of 7 per cent.

These estimates may be unduly optimistic. In all the housing cycles on which the regression was based, housing stock was, for practical purposes, fixed. In Ireland, by contrast, the number of housing units is growing at around 5 per cent per year, which would suggest the potential for larger falls than those experienced in other OECD housing slowdowns.

### 5.1 FUNDAMENTAL REGRESSIONS

The prediction that Ireland may experience house price falls in the range of 50 per cent, is a good way from the OECD estimate (Rae and van den Noord, 2006) that Irish houses are overvalued by only around 20 per cent. However, the OECD methodology, and that of similar studies, is problematic. Such studies run a regression of house prices on interest rates, disposable income, employment and other fundamental variables. The regression residuals are then equated with the degree of over- or under-valuation in the market.

To see this, consider a regression of Irish real house prices on disposable in-come since 1976 gives a residual for the last quarter of 2006 of 17 per cent. If instead house prices had changed by twice as much each quarter as they did, the regression residual would find that they were 35 per cent over-valued, while prices would be four times as high as they are now. Measuring over-valuation using regression residuals is a valid approach if very long-run series are available to tie down coefficient values, but using short-run series, as existing studies do, leads to meaningless results.

### 5.2 MACROECONOMIC CONSEQUENCES

House price falls have three effects. First, households feel less wealthy and consume less. Evidence from the United States points to a final long-run marginal propensity to consume from housing wealth of around 10 per cent: a $100,000 rise in property values, increases household consumption eventually by a total of $10,000 (Carroll, Otsuka and Slacalek, 2006). Second, banks face more bad loans, and become more cautious in their lending, leading to further falls in creditworthiness through the standard financial accelerator. Finally, the value of Tobin's $q$ for residential investment falls, reducing house building. Most countries devote about 5 per cent of national income to building houses and in a typical housing bust, this falls to around 4 per cent of national income.

In most cases then, housing busts are uncomfortable, but not macroeconomically disastrous events. How about Ireland? There is some evidence that the wealth effect on consumption might not

be as strong as in the United States: there has been no fall in personal saving in Ireland during the housing bubble, and households have not consumed home equity through second mortgages (Hogan and O'Sullivan, 2006). Similarly, the larger banks which dominate lending are well capitalised and the banking system has, until recently at least, avoided the worst excesses of the sub-prime mortgage market, although it is likely that many interest-only and 100 per cent mortgages could go sour, especially given the ease with which delinquent borrowers can relocate to England.

It is the scale of the Irish house building industry that makes a fall in house prices potentially troubling. While most economies derive only 5 per cent of their income directly from residential construction, in Ireland house building accounts for around 15 per cent of national income.

Effectively, the recent growth of the Irish economy looks similar to the unstable case of an old-fashioned multiplier-accelerator model. The employment growth in the Celtic Tiger period of the 1990s led to increased demand for housing, reflected in rising real house prices and rent to income ratios. This stimulated house building, which generated more employment, leading to more demand for housing, and so on. Effectively, the Irish economy has come to be driven by building houses for all the people whose jobs have come, directly or indirectly, from building houses.

It is hard to envisage how a fall in house building from 15 per cent to 5 per cent of national income might be achieved without considerable macroeconomic dislocation. Building booms, moreover, tend to end suddenly: the example of Arizona in the summer of 2006 shows how a housing market can move in the space of a few months from buyers queuing overnight to buy, to empty tracts of new houses being priced below construction cost and still failing to sell.

## 6. Conclusions

This paper has taken an international perspective on the Irish housing boom. We have shown that there is a close relationship historically across very different economies and housing markets between the size of increases in real house prices, and subsequent declines. If this relationship were to hold for Ireland, the expected fall in average real house prices is in the range 40 to 60 per cent, over a period of around 8 years. Such a fall would return the ratio of house prices to rents to its level at the start of the decade. Given the unusual reliance of the Irish economy on building houses, the effects of any such fall on national income may be somewhat larger than that experienced at the end of other housing bubbles.

Policy implications are straightforward. Booms and busts are a normal part of property markets. The government did not cause the current boom, and is powerless to do anything about a subsequent bust. In particular, cuts in stamp duty will not change buyers' self-fulfilling incentive to wait and see if prices fall further.

Blanchard (2006) has observed that Euro-area economies appear at risk of rotating recessions: increased domestic demand drives up real wages and erodes competitiveness, but the impossibility of

devaluing means that prolonged rises in unemployment become the only means to reduce real wages. Notable current examples are Italy and Portugal. There may be some risk that the sharp fall in Irish competitiveness since 2000, which has been disguised and, to some extent, caused by the construction boom, may require a lengthy period of high unemployment to reverse.

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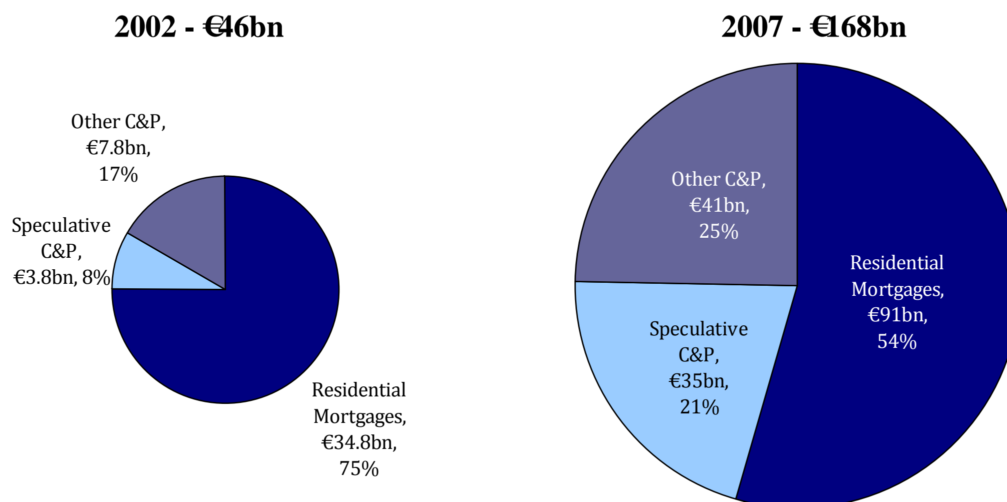
**Figure 2.6: Components of Aggregate Domestic Property Lending Stock to Irish Residents by the Covered Banks**




**Source: Central Bank of Ireland**

2.2.9 The compound annual growth in overall lending and the shift towards speculative C&P lending on the part of the covered banks is illustrated in Figure 2.7 below. Total loans to customers grew by an average of 21.8% annually during the period. Property-related lending grew even faster and the fastest growth of all was in speculative C&P lending which grew by an average of 56.5% each year. Lending to this category increased nine-fold between 2002 and 2007. Similarly, in the Residential Mortgage sector, the more commercial-related buy-to-let lending was increasing at almost twice the rate of lending for owner-occupied housing.

no financial stability problem serious enough to warrant action at the time. While it is possible that a warning from the FR would have changed the CB's view, this is by no means certain.

4.3.12 Finally, the IMF Financial Sector Assessment Programme (FSAP) report on the Irish financial system in 2006 rated the performance of the FR highly. It did not call for any significant changes in its overall approach or methods. It also concluded that the Irish banking system was basically sound.[107] The FSAP methodology itself suffered from weaknesses, especially a concentration on process rather than substance. The positive FSAP report also served to reinforce the confidence in the soundness of the banking system being expressed by the CB/FR in their Financial Stability Report.

## 4.4 The Central Bank Pre-Crisis (2003 to mid-2007)

4.4.1 As in the case of the FR, there was a major domestic policy failure at the CB in respect of the maintenance of financial stability. Not only did the CB (with a small number of contrarians at board level) seriously underestimate the nature and extent of the risks in the Irish financial system but it was content to express only nuanced and somewhat indirect concerns on possible risks rather than study contingent worst-case scenarios. Had it done so, it might have issued stronger warnings (at least confidentially to the Government) or even taken appropriate action.

*Willingness and Ability to take Action*

4.4.2 At the outset, it is important to note that a view was expressed to the Commission that it was not the primary responsibility of the CB to evaluate possible problems in domestic financial markets emanating from the behaviour of individual institutions. CB legislation provides that while the CB was charged with overall financial stability matters, the FR was responsible for identifying and bringing to the attention of the CB any bank-specific/prudential matters of potential system-wide significance. Therefore, according to this view, the CB should not question, or be seen as questioning, the FR's activities. As the FR did not raise any such concerns with the CB, the CB could therefore not have been expected to detect existing or emerging problems. Indeed, it was even suggested that detailed enquiries by the CB regarding the basis for the FR's assessments could have been regarded as an unacceptable intrusion into the autonomous status of the FR.

4.4.3 Such a narrow interpretation of the CB's role is not shared by the Commission. When combined with the static[108] approach of the FR in assessing individual institutions, it could – and did – create a situation where financial stability problems could not be addressed or prevented. Financial stability should be the overriding objective and the CB (as well as other responsible authorities) should do whatever is reasonably necessary to maintain it.

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[107] These views were also broadly reflected in various IMF Article IV Consultation reports during this period. It may be noted that the Independent Evaluation Office of the IMF in its report of 10.1.2011 *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07* paints a bleak picture of the ability of the organisation to detect the financial stability problems arising internationally and particularly in a number of developed countries.

[108] The FR had a static or backward-looking approach to assessing the financial health of institutions (i.e. whether they met certain prudential ratios at the last filing date).

# THEME: R6

Relationship with and oversight by international stakeholders

# LINE OF INQUIRY: R6a

Adequacy and impact of international organisation’s oversight on banking regulation and supervision activity

INTERNATIONAL MONETARY FUND

IRELAND

# Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation with Ireland

Approved by Ajai Chopra and Martin Mühleisen

May 20, 2009


## Executive Summary

**Given its serious internal imbalances, Ireland was especially vulnerable to the recent global shocks.** Overextension in construction and financial intermediation, along with loss of international competitiveness, has meant that the impact will be sizeable. Cumulatively, GDP is projected to contract by 13½ percent through 2010, the largest among advanced economies. Thereafter, as the present dislocations gradually correct themselves, only a modestly-paced recovery is foreseen. The incipient decline in wages will need to be sustained to help redress Ireland's cost disadvantage.

**Rapid progress on bank restructuring is critical to reestablishing a healthy financial sector.** With banks facing liquidity pressures and sizeable losses, the authorities have taken important steps to stabilize the financial system—through the blanket guarantee to depositors and creditors and the recapitalization of banks. ECB credit lines have provided valuable liquidity. The proposed National Asset Management Agency is potentially the right mechanism to separate the good from the bad assets. Its success requires a comprehensive and realistic assessment of impaired assets. The authorities' efforts to press ahead with supportive regulatory and supervisory measures will help manage the current stress and lower the risk of future crises.

**Fiscal consolidation has begun—and requires a sustained effort.** The authorities' sense of urgency is welcome. Such, however, has been the collapse of revenues that the 2009 deficit could reach 12 percent of GDP. The authorities recognize that the execution of their ambitious consolidation plan will require a continuing commitment to address sensitive expenditures, including the public wage bill and the scope of social welfare programs. The consolidation will be more credible the more tightly it is tied to monitorable goals.

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## I. THE CONTEXT[1]

1. **Ireland's ongoing painful adjustment reflects the unwinding of critical internal imbalances.** Since the start of the decade, and especially from 2005 to 2007, easy credit fostered a property bubble, bank exposures to property lending soared while reliance on wholesale funding intensified, and international competitiveness was compromised as wages climbed rapidly. On all these dimensions, Ireland had become remarkably vulnerable (Figure 1). Yet, dazzling growth and buoyant public revenues prompted tax reductions and expansion of public expenditures that have proved unsustainable. Various commentators and the IMF in its Article IV consultations did warn that the seemingly-unstoppable growth masked serious imbalances, including the fragility of public finances.

2. **As the global turmoil has unfolded, Ireland has benefited from the safety provided by its membership in the eurozone.** This has allowed it to avoid the currency pressures that typically accompany financial crises. Moreover, access to ECB financing has been an important source of liquidity for the banking sector. However, since the possibility of adjusting through the depreciation of its own exchange rate is not available, further wage reductions will be required to restore competitiveness and growth prospects.

3. **The Irish authorities have moved with resolve to counter the severe economic and financial shocks—that resolve will need to be sustained.** Recognizing the vulnerabilities that rendered the economy particularly susceptible to the unprecedented events since the onset of the global financial crisis, the authorities have acted to contain the damage. At the same time, they have introduced initiatives to repair the financial and fiscal systems. To bear fruit, these efforts will require determined execution over several years. Robust policy instruments that allow the flexibility to deal with surprises and the self-discipline of transparent benchmarks will help stay the course.

4. **The priorities are clear**:

- Decisive efforts to restore healthy functionality of the financial sector are essential to prevent festering problems and an anemic economy.

- To be sustained, fiscal consolidation measures should be underpinned by a structure of rules and accountability within which politically-sensitive trade-offs can be made.

5. **A continued search for pragmatic policy initiatives will be needed in the face of acute policy dilemmas.** Financial support to banks is necessary but adds to the fiscal burden. Reducing fiscal deficits is needed to maintain credibility with markets but deepens the economic contraction. Expenditure reduction, as distinct from raising taxes, is the superior approach to fiscal consolidation but, unless carefully managed and prioritized, risks hurting the most vulnerable.

[1] The staff team comprised Mr. Mody (head), Mr. Kanda, Ms. Athanasopoulou (all EUR), Messrs. Seelig and Darbar (both MCM), and Ms. Luedersen (LEG), and visited Dublin during April 20-May 1, 2009.

## B. Supporting Measures

27. **Accompanying these immediate crisis management tasks are several supportive crisis prevention measures.** These fall into two broad categories: (a) a framework for bank resolution; and (b) enhancements to supervision. Guided by evolving global and European Union norms, the authorities are engaged in tailoring these to domestic circumstances.

28. **A broader tool kit should allow for more speedy and less disruptive resolution of banks.** When faced with an insolvent bank, Irish authorities can place the bank in a court-supervised insolvency proceeding. To avoid the disruption that this entails for the customers of the bank and to preserve confidence in the system, special legislation was passed allowing the authorities to nationalize Anglo Irish Bank.[7] The authorities were open to exploring the merits of a special bank resolution regime. Such a regime would recognize the unique role played by banks in the economy and give the authorities the power to quickly transfer assets and deposits to another institution (a purchase-and-assumption transaction) or to establish a bridge bank (a new limited life bank into which the old bank is transferred to facilitate its sale). The experience with Northern Rock prompted the U.K. to adopt a special resolution regime to add flexibility in dealing with insolvent banks. The enhanced deposit protection under the European Union guidelines would also strengthen the safety net.

29. **The authorities are undertaking several supervisory and regulatory initiatives.** First, they reported substantial additions of staff enabling them to intensify bank-by-bank surveillance for systemic risks. In this regard, they noted that since January 1, 2003, the concept of a distinct International Financial Services Center no longer exists. Second, they had already moved in establishing a macro-prudential supervisory process that blends considerations of systemic stability with managing the stress in individual financial institutions, in line with the de Larosière report.[8] The authorities agreed that success of this initiative would require further investment in the development of early warning systems and identification of systemic risks, along with necessary precautionary actions. Finally, further safeguards are needed to limit the risks of related-party lending by banks. The authorities are implementing a requirement for the disclosure of related-party exposures. Safeguards should lower the applicable limits, specify non-favorable terms for the transactions, and require strict approval procedures.

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[7] If needed, the government will compensate the shareholders following a valuation assessment.

[8] "The High-Level Group on Financial Supervision in the EU," Jacques de Larosière, Chairman, February 2009.

DOF02B01



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https://www.imf.org/external/np/sec/pn/2006/pn0688.htm

# IMF Executive Board Concludes 2006 Article IV Consultation with Ireland

Public Information Notice (PIN) No. 06/88
August 7, 2006

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with Ireland is also available.

On July 26, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

**Background**

Ireland's economic performance remains strong. In recent years, real GNP growth was one of the highest among industrial countries; the unemployment rate was among the lowest; and HICP inflation declined to close to the euro area average. Employment growth was rapid, reflecting strong immigration and rising labor force participation. This remarkable performance reflected both good policies and fortunate circumstances. Prudent government spending led to declining government debt; low taxes on labor and business income encouraged labor supply and investment; and flexible labor and product markets helped growth. At the same time, favorable demographics boosted the working-age population, and participation in EMU lowered interest rates.

However, economic activity has become reliant on building investment and competitiveness has eroded. The share of the construction sector in economic activity has increased and is now one of the highest in Europe. Bank credit to property-related sectors has grown rapidly and now accounts for more than half of total bank lending. Household debt as a share of household disposable income rose to about 130 percent in 2005, among the highest in Europe. Reflecting the expansion of the labor-intensive construction and services sectors, labor productivity growth has declined. The combination of the slowdown in productivity growth, faster wage growth in Ireland compared to its trading partners, and the appreciation of the euro, has led to an appreciation of the ULC-based real effective exchange rate. Partly as a result, the contribution of net exports to growth has fallen steadily since 2001. After being in balance for several years, the external current account registered a deficit of about 2½ percent of GDP in 2005.

**Executive Board Assessment**

The Executive Directors commended Ireland's continued impressive economic performance, which has been supported by sound policies, including prudent fiscal policy, low taxes on

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

labor and business income, and labor market flexibility. Economic growth is strong, unemployment is low and labor participation rising, and government debt has been reduced dramatically over the past two decades. Nevertheless, Directors observed that growth has become increasingly unbalanced in recent years, with heavy reliance on building investment, sharp increases in house prices, and rapid credit growth, especially to property-related sectors. At the same time, competitiveness has eroded, reflecting the combination of faster wage growth in Ireland compared to its trading partners, declining productivity growth, and the appreciation of the euro against the U.S. dollar. Directors observed that Ireland's small, highly open economy is also vulnerable to external shocks.

Directors expected economic growth in 2006-07 to remain strong, driven by domestic demand and accompanied by a widening current account deficit and continued rapid credit growth. While the contraction of the construction sector to a more sustainable size over the medium term is likely to be smooth, Directors noted that an abrupt correction cannot be ruled out.

Directors welcomed the Financial System Stability Assessment Update, which finds that Ireland's financial sector soundness indicators are generally strong and that the major lenders have adequate buffers to cover a range of shocks. The recent increase in the risk-weighting on high loan-to-value residential mortgages is an important signal of the need for banks to differentiate between higher- and lower-risk lending within an asset class. Directors suggested that the Financial Regulator continue to monitor banks' risk management practices, including for commercial property lending. Going forward, they called for continued updating of the stress-testing framework, and further strengthening of the regulatory and supervisory framework, especially for insurance.

While recognizing that Ireland's fiscal position is sound, most Directors considered that a modest fiscal tightening would be desirable in 2007, given the strength of domestic demand, potential risks of a hard landing, and the need to prepare for population aging. Slowing the growth of current spending to slightly below nominal GDP growth would also help prevent inefficiencies that could otherwise emerge given the rapid increases in spending in recent years. A number of Directors, however, saw less merit in fiscal tightening at the current juncture, pointing to the need for further increases in spending to achieve social goals, as well as to the recent tightening of euro area monetary policy. Directors agreed that improvements in public services remain a key priority, and, in this context, encouraged the authorities to focus on value for money, including by monitoring government outputs and extending multi-year envelopes to current spending. They welcomed the authorities' plans to further deepen the public debate on fiscal priorities.

Directors considered that continued wage moderation and labor market flexibility are essential to support competitiveness. The implementation of the new social partnership agreement should continue to allow flexibility in wage increases at the firm level and minimize the increase in the restrictiveness of employment protection legislation.

## Ireland: Selected Economic Indicators

| | 2002 | 2003 | 2004 | 2005 | 2006 1/ |
|---|---|---|---|---|---|
| **Real Economy (change in percent)** | | | | | |
| Real GDP | 6.0 | 4.3 | 4.3 | 5.5 | 5.8 |
| Real GNP | 2.8 | 5.5 | 3.9 | 5.4 | 6.2 |
| Domestic demand | 4.3 | 4.5 | 3.6 | 8.0 | 6.7 |
| Exports of goods and services | 4.5 | 0.5 | 7.3 | 3.9 | 6.4 |
| Imports of goods and services | 2.4 | -1.2 | 8.6 | 6.5 | 7.5 |
| HICP | 4.7 | 4.0 | 2.3 | 2.2 | 2.8 |
| Unemployment rate (in percent) | 4.4 | 4.7 | 4.5 | 4.3 | 4.3 |
| **Public Finances (percent of GDP)** | | | | | |
| General government balance | -0.4 | 0.2 | 1.5 | 1.0 | 0.7 |
| Structural balance 2/ | -1.3 | 0.4 | 1.9 | 1.0 | 0.5 |
| General government debt | 32.2 | 31.1 | 29.6 | 27.4 | 25.9 |
| **Money and Credit (end-period, percent change)** | | | | | |
| M3 3/ | 9.3 | ... | 22.5 | 19.8 | 20.8 5/ |
| Private sector credit 4/ | 15.0 | 17.9 | 26.6 | 28.8 | 29.8 5/ |
| **Interest Rates (end-period)** | | | | | |
| Three-month | 2.9 | 2.1 | 2.2 | 2.5 | 2.9 5/ |
| 10-year government bond yield | 4.3 | 4.6 | 3.7 | 3.3 | 4.1 6/ |
| **Balance of Payments (percent of GDP)** | | | | | |
| Trade balance (goods and services) | 17.1 | 16.0 | 14.9 | 12.7 | 11.5 |
| Current account | -1.0 | 0.0 | -0.6 | -2.6 | -3.0 |
| Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs) | 4.0 | 2.8 | 1.9 | 0.6 | ... |
| **Exchange Rate** | | | | | |
| Exchange rate regime | Member of euro area | | | | |
| Present rate (July 17, 2006) | US$ per euro 1.2541 | | | | |
| Nominal effective rate (1995=100) | 89.7 | 97.4 | 102.6 | 98.3 | 99.8 7/ |
| Real effective rate (1995=100, CPI based) | 98.0 | 107.9 | 113.7 | 109.2 | 112.0 7/ |

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics.

1/ Staff projections, except where noted.

2/ In percent of potential GDP.

3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.

4/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.

5/ As of May 2006.

6/ As of June 2006.

7/ As of April 2006.

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August 2003
IMF Country Report No. 03/242

# Ireland: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion for Ireland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2003,** with the officials of Ireland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 9, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **July 25, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 30, 2003 discussion** of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.**

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INTERNATIONAL MONETARY FUND

IRELAND

**Staff Report for the 2003 Article IV Consultation**

Prepared by the Staff Representatives for the 2003 Consultation with Ireland

Approved by Ajai Chopra and Martin Fetherston

July 9, 2003

- The Article IV consultation discussions were held in Dublin during May 6–15, 2003. The mission comprised Ms. Coorey (head), Mr. Soikkeli (both EU1), and Mr. Morales (MFD). Ms. Koeva (EU1) contributed at headquarters. The mission met with the Minister for Finance, the Governor of the Central Bank, other senior officials, the employers' federation, trade unions, and members of the financial and academic communities. Mr. Bennett (Executive Director) attended the concluding meeting.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, other than those in accordance with U.N. Security Council resolutions and EU regulations (Appendix I).

- Ireland has subscribed to the Special Data Dissemination Standard (SDDS).

- The authorities intend to publish the staff report.

- A coalition government headed by Prime Minister Ahern, which has been in power since June 1997, was re-elected in May 2002.

- At the conclusion of the last consultation in August 2002, Directors commended the authorities for Ireland's outstanding economic performance. They noted the downside risks to the global recovery and cautioned that euro appreciation and high wage inflation could adversely affect Ireland's competitiveness. Directors expressed concern about the sharp deterioration of the public finances and cautioned against continued rapid increases in public spending.

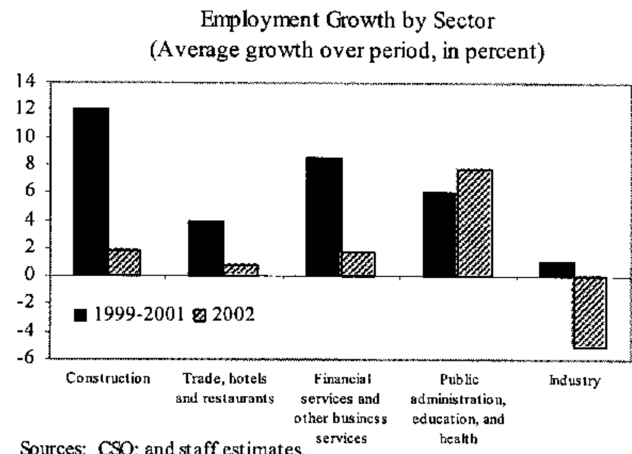
## I. Background and Key Issues

1. **Ireland's economy has performed impressively over the past decade.** Income growth, measured by real GNP, averaged 6½ percent in 1991–2001, bringing per capita income above the euro area average (Table 1 and Figure 1). The unemployment rate plummeted from almost 16 percent to less than 4 percent and the employment ratio rose well above the euro area average. Substantial gains in competitiveness, particularly in the multinational-dominated manufacturing sector, kept the current account in surplus or close to balance. The fiscal position strengthened with the public debt ratio falling from almost 100 percent of GDP in the early 1990s to well below 40 percent in 2001 (Figure 2 and Appendix II).

2. **These enviable achievements have been due in significant measure to sound policies.** A high degree of openness to trade and foreign investment as well as EU and EMU membership, the latter of which caused a sharp decline in real interest rates, were significant factors. National wage agreements quelled industrial unrest and, in the initial stages, delivered wage moderation, allowing the burgeoning labor force to be absorbed into employment. Sensible public policies in the form of investment in education and skills, tax reforms that increased incentives to work and invest, and fiscal restraint were also important. A virtuous circle was created that took advantage of favorable circumstances—in particular, the global high-tech and financial services boom of the late 1990s.

3. **While openness has brought clear benefits to Ireland, it also exposes the economy to shifting global currents, as slowing activity since mid-2001 demonstrates.** GDP growth remained strong reaching almost 6½ percent in 2002 (outpacing that of other EU countries), but GNP growth—which normally better reflects domestic economic conditions[1]—decelerated sharply, from over 10½ percent in 2000 to just ½ percent in 2002 (Figures 3 and 4).

Employment Growth by Sector
(Average growth over period, in percent)




Sources: CSO; and staff estimates.

[1] The substantial contribution of multinationals to Irish output, and associated profits (possibly reflecting transfer pricing), create significant differences between measures of output and income. In 2002, GDP was boosted by unusually strong multinational profits—particularly in pharmaceuticals—which had limited implications for the rest of the economy (Table 2). On the other hand, GNP may exaggerate the slowdown in activity because the unusually sharp drop in profits of Irish firms abroad was partly driven by some firm-specific one-time factors. Officials noted that the growth in domestic demand—at about 2¾ percent—perhaps provided a better indication of the underlying pace of economic activity in 2002.

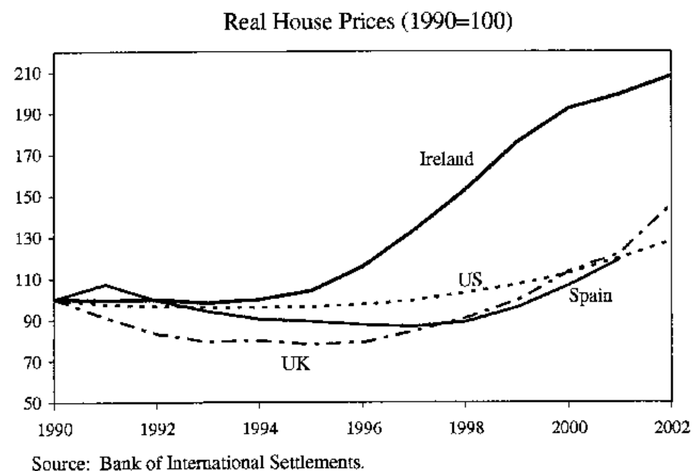
Personal consumption and export growth weakened from their previous rapid pace, while investment increased marginally, with strong residential investment offsetting a fall in business investment (Tables 1 and 3). However, unemployment increased only modestly as the rapid pace of public sector recruitment largely offset layoffs in manufacturing and business services, and wage growth moderated somewhat from the high rates seen in 2001 (Figure 5). Macroeconomic policies facilitated the soft landing: the ECB's monetary easing has kept short-term real interest rates negative since late 2001 (Figure 6), while fiscal policy was expansionary.

4. **Recent indicators suggest that activity has remained subdued so far in 2003.** The trend in manufacturing growth has been weak while both industrial confidence and orders have fallen back to, or below, the low levels of late 2001, after a modest improvement during 2002 (Figure 7). Moreover, consumer and service sector confidence deteriorated further and retail sales remained sluggish. However, unemployment remained stable at 4.6 percent (claimant count basis) in May 2003. Inflation eased to 3.9 percent in May, still well above the euro area average of 1.9 percent (Figure 8).

5. **Ireland has generally responded appropriately to policy challenges identified in previous Article IV consultations.** Fiscal policies were expansionary in 2000–02, contrary to Fund advice. However, starting in 2002, the authorities have reined in spending growth in order to stem the deterioration in the budget balance. In contrast to its predecessor, the national wage agreement signed in spring 2003 offered no fiscal concessions and provided a degree of wage moderation. Financial supervision is being strengthened along the lines recommended in the 2000 FSAP. Progress in improving public expenditure efficiency, controlling public sector wages, and increasing domestic competition has been more limited.

6. **Against this background, discussions focused on near-term vulnerabilities and challenges in sustaining strong medium-term economic performance.** The following questions were key:

- With external demand slowing, strong credit growth and a prolonged house price boom have, to some extent, sustained domestic demand. **Can financial stability and strong macroeconomic performance be maintained if the global economy remains weak, the euro appreciates further, or house prices unwind—perhaps abruptly?**



Source: Bank of International Settlements.

- Inflation has been persistently higher than the euro area average and, if wage bargaining focuses on maintaining real wages, this could lead to higher wage inflation than justified by productivity growth and recent euro appreciation. **Can competitiveness be maintained and wage pressures—particularly in the public sector—be contained?**

- A decade of rapid, export-led, income growth has led to high expectations about the future. **How can strong growth be sustained over the medium term, particularly, how can productivity growth in services (including the public sector), which now accounts for over half of value added, be improved?**

## II. Report on the Discussions

### A. Short-Term Economic Outlook and Risks

7. **There was general agreement that the expected economic recovery would be gradual given the weakness in the global economy.** Staff projects real GDP growth of 2½ percent in 2003—with GNP growing by 1¼ percent—both about a percentage point below the authorities' latest projections released in December 2002 (Table 3). This difference stems mainly from the authorities' expectations of a sharper rebound in global demand that they acknowledged would now need to be revised. Staff projects growth to pick up in 2004, with GNP picking up to about 3 percent (and GDP to 3¾ percent). Following a slowdown in 2003, private consumption growth would recover in 2004 as the external outlook improves. Exports would gather steam in late 2003, but given the ICT overhang, investment would decline before reviving next year as growth prospects improve. Monetary conditions would still remain supportive, as the effects of euro appreciation would be largely offset by the ECB's June rate cut (Figure 6).

8. **The authorities and staff agreed there were significant downside risks to this outlook.** In particular:

- Global economic weakness may be prolonged further, thus delaying the expected rebound in Irish activity. Moreover, the euro could continue to strengthen, squeezing export margins, particularly in the employment-intensive indigenous sector, where productivity gains have been less pronounced.

- Unemployment may rise considerably if external demand does not recover and competitiveness deteriorates further, especially since employers may still be hoarding labor, given the previously very tight labor market. Furthermore, with the planned freeze in public employment, public sector hiring would not offset private sector layoffs.

- 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.

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. Staff's analysis of the empirical evidence indicates 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 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.[3]

11. **Discussions touched on whether the authorities' attempts to control house price developments might have contributed to price instability.** Various tax changes in recent years have sought to achieve a better balance between housing supply and demand, improve the position of first-time buyers, and facilitate the rental market. The stamp duty regime has been changed frequently. After measures to cool the housing market contributed to an unexpectedly sharp deceleration in house prices in 2001, the 2002 budget reintroduced measures that many analysts felt were fuelling the resurgence in house prices. Staff noted that frequent policy reversals could distort intertemporal decisions and induce market volatility. Moreover, 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.

**Financial system risks and reform**

12. **The authorities were concerned about risks to banks from rapid house 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.** The Governor of the CBI had recently issued a warning letter to mortgage lenders on the need to maintain rigorous lending criteria despite intensifying competition. Supervisors were carrying out themed inspections on property loan portfolios of more exposed banks and planned to coordinate a stress testing exercise better tailored to pick up risks in loan portfolios and requiring disclosure of lenders' methodologies. Discussions also covered the health of the insurance sector, which officials noted remained well capitalized and less exposed to equities than U.K. and European counterparts. Staff agreed with the authorities' concerns about risks in mortgage lending, particularly from a possible rise in unemployment and from differential credit risks within mortgage loan portfolios.[4] Staff also noted that the concentration of large exposures to commercial property loans as well as insurance industry risks merited close attention.

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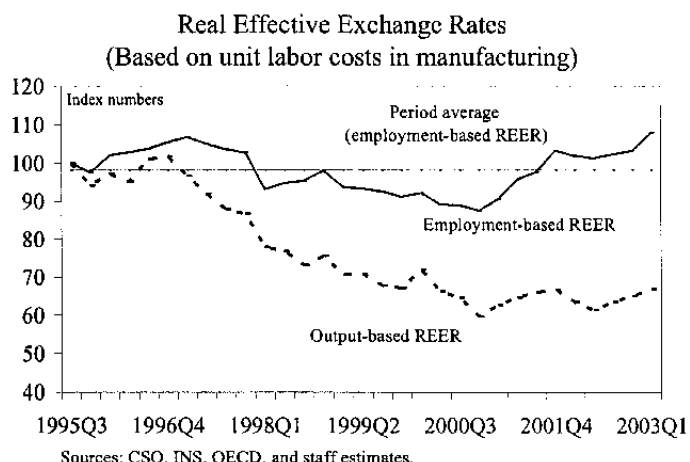
[3] See Annex I at the end of this report, "Can Fundamentals Explain the Growth of House Prices in Ireland?"

[4] See Annex II, "Financial Sector Risks in Ireland."

15. **The authorities were concerned that persistently higher wage and price inflation would worsen competitiveness as the euro strengthened and external demand weakened.**[7] Staff noted that the sharp deterioration in competitiveness in 2001 appeared to reflect mainly a catch-up in wages, since the unit-labor cost based REER—measured on an employment-weighted basis to remove output distortions due to multinational activity—had stabilized in 2002 at a level only somewhat above the average of the past several years.[8] Staff agreed that, from such a starting point, the rapid strengthening of the euro in 2003 was a risk—indeed, in the first quarter, the employment-weighted REER had already appreciated to a level some 10 percent above the period average. Wage growth would thus need to slow sharply to arrest a further deterioration in competitiveness, particularly in indigenous export sectors.




16. **The latest national wage agreement has provided for some degree of wage moderation, without significant fiscal concessions as in the past.** Staff noted, nevertheless, that the negotiated wage increases (some 7 percent over 18 months) might still prove a burden for some producers, given the less favorable external environment. The wage norm for the second phase of the agreement (to be negotiated in spring 2004) would need to reflect the deterioration in competitiveness and anticipate changing cyclical conditions. There should be sufficient de facto flexibility at the firm level to ensure that wages adjusted rapidly to minimize risks to employment and output. Most importantly, public sector wages, which were sheltered from market pressures, would need to be kept under firm control. The mission was assured that the agreement permitted flexibility if economic conditions hampered firms' ability to pay. Given the focus on real wages, social partners stressed that inflation would need to decelerate if wage demands were to moderate by next spring's negotiations.

17. **Many in the private sector regarded last July's pay recommendations of the Public Sector Benchmarking Body as overly generous, given sizeable public wage increases in recent years and because the exercise was carried out at the peak of a cycle.** Concerns were also raised about transparency since the report did not supply evidence of pay gaps vis-à-vis the private sector. (In fact, *all* groups were judged to qualify for a pay raise).

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[7] They noted, for instance, the European Commission's estimate that the Irish price level—measured by the GDP deflator in common currency terms—had increased from under 85 percent of the euro area average in 1995 to over 112 percent in 2002.

[8] The construction of this series is discussed in IMF Staff Country Report No. 02/171.

The pay increases—averaging 9 percent—will be phased in over three years at a cost of about 0.8 percent of 2002 GDP.[9] There could also be potential knock-on effects on inflation—to the extent that user fees and indirect taxes are raised to cover higher expenditure. However, 75 percent of the benchmarking awards and pay increases under the wage agreement are conditional on modernization and productivity improvements. Staff urged the authorities to strictly enforce this conditionality, including by insisting that improvements be substantive and publicly verifiable (see paragraph 26). In addition, the exercise should be a first step in developing a market-linked compensation system for public pay, with merit- and skill-based elements. The authorities noted that the recommendations were based on substantive evidence, the details of which could not be published due to their sensitivity. They stressed their intention to obtain demonstrable improvements in efficiency and acknowledged the need to reform public sector pay.

**Short-term fiscal policy**

18. **Following several years of procyclical, expansionary policy, the major challenge for fiscal policy is to adjust to the new economic reality in the aftermath of the late-1990s' boom.** Ireland's prolonged economic expansion had bolstered fiscal revenue in the late 1990s, allowing the government to maintain sizeable budget surpluses, while simultaneously cutting taxes and increasing expenditure rapidly. As growth slowed in 2001, revenue fell short of expectations but spending overshot (increasing by 12½ percent in real terms), shifting the fiscal balance to a structural deficit for the first time in many years. With prospects for regaining very high output growth rates looking increasingly unlikely, the efficiency and control of public expenditure have become pressing concerns. From a short-term perspective, given the difficulties in precisely estimating Ireland's cyclical position and the well-known lags in adjusting fiscal policy, staff has advised aiming for a broadly neutral fiscal stance (that is, no change in the structural balance and allowing full operation of the automatic stabilizers)—other than to address serious overheating or recession, neither of which has been a significant threat recently.

19. **In 2002, fiscal policy turned out more expansionary than the broadly neutral stance that had been budgeted, mainly because of the overestimation of structural revenue**. The authorities explained that revenue—in particular personal and corporate taxes—underperformed mainly because of: (i) higher-than-expected take up of Special Savings Investment Accounts introduced last year; and (ii) weaker-than-expected corporate profits in 2001 that had a negative impact on 2002 corporate taxes, given collection lags. In contrast to 2001 and despite widespread expectations to the contrary, spending was held below budget due to a mid-year decision to claw back expenditure overruns and fortuitously low interest payments.

[9] The phasing would be: (i) 25 percent from June 2003 (backdated to December 2001); (ii) 50 percent from January 2004; and (iii) 25 percent from June 2005.

## Can Fundamentals Explain the Growth of House Prices in Ireland?[1]

### What do we learn from the empirical analysis?

1. The potential for fundamentals—strong demand and insufficient supply—to justify the sustained rise in house prices in Ireland is easy to recognize *qualitatively*. On the supply side, Ireland's housing stock remains low compared with other countries, despite its comparatively high growth rate in recent years. In 2002, dwellings per thousand persons was 340 in Ireland, well below continental European levels of 400–450. On the demand side, real disposable income has risen by over 70 percent since 1993, real mortgage rates have fallen from over 7 percent in the early 1990s to below zero in 2002, while growth in the number of households has picked up in the 1990s—reflecting a surge in net migration and a rise in the proportion of the population in household-forming age groups.

2. However, it is difficult to assess *quantitatively* the degree to which these strong fundamentals explain Ireland's housing boom.

- First, two standard measures of asset price valuation, the price-to-rent ratio (P/E)—equivalent to a price earnings ratio—and the price-to-income ratio (P/I), do not provide a clear answer (Figure 1.1). In recent years, while the P/E ratio has reached a record-high level, the P/I ratio has exceeded its long-run average only by about 15 percent.

- Second, staff analysis—based on a simple error-correction model of house prices, incorporating the impact of real disposable income, real mortgage rates, and household formation during 1976–2002 (see below)—suggests that the actual house price in 2002 was 16½ percent higher than its long-run equilibrium,[2] but only 3 percent higher than the fitted value that allows for short-run dynamics (Figure 1.2).

- However, the estimated responsiveness of house prices to fundamentals could be biased, given that many observations could be coming from a bubble period. For example, if the model is estimated for 1976–97 and the derived coefficient estimates used to forecast prices in 2002, the implied deviation of the actual house price from its long-run equilibrium is over 50 percent!

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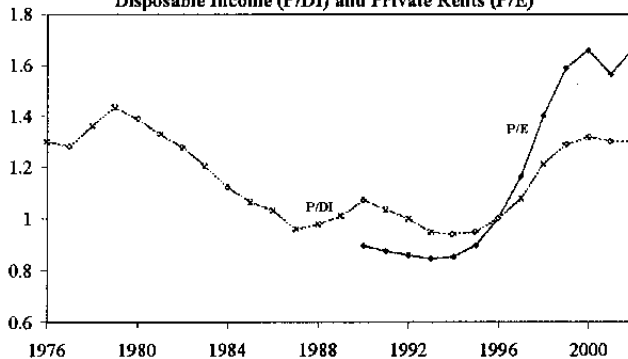
[1] Prepared by Petya Koeva.

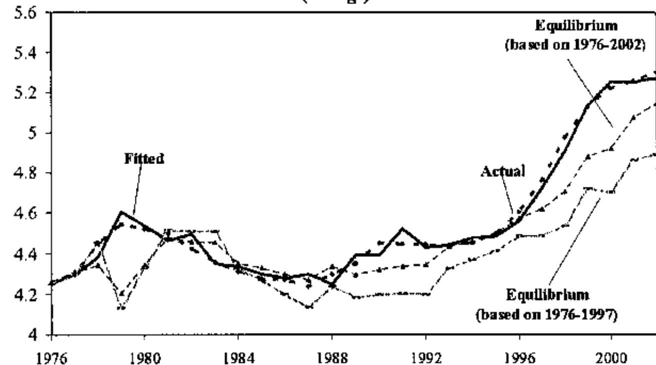
[2] This deviation of actual prices from their long-run equilibrium may be underestimated if one assumes that some of the rise in fundamentals in the late 1990s is temporary and should not be taken into account in the computation of long-run equilibrium house prices.

Figure 1.1 Ratios of House Prices to Disposable Income (P/DI) and Private Rents (P/E)




Sources: ESRI, CSO, and staff estimates.

Figure 1.2 Actual, Fitted, and Equilibrium Real House Prices (In logs)




Source: Staff estimates.

3. In conclusion, no one can know the equilibrium price of an asset with any degree of certainty. In the case of Irish house prices, the empirical evidence suggests, that as long as the change in demand behavior that seemed to have occurred in the late 1990s is permanent, the sustained rise is quite consistent with the strong fundamentals. (Some of these fundamentals, particularly real interest rates could reverse, but not necessarily abruptly). For instance, it is possible that as it became clear in the mid-1990s that Ireland would join EMU and real interest rates would decline permanently, there was a structural shift in the demand for housing. Similar arguments could be made with regard to the extensive structural changes that have taken place in the economy, including increased financial sector competition and the reduced future tax burden associated with the strengthening of the fiscal position. On the other hand, it is possible that the housing boom itself spurred changes in market psychology and led to a temporary change in demand behavior. If so, the underlying behavioral relationships would be better represented by the coefficients of the regression covering the pre-boom period. In this case, house prices would be considerably above their long-run equilibrium values, indicating a bubble.

## Empirical methodology[3]

4. House prices can be estimated from a system of two structural (supply and demand) equations. However, these equations are difficult to estimate consistently given simultaneity problems. Hence, the empirical approach used in the analysis focused on estimating a reduced-form equation of log real house prices (*p)* as a function of log disposable income (*di)*, real mortgage rates (*mr*), and the share of households aged 25–35 (*dem*). After testing that all variables were nonstationarity (that is I(1)), an error-correction VAR model produced the following house-price equation:

[3] The estimation was conducted using data on house prices, disposable income, and mortgage interest rates from the Economic and Social Research Institute (ESRI). Household formation and construction cost data were available from the Central Statistics Office (CSO).

## Financial Sector Risks in Ireland[1]

The financial sector faces numerous risks related to loan quality, competition pressures, the macroeconomic environment, and the insurance industry.

### A. Banks' Risks

#### Credit risks

- Credit growth has remained very high for some years, with heavy exposure to the mortgage and real estate markets. While growth in non-mortgage credit to the private sector slowed to 10 percent in 2002, mortgage loans rose by 23 percent and other real estate lending by 28 percent. At end-2002, mortgage loans accounted for over 42½ percent, and commercial real estate for an additional 22 percent, of total loans (excluding financial intermediation). (See Table 2.1).

- Credit risks within the mortgage portfolio have also risen. The boom in house prices has led to an increase in borrowers' leverage, resulting in rising mortgage equity withdrawal and loans to small investors to acquire rental properties. (The latter was boosted by measures introduced in the 2002 budget as well). A recent survey indicated that about 60 percent of landlords in Ireland have entered the property market in the last 3 years.

- In commercial real estate, borrowers' cash flow likely declined in 2002 as office rents fell by 6 percent and office values declined by 8 percent, while vacancy rates rose to 14 percent. No defaults have occurred so far and market participants were of the view that profitability, while lower than anticipated, was sufficient to service debt at current interest rates. Nonetheless, the largest banks appear to have become more cautious in lending to this sector and exposures appear to be concentrated around a few institutions.

#### Risk management and competition issues

- Banks have shifted their loan policy from loan-to-value (LTV) criteria to capacity-to-repay considerations based on the borrowers' disposable income, resulting in a non-negligible share of loans showing LTV ratios above 90 percent. Most banks, however, insure the segment of mortgage loans exceeding LTV ratios above 70-80 percent at origination through indemnity guarantees.[2]

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[1] Prepared by Armando Morales.

[2] Some banks indicated that the social welfare system also provides for mortgage repayment protection to lower-income borrowers. In fact, mortgage borrowers eligible for social welfare assistance (i.e., those who satisfy means test criteria) can also apply for assistance towards the interest portion of their mortgage repayments.

- A fall in house prices was perceived as less of a vulnerability in and of itself. The general view was that, given the strong preference for home ownership, borrowers were unlikely to renege on debt obligations in the face of negative equity. However, risks remain, since about one-third of mortgage loans were approved in the last two years (at higher loan-to-value ratios) and exposures to small investors in the rental property market—who may behave differently from owner-occupiers—have increased (see above). Moreover, even if only a small portion of borrowers renege on obligations, execution of the 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).

These risks and vulnerabilities are mitigated by several factors:

- Domestic banks have comfortable levels of capitalization and profitability. In 2002, the average risk-weighted capital-asset ratios increased to 12.5 percent (Table 2.1), while the two main banks showed rates of return on equity of 25–29 percent. The average rates of return on assets were 0.9 percent in 2001, above that of comparable financial systems, except those in the United Kingdom and the United States.

- Asset quality remains high, with non-performing loans at 1.7 percent of total loans; and loan-loss provisions accounted for more than 100 percent of nonperforming loans (Table 2.1).

- Small mortgage-lending institutions—identified in the 2000 FSAP as being more vulnerable to adverse macroeconomic shocks—have, for the most part, been absorbed by better-capitalized domestic and foreign commercial banks.

- Supervision is being strengthened under the newly formed IFSRA, particularly with regard to the insurance/reinsurance industry and the consolidated supervision of complex financial groups. The central bank's monitoring and analysis of systemic risks is also being continually enhanced, as recommended by the 2000 FSAP.

INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/93
FOR IMMEDIATE RELEASE
August 6, 2003

International Monetary Fund
700 19th Street, NW
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# IMF Concludes 2003 Article IV Consultation with Ireland

On July 30, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

## Background

Over the past decade, Ireland has experienced a sustained expansion in output and employment that has raised its per capita income above the EU average. During 1991-2001, income growth, measured by real GNP, averaged 6.5 percent, while the unemployment rate plummeted from almost 16 percent to below 4 percent. The fiscal position strengthened, with the public debt ratio falling from close to 100 percent of GDP in the early 1990s to well below 40 percent of GDP in 2001. Substantial gains in competitiveness, particularly in the multinational dominated manufacturing sector, kept the current account in surplus or close to balance.

Growth began to slacken in mid-2001 as the global economy started to slow. While GDP growth remained robust at 6.9 percent in 2002, GNP growth slowed sharply from 10.2 percent in 2000 to just 0.1 percent in 2002. Private consumption and export growth weakened from their previous rapid pace while investment increased marginally mainly because strong residential investment offset a fall in business investment. Yet the unemployment rate rose only slightly to 4.4 percent, while the current account remained in a small deficit. Recent indicators suggest that economic activity remains sluggish in 2003—industrial confidence and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

orders have fallen, retail sales remain weak, and consumer and service sector confidence have deteriorated further. Inflation eased to 3.8 percent in June, still well above the euro area average of 2 percent, while wage growth moderated somewhat.

Monetary conditions have remained easy for several years. Interest rates fell markedly in the run up to joining European Monetary Union in 1999 and credit to the private sector rose sharply. With inflation persistently above the euro area average, short- term interest rates have been negative since late 2001. Credit to households has grown in real terms at rates of 15–30 percent each year since 1996, but the average household debt to income ratio is still not high by international comparison. The decline in interest rates and increasing financial sector competition as well as rapidly rising disposable income and high rates of household formation have fuelled a spectacular increase in house prices, with real house prices rising by over 130 percent since 1993.

The prolonged economic expansion bolstered fiscal revenue in the late 1990s, allowing the government to maintain sizeable budget surpluses, while simultaneously cutting taxes and increasing expenditure rapidly. As growth slowed in 2001, revenue fell short of expectations, but spending rose sharply (by 12.6 percent in real terms), shifting the fiscal balance to a structural deficit for the first time in many years. In 2002, when adjusted for the effects of the economic cycle, the general government balance turned out somewhat weaker than budgeted mainly due to the underperformance of structural revenues—particularly in personal and corporate taxes. After an initial rapid increase, expenditure was brought under control and ended the year below budget. The cyclically-adjusted general government deficit increased to 1.8 percent of GDP, resulting in a fiscal expansion in excess of 1 percent of GDP.

Staff projects a gradual recovery in line with the expected pick up in global growth. Real GNP is projected to grow by 1.5 percent in 2003 and to rebound to about 3 percent in 2004 as private consumption and exports recover in late 2003, with the improvement in external demand. Given the information and communication technology overhang, investment would continue to decline in 2003 before reviving in 2004 as growth prospects improve. Monetary conditions would remain supportive, as the effects of euro appreciation so far would be largely offset by the European Central Bank's recent rate cuts. Over the medium-term, output is projected to grow at a trend rate of about 4-5 percent a year reflecting slower labor force and productivity growth compared with the late-1990s due to income convergence and lower foreign direct investment flows following the bursting of the global ICT bubble.

**Executive Board Assessment**

Directors commended the Irish authorities for their exemplary track record of sound economic policies, which have resulted in a dynamic, open, and robust economy—with growth notably above the EU average over the past decade—and resilience to external shocks. Directors saw signs, however, that trend growth was beginning to moderate toward euro-area levels, with implications for macroeconomic policy implementation and the expectations of economic agents. The likelihood of sustained slower growth in the period ahead calls for a sharper policy focus on reducing inflation further toward the euro-area average, improving competitiveness,

safeguarding financial sector soundness and flexibility, and securing the medium-term fiscal position, in line with the Stability and Growth Pact (SGP) objective.

Directors expected activity to pick up with the recovery in world demand towards the end of this year and to accelerate thereafter to a sustainable rate. Nevertheless, they saw some risks to the outlook. The global recovery could be more anemic than expected and the euro may continue to appreciate, adversely affecting competitiveness and employment, particularly in indigenous, employment-intensive industries. A sharp rise in unemployment could, moreover, pose risks to the housing market and to the financial sector. Given Ireland's prolonged credit boom, Directors noted that there is a significant risk that house prices could be overvalued, although financial sector risks appear to be manageable.

Directors observed that high levels of capitalization and profitability have strengthened banks' capacity to absorb the effects of potential macroeconomic shocks without systemic distress. However, credit risks related to investor-owned housing properties, the concentration of exposures in the commercial property market among a few institutions, and the health of the insurance industry merit close attention. Directors stressed the need for continued supervisory vigilance to ensure the stability of the financial system, and they welcomed the unification of supervision under the Irish Financial Services Regulatory Authority (IFSRA) within the central bank, which has enhanced the supervisory regime. They also welcomed the authorities' plans to improve insurance supervision and the consolidated supervision of complex financial groups. Directors encouraged the authorities to continue strengthening the monitoring of forward-looking systemic risks.

Directors emphasized that wage growth must moderate in order to preserve external competitiveness and avoid risks to output and employment. They welcomed the new national wage agreement in this regard, but emphasized that the wage norm for the agreement's second phase would need to reflect closely changes in productivity and economic conditions. With temporary factors adding to inflation this year, Directors felt that real wage declines may need to be accepted in that phase, especially in the public sector and publicly-owned enterprises. Directors noted the importance of having substantive and publicly verifiable evidence of productivity improvements in order to support benchmarking pay increase recommendations. They suggested that the compensation system for public pay be based on private sector comparators, and that merit and skill differences be taken into account.

Following several years of procyclical fiscal expansion, Directors welcomed the somewhat contractionary fiscal stance envisaged for 2003. Since structural revenue could continue to underperform, they stressed that spending should be held to budgeted levels, and that any revenue shortfalls be offset by restraint with respect to the wage bill and transfers; given the pressing need to invest in infrastructure, capital spending should be protected. Barring major adverse shocks to output and employment, the fiscal stance should—at a minimum—be neutral in 2004, with no increase in the cyclically-adjusted deficit, and with the automatic stabilizers allowed to operate freely.

Directors agreed that the authorities' medium-term fiscal target of overall structural balance is appropriate. However, the authorities should not rely on continued strong output growth to eliminate the deficit. In the view of most Directors, implementation of moderate contractionary

measures once the economic recovery is established, would protect policy credibility and secure the path toward achieving the medium-term objective. However, a few Directors noted the urgency of targeting the medium-term balance decisively and early, and recommended that adjustment measures be taken soon.

Directors observed that restraining current expenditure was preferable to increasing taxes as a means to improve the fiscal balances. In that vein, they urged limiting public sector wage increases, raising productivity, and continuing to strengthen public expenditure management across all levels of general government. They noted that greater competition and private provision of public services could also foster efficiency and reduce costs. They welcomed the recently announced plans to reform healthcare. If a compelling need to address taxation arose, broadening the tax base and the scope of user fees, with targeted transfers to the poor when appropriate, would be less distorting than increasing tax rates. Directors drew attention to the considerable improvements to the tax system made in recent years, which should be preserved.

Directors considered that the adoption of a formal medium-term fiscal framework at the general government level would improve transparency and policy predictability. Such a framework could include an overall fiscal constraint consistent with the SGP, and budget projections based on a medium-term expenditure framework. Directors welcomed the planned multi-year departmental capital spending envelopes, and recommended extending them to cover all non-cyclical primary expenditure, with safeguards to protect capital spending from budget pressures. They urged more extensive publication of public service commitments and ex-post evaluations of the effectiveness of public services. A few Directors suggested that the authorities undertake a fiscal Reports on Observance of Standards and Codes to identify ways to further improve fiscal transparency.

Directors agreed that enhancing competition and lowering regulatory obstacles will be important for sustaining medium-term productivity and income growth. Regulatory reform should be oriented firmly toward serving consumer welfare. Directors welcomed the strengthening of the Competition Authority's powers and the legal framework governing competition. They also welcomed the Competition Authority's scrutiny of restrictive practices in services, and encouraged the government to address the issues identified.

Directors noted the progress made in the provision of statistics, and encouraged the authorities to make further improvements, especially regarding the timeliness of general government accounts, and development of a national earnings index and sectoral balance sheets.

Directors encouraged the authorities to adopt a more supportive stance within the EU in favor of trade liberalization, in particular on the Common Agricultural Policy. They commended the authorities for their progress toward achieving the U.N.'s target for official development assistance by 2007.

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August 2006
IMF Country Report No. 06/293

# Ireland: 2006 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 17, 2006, with the officials of Ireland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 27, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of July 18, 2006, updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 26, 2006 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Financial System Stability Assessment Update

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.**

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## EXECUTIVE SUMMARY

**Background:** Economic performance remains strong, assisted by good policies. However, growth has become heavily reliant on building investment and competitiveness has eroded. The share of the construction sector in GDP is high and likely to fall over the next few years. Rapid growth could lead to overheating and wage pressures, which would further undermine competitiveness. Ireland is also vulnerable to external shocks.

**Key Policy Issues:** With strong but unbalanced growth in prospect, policies should encourage rebalancing and prepare cushions for the risk of a hard landing:

- The FSAP Update found that the financial system continues to perform well, but rapid credit growth is a vulnerability. The strengthening of the regulatory and supervisory framework is welcome and should continue, especially for insurance.

- Fiscal policy has been prudent. For 2007, staff recommends modest fiscal tightening, given the need to dampen aggregate demand, build a cushion against the risk of a hard landing, and prepare for population aging.

- Continued wage moderation and labor market flexibility are essential to support competitiveness.

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## I. Background

1. **Ireland's economic performance remains strong** (Figure 1). In recent years, real GNP growth was one of the highest among industrial countries; the unemployment rate was among the lowest; and HICP inflation declined to close to the euro area average. Employment growth was rapid, reflecting strong immigration and rising labor force participation. This remarkable performance reflected both good policies and fortunate circumstances. Economic policies have been in line with Fund policy advice: prudent government spending led to declining government debt; low taxes on labor and business income encouraged labor supply and investment; and flexible labor and product markets helped growth. At the same time, favorable demographics boosted the working-age population, and participation in EMU lowered interest rates.

2. **However, economic activity has become reliant on building investment and competitiveness has eroded** (Figures 2 and 3). The share of the construction sector in economic activity has increased and is now one of the highest in Europe. Bank credit to property-related sectors has grown rapidly and now accounts for more than half of total bank lending. Household debt as a share of household disposable income rose to about 130 percent in 2005, among the highest in Europe. Reflecting the expansion of the labor-intensive construction and services sectors, labor productivity growth has declined. The combination of the slowdown in productivity growth, faster wage growth in Ireland compared to its trading partners, and the appreciation of the euro, has led to an appreciation of the ULC-based real effective exchange rate. Partly as a result, the contribution of net exports to growth has fallen steadily since 2001. After being in balance for several years, the external current account registered a deficit of about 2 percent of GDP in 2005.

3. **As agreed with the authorities, this year's Article IV consultation is streamlined**. The focus is on financial stability (building on the concurrent FSAP Update), fiscal policy, and wage policy. This staff report and the FSAP Update paper are the only documentation for the consultation.

## II. Report on the Discussions

### A. Outlook: Sunny in the Short Term but Clouds on the Horizon

4. **The authorities and staff agreed that economic growth is likely to be strong in the short term** (Table 1). Staff project real GNP growth in 2006–07 of about 5½ percent, driven by private consumption, in turn boosted by strong employment and income growth, and maturing Special Saving Incentive Accounts. Business investment is expected to remain robust, reflecting continued low interest rates and the strength of the global economy. In line with the re-acceleration of house prices since mid-2005, residential investment is likely to

expand further in 2006 before reaching a plateau in 2007. Export growth is projected to increase, given rapid growth in partner countries and the reversal of the temporary weakness in the chemicals sector, and import growth to remain strong. HICP inflation is expected to fall back to 2 percent over the medium term, as the impact of higher energy prices fades. Officials at the Central Bank of Ireland (CBI) and the Department of Finance (DOF) gave broadly similar characterizations of the outlook.

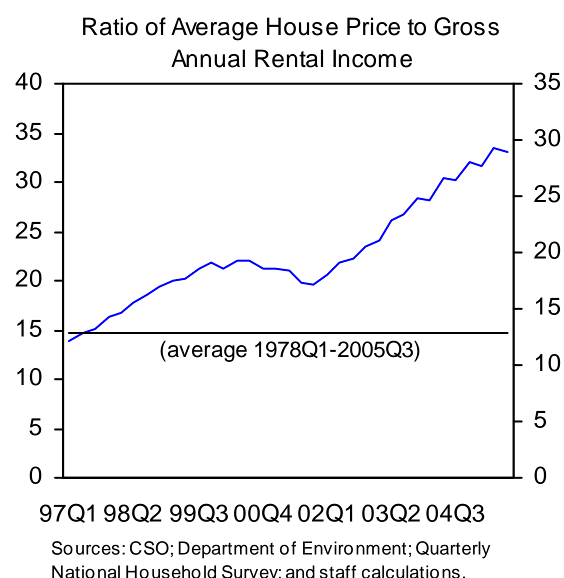
**Macroeconomic Projections**

(Percentage change, unless otherwise indicated)

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| Real GNP | 5.1 | 4.0 | 5.4 | 5.4 | 5.4 |
| Real GDP | 4.4 | 4.5 | 4.7 | 5.4 | 5.4 |
| Real domestic demand | 4.6 | 4.3 | 6.8 | 6.3 | 5.7 |
| Private consumption | 3.4 | 3.8 | 5.6 | 6.5 | 6.8 |
| Public consumption | 3.5 | 2.4 | 3.1 | 3.5 | 3.5 |
| Fixed investment | 5.6 | 8.0 | 13.1 | 7.1 | 4.8 |
| Structures | 7.9 | 9.1 | 9.8 | 6.9 | 3.7 |
| Residential investment | 14.8 | 12.9 | 7.0 | 5.5 | 0.0 |
| Non-residential investment | -0.9 | 3.4 | 14.3 | 9.1 | 9.1 |
| Equipment | 1.0 | 5.0 | 22.0 | 7.5 | 7.5 |
| Change in stocks 1/ | 0.5 | -0.3 | -0.4 | 0.1 | 0.0 |
| Net exports 1/ | 1.7 | 0.8 | -1.7 | 0.0 | 0.5 |
| Exports | 0.8 | 7.0 | 1.8 | 4.3 | 5.0 |
| Imports | -1.4 | 7.6 | 4.6 | 5.1 | 5.3 |
| | | | | | |
| Current account (in percent of GDP) | 0.0 | -0.8 | -1.9 | -3.2 | -3.5 |
| Consumer Prices (HICP) | 4.0 | 2.3 | 2.2 | 2.7 | 2.5 |
| Unemployment rate (in percent) | 4.7 | 4.5 | 4.3 | 4.3 | 4.2 |

1/ Contributions to growth

5. **Given the large construction sector, the authorities and staff expected its share of economic activity to decline over the next few years** (Table 2). With rapid population growth and a low number of dwellings per capita, the underlying demand for housing in Ireland is strong. Nevertheless, most estimates of the underlying demand are lower than the current pace of house completions. House prices are seen as somewhat overvalued by staff, becoming somewhat overvalued by CBI officials, and in line with fundamentals by DOF officials. However, since CBI and DOF officials and staff concurred that



Sources: CSO; Department of Environment; Quarterly National Household Survey; and staff calculations.

housing wealth effects on consumption in Ireland are small, all saw an abrupt contraction of the construction sector—which could occur without a fall in house prices—as the key risk.

6. **The authorities and staff concurred that rapid wage growth would undermine competitiveness.** Although there is no evidence of fundamental misalignment at present, the real effective exchange rate is slightly higher than most estimates of the equilibrium rate. Export market share is projected to continue its gentle decline, and the current account deficit to widen further (Table 3). As the unemployment rate is now in the vicinity of the natural rate, strong economic growth may lead to overheating. However, officials and staff recognized that strong net immigration will likely continue to dampen wage pressures and that labor productivity growth is likely to increase to about 2 percent, reflecting a combination of TFP growth, capital deepening, and improving educational attainment. In addition, officials noted that the pipeline of inward foreign direct investment remains healthy.

7. **The authorities and staff shared the view that, as a small open economy, Ireland is vulnerable to external shocks**. A disorderly unwinding of global imbalances could lead to a sharp appreciation of the euro, which would dampen export growth. A reversal of still benign global financial market conditions could lead to a deterioration of investor sentiment toward Ireland.

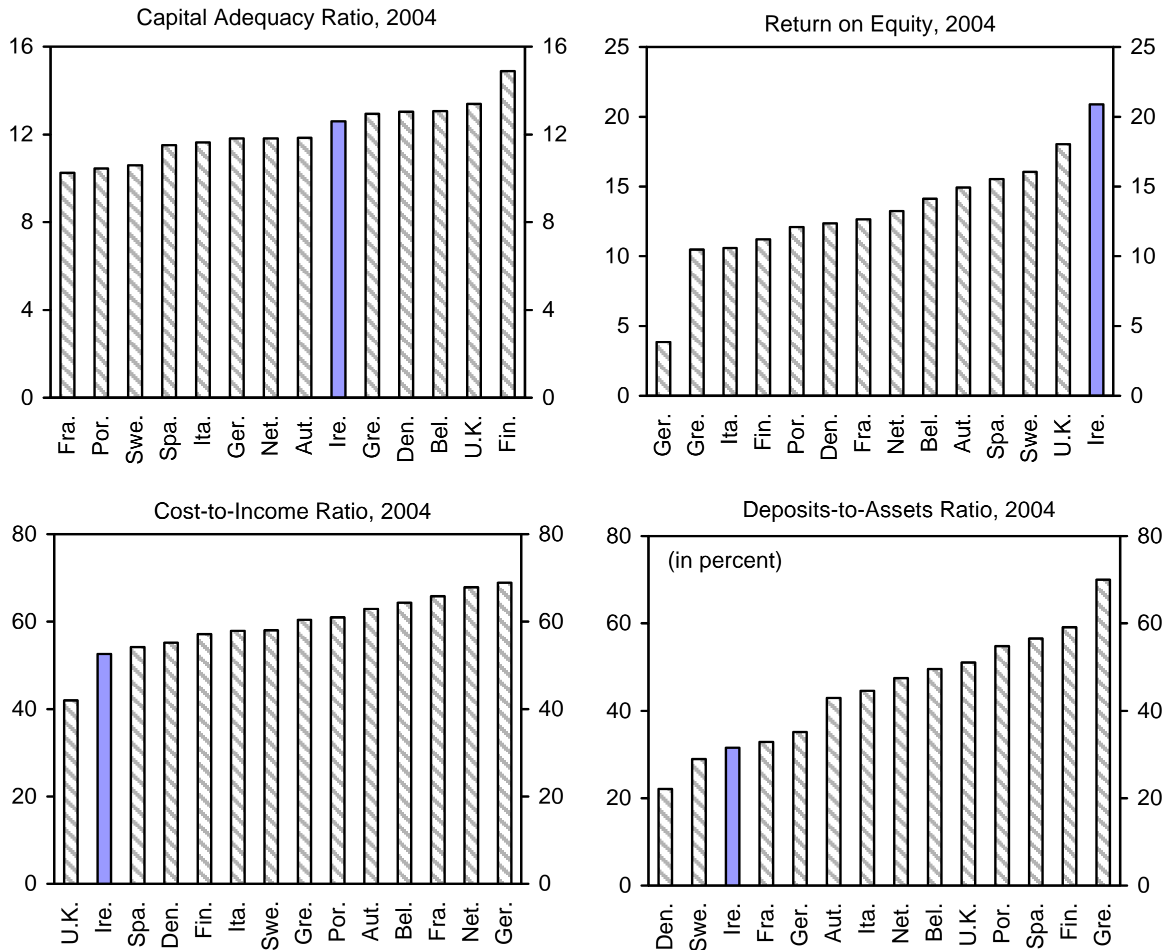
8. **With strong but unbalanced growth in prospect, the policy discussions focused on the need to rebalance growth and prepare for the risk of a hard landing**. Specifically:

- What are the risks to financial stability and how are they being addressed?
- How can fiscal policy help with rebalancing and preparing cushions?
- How are labor market policies supporting competitiveness?

## B. Financial Stability: Rapid Credit Growth Implies Risks

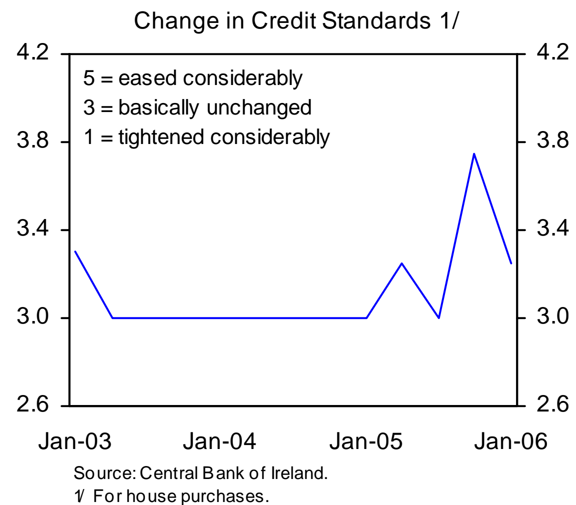
9. **The Financial Sector Assessment Program (FSAP) Update found that the financial system continues to perform well but rapid credit growth is a vulnerability** (Table 4). Reflecting the strength of the economy, the banking system is well-capitalized and profitable, and nonperforming loans are low. 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. Officials observed that, while this has not given rise to exchange rate risk, as the funding is mostly

euro-denominated, it is more expensive than retail funding and is likely to be affected more quickly by a change in international sentiment toward the Irish economy. Officials noted that an improved liquidity management framework for banks, in line with international best practice, would be implemented soon.




10. **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.

11. **The Financial Regulator observed that the risk weighting on high loan-to-value mortgages was increased, consistent with the advice of the FSAP Update mission.** High loan-to-value mortgages and interest-only mortgages became more prevalent in 2005. While banks claim that the credit assessment procedures for these loans are robust and that access to these products is restricted to only the most creditworthy customers, their introduction coincided with survey results that suggested a relaxation of bank lending standards. In response, the Financial Regulator increased the risk weighting from 50 percent to 100 percent on the portion of each residential mortgage loan that exceeds 80 percent of the value of the property. Looking forward, officials and staff agreed that nonfinancial sector debt servicing costs are likely to rise further with continued rapid credit growth and the ongoing tightening cycle in ECB interest rates.

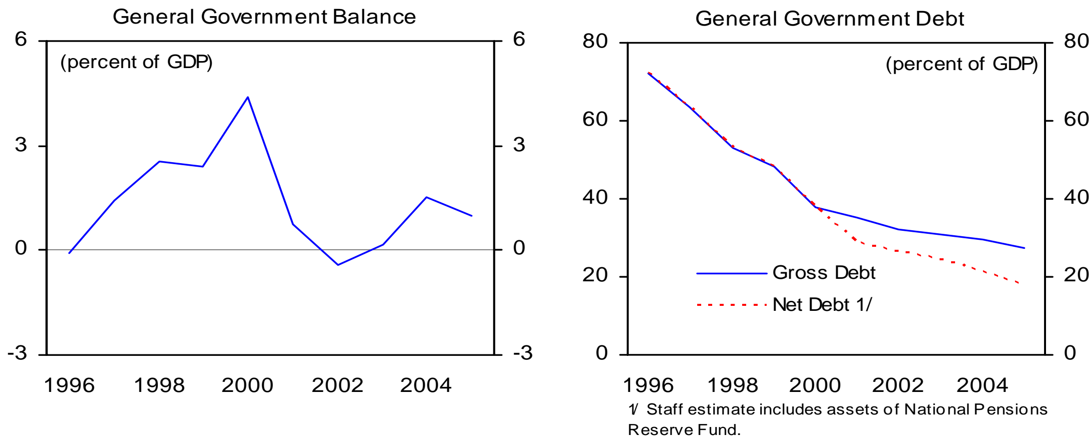


Source: Central Bank of Ireland.
1/ For house purchases.

12. **The FSAP Update found that the regulatory and supervisory framework has been strengthened in line with the recommendations of the 2000 FSAP**. Supervision was unified in the Financial Regulator in 2003 and the regulatory regime for insurance was overhauled. The Financial Regulator has put in place a risk-based framework that aims to prioritize supervisory resources in a consistent manner across sectors based on risk profile and impact of default. Staff suggested several further improvements, notably in the insurance sector. The key priorities are to continue to strengthen the on-site supervision of insurers, especially regarding assessments of overall risk management and corporate governance practices, and to enhance public disclosure requirements for insurers in line with international best practice. The Financial Regulator agreed with staff's assessment and said that these recommendations would be implemented. In the near term, the insurance supervision department will be reorganized to enable more specialization and support a strengthening of on-site supervision. Staff also suggested that the authorities consider making the Prudential Director a member of the Board on par with the Consumer Director.

### C. Fiscal Policy: Preparing Cushions and Achieving Social Priorities

13. **The general government fiscal position has been either close to balance or in surplus for the past decade** (Table 5). Combined with rapid economic growth, this has led to a sharp decline in the government debt ratio. In 2005, the general government recorded a surplus of 1 percent of GDP and staff's estimate of net debt fell to 18 percent of GDP. The fiscal outturn was considerably better than expected, mainly reflecting strong property-related revenues. For the remainder of 2006, the authorities and staff agreed that budget




execution should remain prudent and that any windfall revenues should be saved. Given the likely overperformance of property-related revenues, officials and staff expected the fiscal balance in 2006 to be stronger than anticipated in the Budget. Staff project a surplus of ½ percent of GDP.

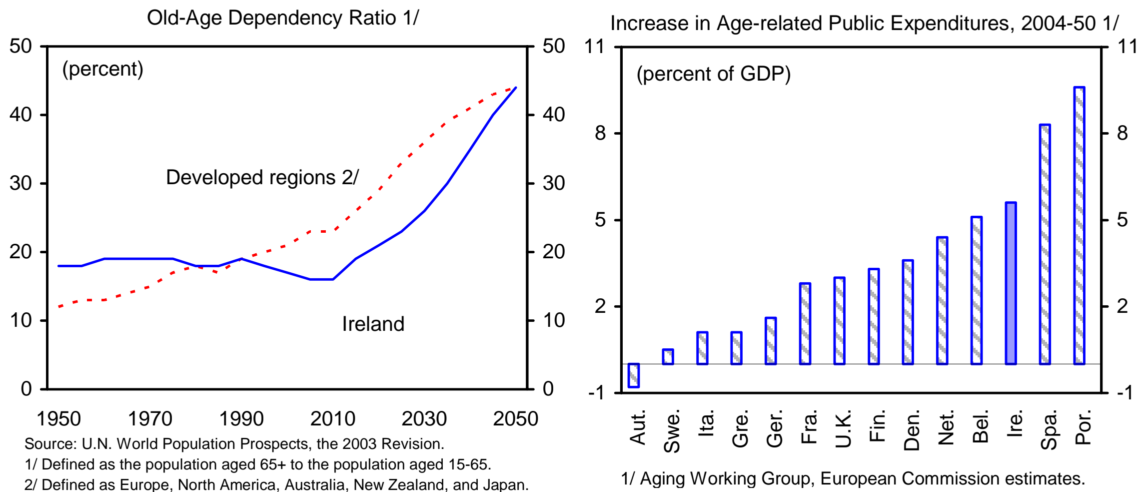
14. **For 2007, staff called for modest fiscal tightening, in contrast to the substantial loosening implicit in the authorities' projection**. Given the likely outcome for 2006, staff observed that the Budget 2006 projection for 2007 would imply fiscal stimulus of more than 1 percentage point of GDP. Staff suggested that fiscal tightening of ½ percentage point of GDP (implying a surplus of 1 percent of GDP in 2007) would be desirable in light of short-, medium-, and long-term considerations. In the short term, given Ireland's advanced cyclical position and still-accommodative euro area monetary policy, tighter fiscal policy is needed to dampen aggregate demand. Excess aggregate demand would give rise to wage pressures, which would undermine competitiveness. In the medium term, given the risk of a sharp fall in tax revenue due to either domestic or external shocks, a larger fiscal cushion is needed to allow automatic stabilizers to work fully in a possible downturn. During the 2000–02 downturn, the fiscal balance deteriorated by nearly 5 percentage points of GDP. In the long term, given that the projected rise in age-related spending through 2050 will be only partly

General Government Balances
(In percent of GDP)

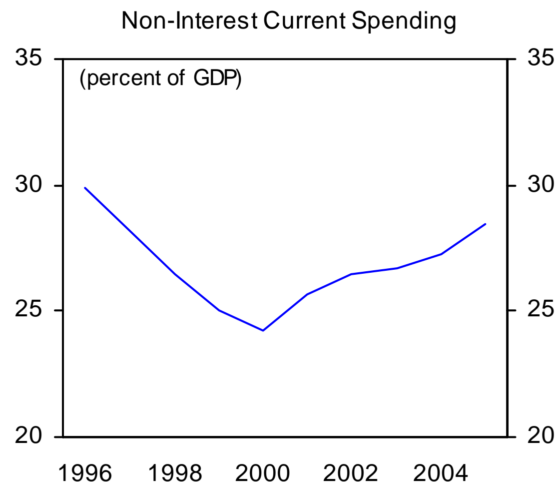
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| | | Actual | | | Projections | |
| Overall balance | | | | | | |
| Budget 2006 | | | | -0.6 | -0.8 | -0.8 |
| Staff projections 1/ | 0.2 | 1.5 | 1.0 | 0.5 | -0.6 | -0.6 |

1/ Staff projections adjust the Budget 2006 projections for staff's macroeconomic and revenue buoyancy assumptions.

offset by the National Pensions Reserve Fund and the eventual decline in government investment spending (as a share of GDP), greater pre-funding would allow for a smoother tax burden over time.




15. **The authorities acknowledged these arguments, but pointed to the need to achieve social priorities**. Given Ireland's relatively low level of public capital, the authorities argued—and staff agreed—that a continued high level of government investment is appropriate for now. The authorities added that it is important to further improve public services, especially in the areas of education, health, and childcare, and that pressures would be especially intense in the run-up to general elections, due by mid-2007. The authorities agreed with staff, however, that the recent rapid increases in current spending had strained absorptive capacity and hence the growth rate of current spending needed to slow. 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.

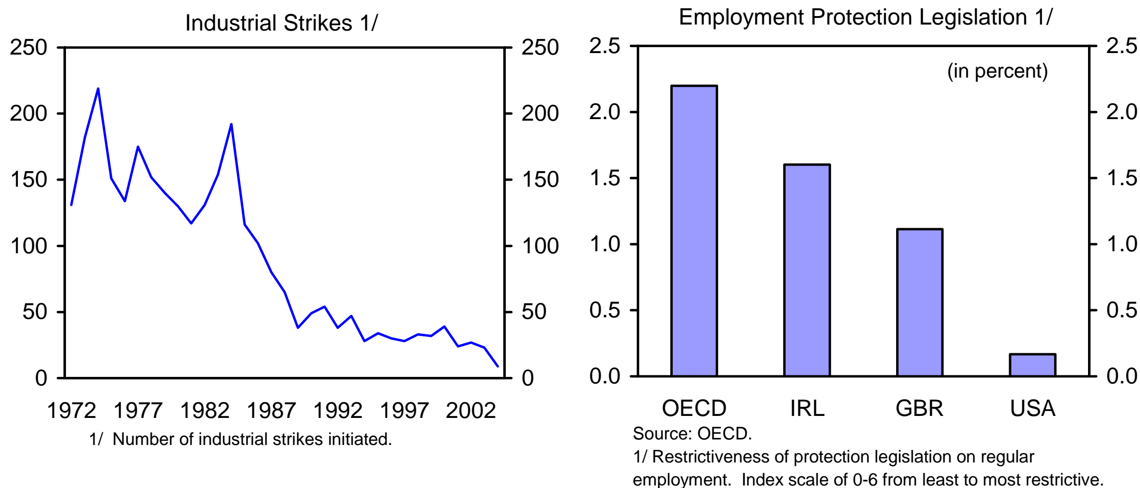



16. **Staff welcomed the planned improvements in the fiscal framework**. The Department of Finance will publish an annual pre-budget report, with updated three-year economic and fiscal projections. Staff suggested that this report, along with the Budget,

could underline the importance of countercyclical policy in the short term, of fiscal cushions to prepare for medium-term risks, and of increasing the pre-funding of age-related spending over the long term. Officials said that the DOF is enhancing its capacity to do long-term fiscal projections. In addition, spending departments will be required to prepare targets for outputs and to report on the fulfillment of those targets. Staff suggested that extending multi-year envelopes to current spending could help improve value for money in the delivery of public services. Finally, the Minister for Finance intends to meet annually with the parliamentary Finance and Public Services Committee to discuss the economic and fiscal outlook.

### C. Wage Policy: Flexibility and Competitiveness

17. **The authorities and staff were concerned that the social partnership negotiations underway at the time of the consultation discussions could undermine competitiveness**. In the past, social partnership agreements (between labor unions, employers, and the government) have preserved peaceful labor relations, provided a useful vehicle for developing a common view of economic prospects, and established sensible guidelines for wage increases while allowing considerable flexibility at the firm level. There was agreement that—in order to contain Ireland's already high labor costs—prospective wage growth should be kept in line with the sum of projected productivity growth (about 2 percent)




1/ Number of industrial strikes initiated.

Source: OECD.
1/ Restrictiveness of protection legislation on regular employment. Index scale of 0-6 from least to most restrictive.

and inflation (about 2 percent). Staff noted that the recent increase in headline inflation was due to higher global energy prices and mortgage costs, which should not be allowed to feed into wage growth in Ireland. Given the likelihood that the partnership agreement would include some increase in firing costs, staff observed that employment protection legislation in Ireland is less restrictive than the OECD average, but more restrictive than in the UK or the US. DOF officials and business employers said that the circumstances under which the higher firing costs would apply are expected to be narrow, so there would be little impact on

firms' ability to adjust labor input. After the consultation discussions concluded, the social partners reached a 27-month agreement that implies annual wage increases of about 4½ percent and some increase in firing costs.

## III. Staff Appraisal

18. **Economic performance in Ireland continues to be impressive**. In 2005, real GNP growth was the fastest in the EU15; the unemployment rate was among the lowest in industrial countries; and inflation was close to the euro area average. Ireland's robust performance has been supported by sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and labor market flexibility.

19. **However, economic growth has become unbalanced, with heavy reliance on building investment**. House prices accelerated over the past year and may be somewhat overvalued. Bank credit has grown rapidly, especially to property-related sectors, and banks' reliance on wholesale funding—mainly from the euro area—has increased. At the same time, competitiveness has eroded, reflecting the combination of faster wage growth in Ireland compared to its trading partners, declining productivity growth, and the appreciation of the euro against the U.S. dollar.

20. **Looking ahead to 2006–07, economic growth will likely remain strong but unbalanced**. Domestic demand is projected to drive growth, with a continued gentle decline in export market share and a further widening of the current account deficit. Bank credit is expected to continue to expand rapidly, exacerbating financial sector risks. With the economy close to full employment, rapid growth may lead to overheating, which would put pressure on wages and further erode competitiveness. 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. In addition, Ireland is vulnerable to external shocks. Whatever the trigger, a hard landing would have adverse consequences for financial institutions and public finances. Recent stress tests indicate that the major lenders have adequate buffers to cover a range of shocks.

21. **The key task for financial supervision is to maintain the soundness of the financial system**. The general approach of the Central Bank and the Financial Regulator is appropriate for the mature and sophisticated—but still relatively small—financial market. Stress tests should be done more frequently and the stress testing framework should continue to be upgraded. The increase in the risk weighting on high loan-to-value residential mortgages was an important signal of the need for banks to differentiate between higher- and lower-risk lending within an asset class. Looking forward, the Financial Regulator should continue to monitor banks' risk management practices, including for commercial property lending. The recent strengthening of the regulatory and supervisory framework is welcome and should continue, especially for insurance.

22. **Fiscal policy should be countercyclical and prudent.** 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. Slowing the growth of current spending to slightly below nominal GDP growth would help guard against the risk of inefficiencies, inherent in the rapid increases in spending in recent years. Improving public services is also a priority, but should be achieved by focusing on value for money, such as by monitoring government outputs and extending multi-year envelopes to current spending. The tax base could be broadened by phasing out the remaining property-based tax incentive schemes, reducing mortgage interest tax relief, or introducing a property tax. The authorities' plans to further improve the public debate on fiscal priorities are welcome.

23. **Continued wage moderation and labor market flexibility are essential to support competitiveness**. The implementation of the recently-concluded social partnership agreement should continue to allow flexibility in wage increases at the firm level and minimize the increase in the restrictiveness of employment projection legislation.

24. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 06/88
FOR IMMEDIATE RELEASE
August 7, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2006 Article IV Consultation with Ireland

On July 26, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

**Background**

Ireland's economic performance remains strong. In recent years, real GNP growth was one of the highest among industrial countries; the unemployment rate was among the lowest; and HICP inflation declined to close to the euro area average. Employment growth was rapid, reflecting strong immigration and rising labor force participation. This remarkable performance reflected both good policies and fortunate circumstances. Prudent government spending led to declining government debt; low taxes on labor and business income encouraged labor supply and investment; and flexible labor and product markets helped growth. At the same time, favorable demographics boosted the working-age population, and participation in EMU lowered interest rates.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

However, economic activity has become reliant on building investment and competitiveness has eroded. The share of the construction sector in economic activity has increased and is now one of the highest in Europe. Bank credit to property-related sectors has grown rapidly and now accounts for more than half of total bank lending. Household debt as a share of household disposable income rose to about 130 percent in 2005, among the highest in Europe. Reflecting the expansion of the labor-intensive construction and services sectors, labor productivity growth has declined. The combination of the slowdown in productivity growth, faster wage growth in Ireland compared to its trading partners, and the appreciation of the euro, has led to an appreciation of the ULC-based real effective exchange rate. Partly as a result, the contribution of net exports to growth has fallen steadily since 2001. After being in balance for several years, the external current account registered a deficit of about 2½ percent of GDP in 2005.

**Executive Board Assessment**

The Executive Directors commended Ireland's continued impressive economic performance, which has been supported by sound policies, including prudent fiscal policy, low taxes on labor and business income, and labor market flexibility. Economic growth is strong, unemployment is low and labor participation rising, and government debt has been reduced dramatically over the past two decades. Nevertheless, Directors observed that growth has become increasingly unbalanced in recent years, with heavy reliance on building investment, sharp increases in house prices, and rapid credit growth, especially to property-related sectors. At the same time, competitiveness has eroded, reflecting the combination of faster wage growth in Ireland compared to its trading partners, declining productivity growth, and the appreciation of the euro against the U.S. dollar. Directors observed that Ireland's small, highly open economy is also vulnerable to external shocks.

Directors expected economic growth in 2006–07 to remain strong, driven by domestic demand and accompanied by a widening current account deficit and continued rapid credit growth. While the contraction of the construction sector to a more sustainable size over the medium term is likely to be smooth, Directors noted that an abrupt correction cannot be ruled out.

Directors welcomed the Financial System Stability Assessment Update, which finds that Ireland's financial sector soundness indicators are generally strong and that the major lenders have adequate buffers to cover a range of shocks. The recent increase in the risk-weighting on high loan-to-value residential mortgages is an important signal of the need for banks to differentiate between higher- and lower-risk lending within an asset class. Directors suggested that the Financial Regulator continue to monitor banks' risk management practices, including for commercial property lending. Going forward, they called for continued updating of the stress-testing framework, and further strengthening of the regulatory and supervisory framework, especially for insurance.

While recognizing that Ireland's fiscal position is sound, most Directors considered that a modest fiscal tightening would be desirable in 2007, given the strength of domestic demand, potential risks of a hard landing, and the need to prepare for population aging. Slowing the growth of current spending to slightly below nominal GDP growth would also help prevent inefficiencies that could otherwise emerge given the rapid increases in spending in recent years. A number of Directors, however, saw less merit in fiscal tightening at the current juncture, pointing to the need for further increases in spending to achieve social goals, as well as to the recent tightening of euro area monetary policy. Directors agreed that improvements in public services remain a key priority, and, in this context, encouraged the authorities to focus on value for money, including by monitoring government outputs and extending multi-year envelopes to current spending. They welcomed the authorities' plans to further deepen the public debate on fiscal priorities.

Directors considered that continued wage moderation and labor market flexibility are essential to support competitiveness. The implementation of the new social partnership agreement should continue to allow flexibility in wage increases at the firm level and minimize the increase in the restrictiveness of employment protection legislation.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with Ireland is also available.

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September 2007
IMF Country Report No. 07/325

**Ireland: 2007Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 27, 2007, with the officials of Ireland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 2, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of September 11, 2007, updating information on recent economic developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 14, 2007 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

IRELAND

**Staff Report for the 2007 Article IV Consultation**

Prepared by the Staff Representatives for the 2007 Consultation with Ireland

Approved by Robert Ford and Michael Hadjimichael

August 2, 2007

## Executive Summary

**Background and outlook**: Economic performance remains impressive, though in recent years economic growth became increasingly reliant on house building. Competitiveness eroded somewhat, though it is still broadly appropriate. The rise in euro area interest rates has prompted a welcome cooling of the housing market, which will help to rebalance economic growth and reduce inflation, though there is a risk of a sharper slowdown. The key policy challenges are therefore to support adjustment to sustainable growth.

**Fiscal policy**: Fiscal stabilizers have ample room to operate fully, but discretionary measures that weaken the underlying fiscal position should be avoided. The authorities and staff agreed on the importance of maintaining fiscal prudence. Over the medium term, it will be important to further improve the quality of spending and review the tax base. As age-related spending will rise considerably in the long term, improving public understanding of fiscal pressures and a better approach to pension planning are needed.

**Financial system**: Banks have large exposures to the property market, but stress tests suggest that cushions are adequate to cover a range of shocks. Financial regulation and supervision have improved over the past year with the introduction of a new liquidity management framework for banks and the strengthening of capacity for insurance supervision. The authorities and staff shared the view that continued careful monitoring of banks' risk management practices is essential.

**Labor market policies**: The authorities and staff concurred that wage moderation—in both the social partnership agreement and the forthcoming public sector pay benchmarking exercise—and firm-level wage flexibility are crucial to minimizing the expected rise in unemployment and seizing new growth opportunities.

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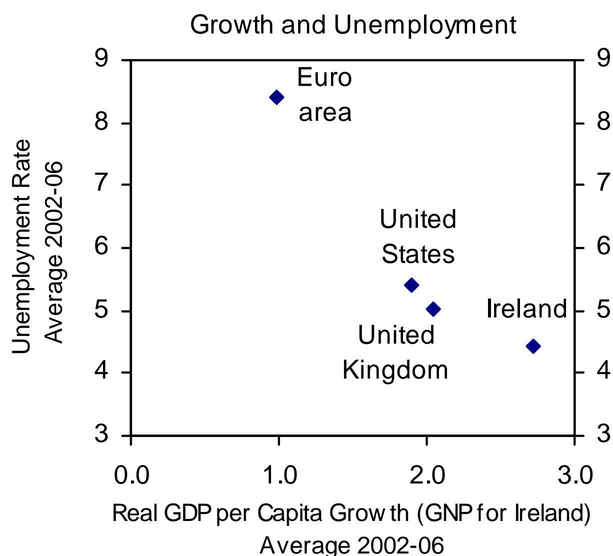
# I. Introduction[1]

1. **Economic performance remains very strong, supported by sound policies**. The growth rate of real GNP per capita continues to be one of the highest among advanced economies and the unemployment rate one of the lowest. Higher value-added activities such as financial services, information technology services, and other business services are expanding. Inward foreign direct investment is boosting labor productivity, while outward FDI—and increases in foreign holdings more generally—are allowing Irish households, corporations, and financial institutions to diversify their assets. Ireland's open door for workers from new EU member states is supporting economic growth and mitigating potential labor-market bottlenecks. In addition to outward oriented policies, key pillars of Ireland's performance are prudent fiscal policy, low taxes on labor and business income, and labor market flexibility (Box 1).




**Box 1. Fund Policy Recommendations and Implementation**

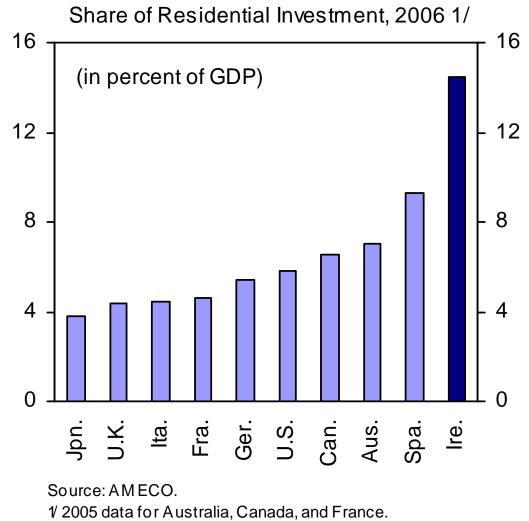
**Fiscal policy**: Fiscal policy has been prudent, with a medium-term fiscal objective of close to balance or surplus, in line with Fund advice. In the past couple years, windfall property-related revenues were saved and the fiscal stance was not procyclical, in line with Fund advice.

**Financial stability**: The Fund supports the supervisory framework, which aims to prioritize resources across sectors based on risk profile. The regulatory and supervisory framework continues to be strengthened in line with the recommendations of the 2006 FSAP Update.

**Wage policies**: The present social partnership agreement contained no fiscal concessions, in line with Fund advice, though the wage increases were a little on the high side.

[1] Mission: Dublin, June 19–27, 2007. Staff team: Mr. Morsink (head), Mr. Kanda, Ms. Iakova, and Mr. Tang (all EUR). Country interlocutors: The Tanaiste (Deputy Prime Minister) and Minister for Finance, the Governor of the Central Bank, the Chief Executive Officer of the Financial Regulator, other senior government officials, academics, and representatives of the employers' federation, the labor unions' congress, the financial community, and the principal research institute. Mr. Fried (Executive Director) and Mr. Charleton (Alternate Executive Director) attended the meetings. Staff analytical work is listed in Appendix I. Ireland is an Article VIII member. Data provision is adequate for surveillance.

2. **However, in recent years, economic growth has become more reliant on house building and competitiveness has eroded**. The share of residential investment in economic activity rose to a higher level than in other advanced economies. 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.

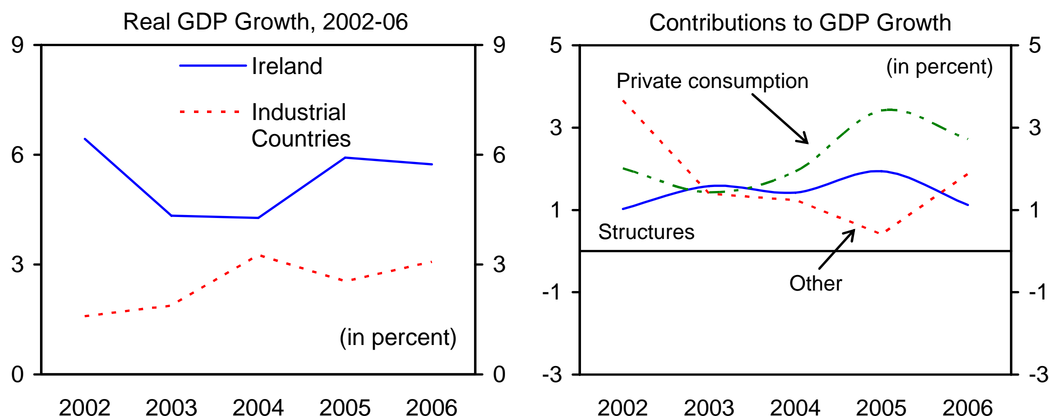


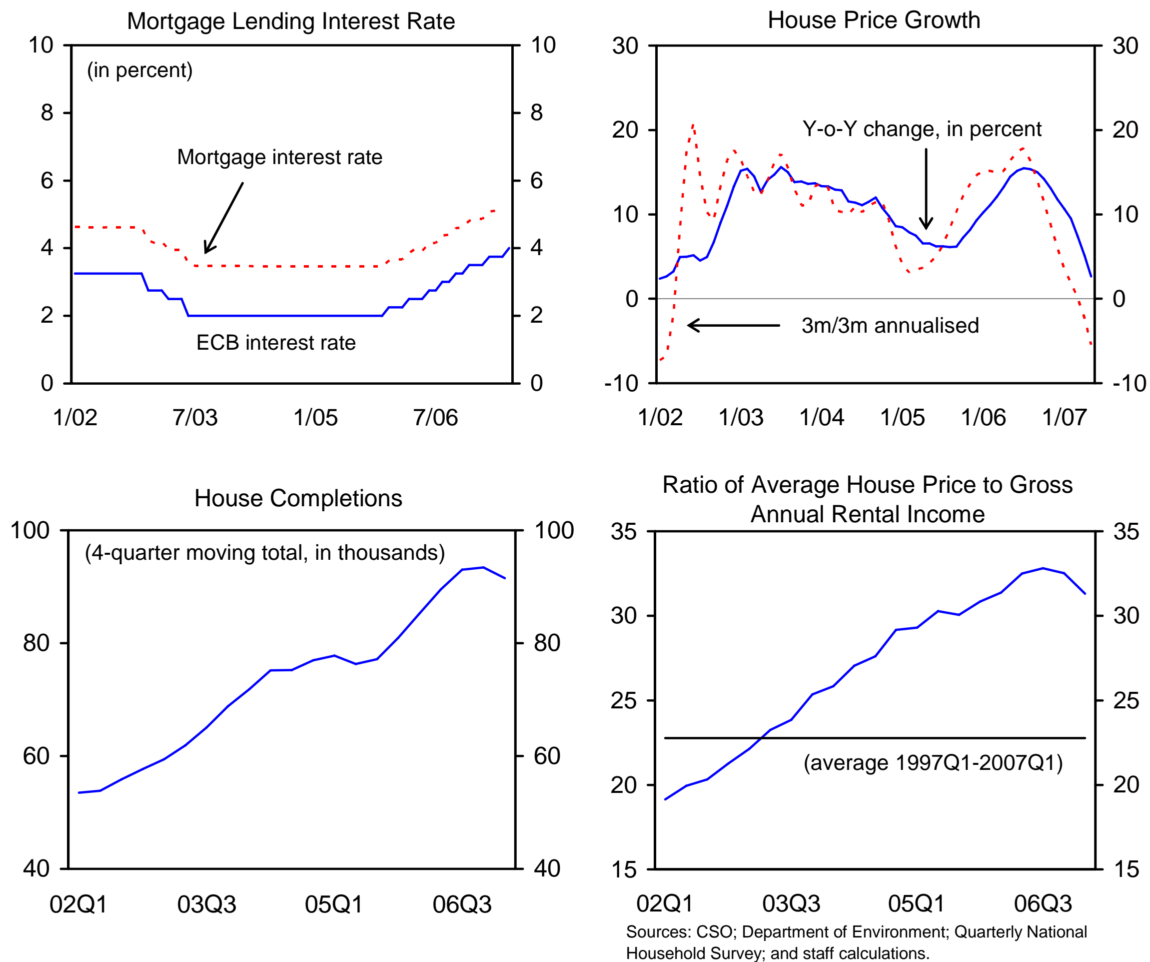
Source: AMECO.
1/ 2005 data for Australia, Canada, and France.

3. **A new government was formed in June following parliamentary elections, but substantial continuity in economic policies is expected**. Fianna Fail remained the largest party in parliament and Prime Minister Ahern formed a coalition government with the Green Party, the Progressive Democrats and supported by some independent members of parliament. Brian Cowen was reappointed as Finance Minister and also appointed as Tanaiste (Deputy Prime Minister). Given the comfortable majority of the ruling coalition, parliament is likely to run its full course, with the next general election in mid-2012.

## II. Strong Growth in 2006, Though Housing Market Started to Cool

4. **Economic growth was strong in 2006, driven by robust domestic demand** (Table 1). Private consumption growth remained buoyant, as support from dynamic employment growth and steady wage growth partly offset the adverse effects of higher debt service and energy costs. Business investment growth fell sharply, reflecting the base effect of exceptionally large purchases of aircraft the previous year (and was therefore matched by a decline in import growth). Residential investment growth slowed, but this was partly offset by a pickup in nonresidential building investment. Lost competitiveness contributed to a slower growth of exports of goods and services.





Sources: CSO; Department of Environment; Quarterly National Household Survey; and staff calculations.

## III. Growth Slowdown Ahead, With Risks on the Downside

8. **Residential investment is expected to wind down as house completions return to a sustainable level**. Although rapid population growth and a relatively low number of dwellings per capita ensure strong underlying demand for housing, the staff consider the sustainable level of house completions to be about 50,000 to 70,000, well below the 88,000 dwellings finished in 2006. Thus, residential investment is projected to contract substantially during 2007–10. 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. The authorities and staff agreed that housing wealth effects on consumption are small.[3]

9. **The growth slowdown in 2007 will be cushioned by strong private consumption and fiscal stimulus** (Table 3). In addition to robust employment growth, steady wage

[3] Marialuz Moreno-Badia, "Who Saves in Ireland? The Micro Evidence," IMF Working Paper 06/131, 2006.

growth, and increased government transfers to households, private consumption will be supported by maturing Special Saving Investment Accounts (amounting to about 12 percent of private consumption), a small portion of which will be spent. Nonresidential structures investment is also expected to be strong, in light of continued favorable growth prospects over the medium term and Ireland's need for public infrastructure. Altogether, staff project that real GDP will grow by about 4¾ percent. Given the strength of domestic demand, the current account deficit is expected to widen further to about 4½ percent of GDP.

**Macroeconomic Projections**
(Percentage change, unless otherwise indicated)

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| Real GNP | 3.7 | 4.9 | 6.5 | 4.3 | 3.2 |
| Real GDP | 4.3 | 5.9 | 5.7 | 4.8 | 3.5 |
| Real domestic demand | 3.8 | 8.0 | 5.7 | 4.8 | 1.9 |
| Private consumption | 4.1 | 7.3 | 5.7 | 7.0 | 3.7 |
| Public consumption | 1.5 | 4.0 | 5.3 | 5.5 | 3.5 |
| Fixed investment | 6.9 | 11.8 | 3.1 | 1.4 | -2.2 |
| Structures | 7.7 | 10.1 | 5.6 | -2.3 | -5.1 |
| Residential investment | 12.0 | 12.4 | 3.5 | -9.0 | -13.0 |
| Non-residential investment | 0.7 | 6.2 | 9.5 | 9.5 | 6.6 |
| Equipment | 5.5 | 17.9 | -5.1 | 14.7 | 6.5 |
| Change in stocks 1/ | -0.6 | -0.1 | 0.7 | -0.2 | -0.1 |
| | | | | | |
| Net exports 1/ | 0.3 | -1.0 | 0.6 | 0.7 | 1.9 |
| Exports | 7.3 | 5.2 | 4.4 | 5.6 | 4.8 |
| Imports | 8.5 | 7.7 | 4.4 | 5.5 | 2.8 |
| | | | | | |
| Current account (in percent of GDP) | -0.6 | -3.5 | -4.2 | -4.4 | -3.3 |
| Consumer Prices (HICP) | 2.3 | 2.2 | 2.7 | 2.7 | 2.1 |
| Unemployment rate (in percent) | 4.4 | 4.4 | 4.4 | 4.7 | 5.3 |

1/ Contributions to growth

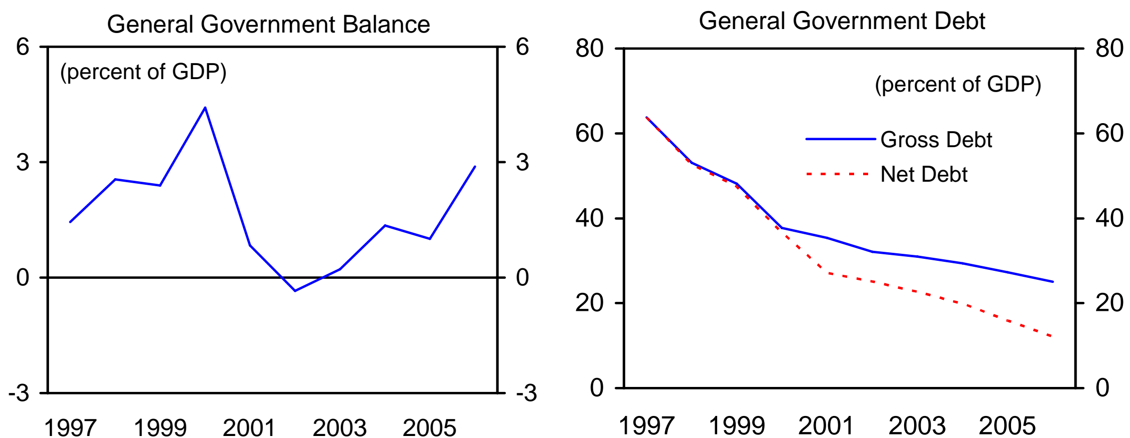
10. **Growth will rebalance further in 2008, as the easing of domestic demand relieves inflationary pressures and helps to narrow the current account deficit.** Economic growth is projected to slow further, as the temporary supports to private consumption fade, euro area interest rates continue to rise, and the downturn in residential investment gains momentum. The slowdown in domestic demand growth should increase economic slack and dampen import growth. Over the medium term, assuming the completion of the adjustment in the housing market, GDP growth will likely run at about 4 percent, reflecting employment growth of about 2 percent and labor productivity growth of about 2 percent. The authorities noted that official projections would only be updated in the autumn, but gave a broadly similar characterization of the outlook.

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:

- How can wage-setting mechanisms help to ensure wage moderation and wage flexibility in response to changing macroeconomic conditions?

## IV. Ample Room for Fiscal Stabilizers, but Population Aging Ahead

13. **Already-strong fiscal performance improved further in 2006** (Table 4). Following a decade of close-to-balance-or-surplus fiscal positions, the general government surplus surged to almost 3 percent of GDP in 2006 and net debt fell to about 12 percent of GDP. The better-than-expected fiscal outturn reflected mainly the strength of property-related revenues, as stamp duties and capital gains tax benefited from rising house prices. Government expenditure as a share of GDP fell slightly, as a decline in current spending more than offset a rise in investment.




14. **The budget for 2007 implies substantial fiscal stimulus at a time when the economy may be operating at or above capacity.**[4] In staff projections, most of the 2 percentage point of GDP deterioration in the fiscal position comes from a rise in expenditure, due to increases in social welfare payments and higher education and health spending. The revenue-to-GDP ratio is projected to fall, reflecting both lower corporate income tax and some weakening of stamp duties and capital gains taxes in the second half of the year. While tax buoyancy could once again surprise on the upside (as it has done in recent years[5]), housing market turnover (the base for property-related taxes) could slow more sharply than expected. 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.

[4] After the election, the new government announced a reduction in stamp duty on house transactions, but the fiscal cost is very small (less than 0.05 percent of GDP on a full-year basis).

[5] Keiko Honjo, “Favorable Fiscal Outturns: Is it Just the Luck of the Irish?” IMF Country Report 05/370, 2005.

General Government Finances
(In percent of GDP)

| | Actual | | | Staff Projections 1/ | | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| General government balance | 1.4 | 1.0 | 2.9 | 0.8 | 0.4 | 0.2 |
| Current revenue | 33.2 | 33.6 | 35.5 | 34.9 | 34.3 | 34.2 |
| Current expenditure | 28.4 | 28.8 | 28.6 | 29.6 | 29.6 | 29.6 |
| Capital balance | -3.5 | -3.8 | -4.0 | -4.5 | -4.3 | -4.4 |
| Government balance (cyclically-adjusted) | 1.5 | 1.0 | 2.7 | 0.7 | 0.6 | 0.3 |
| Government balance (cyclically-adjusted, excluding one-off factor) | 0.6 | 1.4 | 2.6 | 0.5 | 0.6 | 0.3 |
| Output Gap | -0.4 | -0.1 | 0.4 | 0.2 | -0.4 | -0.2 |
| General government net debt (as percent of GDP) 2/ | 19.9 | 15.9 | 12.2 | 10.3 | 9.1 | 8.1 |

Sources: Department of Finance and staff estimates.
1/ Staff projections are based on the 2007 budget, adjusted for staff's macroeconomic and revenue buoyancy assumptions.
2/ Net debt is defined as gross debt minus the value of the National Pensions Reserve Fund and the Social Insurance Fund.

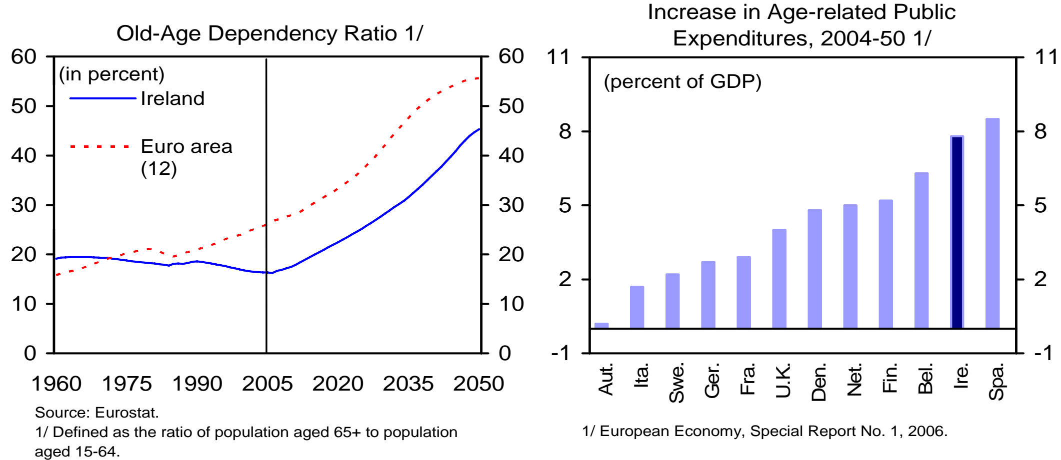
15. **On unchanged policies, some cyclical weakening of the fiscal position in 2008 is likely, stemming from the impact of the growth slowdown on government revenue**. In staff's central scenario, the fiscal balance is projected to decline by ½ percent of GDP, with risks to this projection tilted to the downside. 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 authorities agreed with the characterization of risks.

16. **Against this background, the authorities and staff shared the view that prudent fiscal policy should be maintained**. With the new government's five-year program containing some potentially costly proposals, such as a reduction in the social security contribution rate, a rise in pension benefits relative to average earnings, and a cut in personal income tax rates, staff cautioned against discretionary measures that would weaken the underlying fiscal position and suggested restraining the growth of current spending to nominal GDP growth. The authorities said that a sound fiscal position would be maintained by reducing current expenditure growth and targeting a balanced budget.

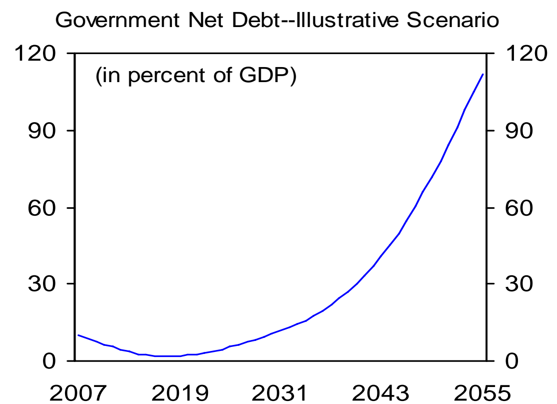
17. **Turning to the medium term, the authorities and staff agreed on the importance of further improving the quality of spending and reviewing the tax base**. Specifically, while a high level of government investment spending is appropriate given Ireland's significant infrastructure needs, robust cost-benefit analysis is needed to ensure value for money. In this regard, project sponsors need to ensure that full economic analysis is carried out: compliance with this requirement should be subject to audit by the central unit responsible for oversight and quality control of cost-benefit analysis. Turning to current spending, value for money could be enhanced by introducing multi-year envelopes and requiring efficiency gains in the delivery of public services. 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.

18. **Looking further ahead, population aging will put increasing pressure on public finances**. While Ireland's population actually became slightly younger over the past 50 years, the old-age dependency ratio will start to rise quite steeply very soon. As a result, the EC Aging Working Group projects a rise in age-related government spending between 2004–50 of about 8 percentage points of GDP (primarily due to increased pension spending), higher than the average for other EU countries.[6] To prepare for this spending, the government is




setting aside every year 1 percent of GNP in a National Pensions Reserve Fund. Another partial offset will be an eventual decline in government investment spending as a share of GDP to a level more in line with the industrial country average. Nevertheless, an illustrative scenario shows that government net debt could rise substantially by mid-century. To improve public understanding of the pressures on public finances, staff suggested the regular publication of a report on long-term fiscal sustainability, as



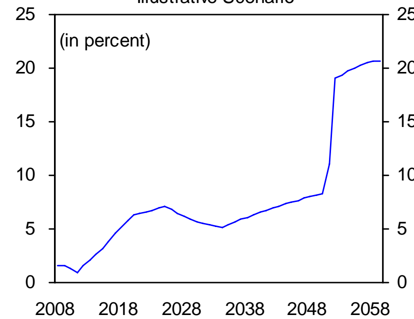

[6] Unlike several EU countries, Ireland has not introduced reforms to reduce effective pension benefits.

is done in some other countries. The authorities noted that the budget documents regularly cover these issues and that work on a longer report is underway.

19. **To address long-term fiscal pressures, the authorities and staff agreed that a mix of measures will be needed** (Box 3). Staff noted that the state pensionable age (currently 65) could be raised in line with rising life expectancy and that the government's annual contribution to the National Pensions Reserve Fund could be raised. Staff further observed that some other countries are addressing concerns about the adequacy of private saving for retirement by introducing a national defined-contribution scheme with automatic enrolment and low operating costs. The authorities responded that these and other options would be analyzed in a forthcoming Green Paper on Pension Policy.

**Box 3. Long-Term Fiscal Sustainability**

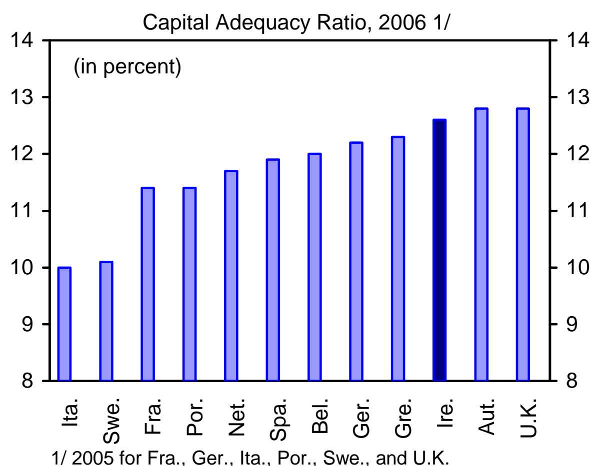
The Global Fiscal Model is used to simulate the macroeconomic effects of different options to restore debt sustainability.[1/] Funding the rise in age-related spending through a concomitant increase in social security contributions would require substantially higher contribution rates—up to 20 percentage points by 2055. This policy would have negative effects on labor supply, which would already be shrinking as the population ages. A more growth-friendly option would be a combination of raising the retirement age, broadening the tax base, and increasing less distortionary indirect taxes, the base for which is more resilient in an aging society.

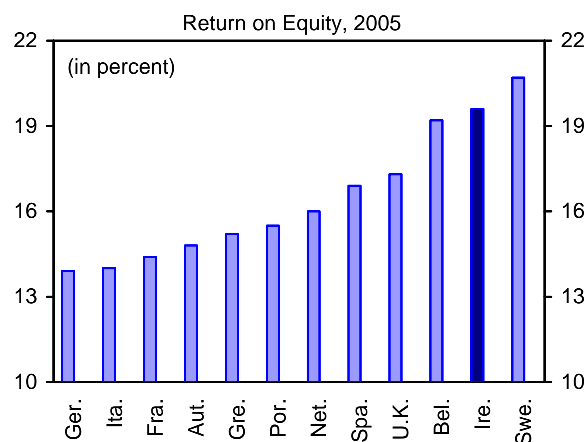


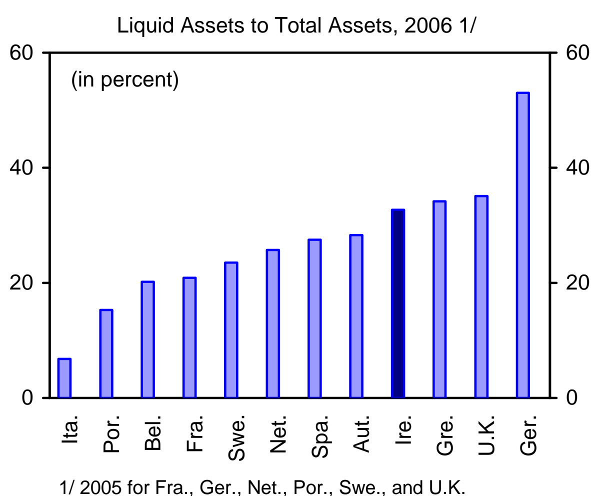

[1/] Dennis Botman and Dora Iakova, "Policy Challenges of Population Aging in Ireland," Selected Issues Paper.

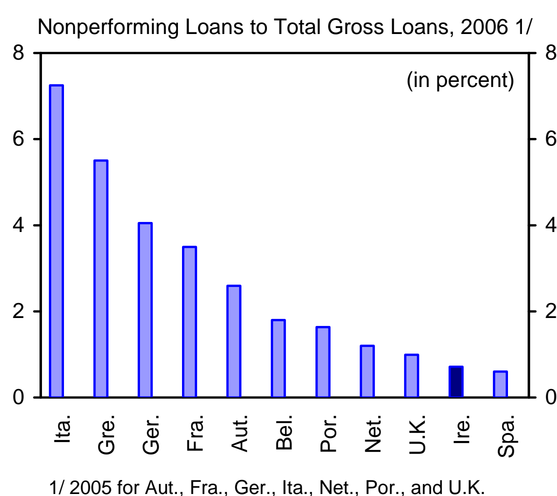
## V. Banks Have Large Exposures to Property, but Big Cushions Too

20. **The banking system continues to perform well, but rapid credit growth has led to vulnerabilities** (Table 5). Reflecting the strength of the economy, the banking system is well-capitalized, profitable, and liquid, and nonperforming loans are low. However, bank lending to construction and real estate firms amounts to about 47 percent of GDP (Figure 1). Household debt now amounts to about 160 percent of household disposable income and, with most debt at variables rates, rising euro area interest rates have raised households' debt burdens. While about ⅓ of the mortgages taken out by first time buyers in 2006 was at a 100 percent loan-to-value ratio, the average loan-to-value ratio is low compared to other countries and households' financial assets far exceed financial liabilities. At the same time, as loan growth has outstripped deposit growth, banks have become more reliant on wholesale funding, which is more expensive and potentially more volatile than retail funding. However,




Source: IMF.

banks also hold high levels of liquid assets. Looking forward, the slowdown in credit growth associated with the cooling housing market is expected to put some pressure on profits.

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. In addition, even a very substantial withdrawal of private sector deposits would not exhaust any major lender's stock of liquid assets. However, the stress tests only incorporate first-round effects and the long period of strong economic performance limits the ability to quantify the relationship between macroeconomic variables and credit risk. The Central Bank is working on extending stress tests to banks' foreign exposures.

22. **The regulatory and supervisory system has been strengthened over the past year, in line with the recommendations of the 2006 FSAP Update**. New liquidity requirements for credit institutions—involving a forward-looking mismatch approach under which cash flows are assigned to relevant time bands—came into effect in July 2007. In insurance supervision, the Financial Regulator has recruited experts, trained staff, and

reorganized, with the new structure having both an on-site inspection unit and a reinsurance unit. Insurance supervisors are focusing on assessing companies' risk management frameworks and capacities, in preparation for the eventual adoption of Solvency II. The implementation of the EU Capital Requirements Directive could lead to declines in regulatory capital, though the declines would initially be limited by the capital floors imposed by the Capital Requirements Directive. As banks could use any excess capital to expand into unfamiliar activities, the authorities and staff agreed that it will be important to continue to carefully monitor banks' risk management practices, including for commercial property lending. Staff supported the Financial Regulator's prudent approach on the risk-weighting of lending to speculative commercial property and residential investment property. Although the amount of subprime mortgage loans is small (less than 2 percent of outstanding mortgage loans), staff supported the proposal to make all subprime lenders subject to the consumer protection code.

23. **Over the medium term, the financial system has an important role to play in supporting economic growth**. Staff noted that Ireland's financial system is already characterized by a relatively high degree of arm's length transactions (Box 4). In addition to maintaining high standards in areas such as bank competition, investor protection, and corporate transparency, policy measures that contribute to the further development of securities markets could be considered. For example, the relatively high stamp duty on securities transactions could be dampening market turnover.

## VI. Labor Market Flexibility is Crucial to Facilitating Adjustment

24. **The reallocation of workers from residential construction to other parts of the economy will depend on the flexibility of the labor market.** Earlier reform of the tax and

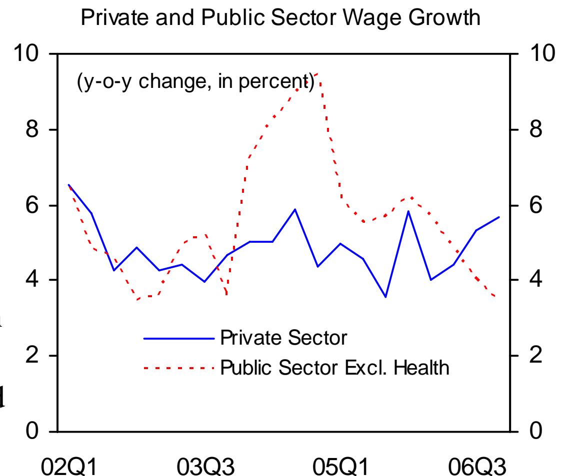
Source: OECD.
1/ Percentage of total labor compensation.

Source: OECD.
1/ Restrictiveness of protection legislation on regular employment. Index scale of 0-6 from least to most restrictive.

benefit system resulted in a sharp fall in the structural unemployment rate during the 1990s.[7] The tax wedge is now one of the lowest among industrial countries. Employment protection legislation in Ireland is less restrictive than the OECD average, though more restrictive than in the United Kingdom or the United States.

25. **Wage moderation and wage flexibility under the social partnership agreement will also be essential to limiting the depth of the downturn and avoiding any further loss of competitiveness.** Social partnership agreements (between employers, unions, and the government) have provided a useful vehicle for developing a common view of economic prospects, established sensible guidelines for wage increases while allowing considerable flexibility at the firm level, and preserved peaceful labor relations. With current wage growth (about 5 percent) already somewhat above the sum of projected HICP inflation (about 2 percent) and projected labor productivity growth (also about 2 percent), the staff suggested that increases in global energy prices and mortgage costs should not be allowed feed into wage growth.

26. **Similarly, wage increases under forthcoming public sector pay benchmarking exercise have the potential to affect private sector wages.** The authorities and staff agreed that any wage increases under the forthcoming exercise should be small. Staff also suggested that the exercise be appropriately transparent, increase the focus on recruitment and retention in pay determination, assess more accurately the value to employees of public sector pensions, and put more emphasis on the flexibility of work practices.




## VII. Staff Appraisal

27. **Economic performance remains impressive, though in recent years growth became increasingly reliant on house building and competitiveness eroded somewhat**. In 2006, real GNP growth was the fastest in the EU15 and the unemployment rate among the lowest in advanced economies. Ireland's remarkable performance continues to be underpinned by outward-oriented policies, prudent fiscal policy, low taxes on labor and business income, and labor market flexibility. However, rapid increases in house prices and a boom in residential construction have been accompanied by surging credit to property-related sectors, inflationary pressures, and a deteriorating external current account balance. While

[7] Dora Iakova, "The Evolution of Unemployment in Ireland: The Role of Labor Market Policies," IMF Country Report 05/370, 2005.

still broadly appropriate, competitiveness has eroded. Ireland's real effective exchange rate is now close to, but perhaps slightly above, its equilibrium value.

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**. As residential investment winds down and house completions return to a more sustainable level, real GNP growth is projected to slow considerably by 2008. This will dampen inflationary pressures and narrow the current account deficit. However, 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. Over the medium term, strong fundamentals are expected to drive robust growth.

29. **Fiscal stabilizers have ample room to operate fully, but discretionary measures that weaken the underlying fiscal position should be avoided**. Fiscal performance in 2006 was very strong, though the fiscal stimulus in 2007 is unfortunate, in light of inflationary pressures and the widening current account deficit. 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.

30. **Looking further ahead, Ireland's current demographic sweet spot is already passing**. The authorities' coverage of long-term fiscal issues in the budget and their commitment to improve public understanding of these issues are therefore welcome. Consideration of future pension policy needs to include a review of the state pensionable age in line with rising life expectancy, the contributions to the National Pensions Reserve Fund, and the level of private saving for retirement, with a view to encouraging a better approach to long-term pension planning.

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.

32. **Wage moderation and labor market flexibility are essential to minimizing the expected rise in unemployment and seizing new growth opportunities**. Both the

implementation of the current social partnership agreement and the forthcoming public sector pay benchmarking exercise should avoid adding to wage pressures.

33. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No.117
FOR IMMEDIATE RELEASE
September 24, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes Article IV Consultation with Ireland

On September 14, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

**Background**

Economic performance remains very strong, supported by sound policies. The growth rate of real GNP per capita continues to be one of the highest among advanced economies and the unemployment rate one of the lowest. However, in recent years, economic growth became more reliant on house building and competitiveness eroded. Rapidly rising house prices were accompanied by surging bank credit to property-related sectors, strong wage growth and inflation measured by the Harmonized Index of Consumer Prices (HICP) above the euro area average, and a deterioration in the current account balance. The rise in euro area interest rates since late 2005 has prompted a significant fall in the growth of residential investment and declines in house prices in recent months.

Following a decade of close-to-balance-or-surplus fiscal positions, the general government surplus rose to almost 3 percent of GDP in 2006 and net debt fell to 12 percent of GDP. The better-than-expected fiscal outturn reflected mainly the strength of property-related revenues, as well as a small decline in government expenditure relative to GDP. To prepare for the projected rise in age-related spending over the long term, the government is setting aside every year 1 percent of GNP in a National Pensions Reserve Fund.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The banking system continues to perform well, but rapid credit growth has led to vulnerabilities. The banking system is well-capitalized, profitable, and liquid, and nonperforming loans are low. However, bank lending to construction and real estate firms amounts to 47 percent of GDP. Most lending to households is at variable rates and household debt amounts to 160 percent of household disposable income. At the same time, loan growth has outstripped deposit growth, so banks have become more reliant on wholesale funding.

**Executive Board Assessment**

The Executive Directors commended Ireland's continued impressive economic performance, characterized by one of the highest growth rates of GNP per capita among advanced countries and one of the lowest unemployment rates. This performance has been underpinned by outward-oriented policies, prudent fiscal policy, low taxes, and labor market flexibility.

Given the Irish economy's strong fundamentals and the authorities' commitment to sound policies, Directors expected economic growth to remain robust over the medium term. At the same time, however, a number of downside risks will need careful attention in the period ahead. Directors pointed to inflationary pressures in the context of an economy that is operating at or above full capacity, declining competitiveness and a widening current account deficit, a deterioration in global financial market conditions and the growth outlook of the United States, and the adjustment to a cooling of the housing market. Directors underscored that rapid house price increases and a boom in residential construction have been an important driver of growth and bank lending. While the slowdown of the housing sector has been gradual so far, and will help to rebalance growth and contain inflationary pressures, a sharper correction in house prices could significantly slow economic growth.

Directors commended Ireland's sustained strong fiscal performance, and the authorities' firm commitment to fiscal discipline over the medium term. Many Directors, however, saw the planned reduction in the fiscal surplus in 2007 as an undesirable pro-cyclical fiscal stimulus, while acknowledging Ireland's pressing need to increase infrastructure and social spending, and the leeway to do so provided by the strong fiscal position. Looking ahead to 2008, Directors cautioned against discretionary measures that would weaken the underlying fiscal position. They encouraged the authorities to restrain current expenditure growth and to continue to focus on improving the quality of public spending through cost-benefit analysis. They also welcomed the decision to establish a Commission to review the tax system.

Over the long term, Directors considered the projected increase in age-related spending to be the most important fiscal challenge. They concurred that Ireland is well-placed to meet this challenge, noting that the authorities have been preparing for it, and welcomed the forthcoming Green Paper on Pension Policy. They agreed that a combination of measures is preferable to a policy based solely on increasing social security contribution rates. In this regard, Directors saw merit in reviewing the state pensionable age and the level of contributions to the National Pensions Reserve Fund, and strengthening incentives for private savings. They also supported the authorities' commitment to improve public understanding of fiscal challenges.

Directors welcomed the indicators confirming the soundness of the Irish banking system, including the stress tests suggesting that cushions are adequate to cover a range of shocks even in the face of large exposures to the property market. Nevertheless, financial sector vulnerabilities, including those arising from high household indebtedness and rising interest rates, require continued supervisory vigilance. In this context, Directors commended the progress in implementing the recommendations of the 2006 Financial Sector Assessment Program update. They called for continued careful monitoring of banks' risk management practices, including those pertaining to commercial property lending. Directors supported the envisaged upgrading of the stress-testing framework and the commitment to continue to improve supervision.

Directors stressed that preserving and enhancing Ireland's external competitiveness will be key to underpinning future growth prospects. To this end, wages should continue to grow in line with productivity, and increases in global energy prices and mortgage costs should not be allowed to feed into wage growth. Directors recommended that both the implementation of the current social partnership agreement and the forthcoming public sector pay benchmarking exercise avoid adding to wage pressures. Directors underlined the importance of labor market flexibility in facilitating adjustment to the cooling housing market.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/305

# IRELAND

## ELEVENTH REVIEW UNDER THE EXTENDED ARRANGEMENT

October 2013

In the context of the Eleventh Review Under the Extended Arrangement, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 25, 2013, following discussions that ended on July 18, 2013, with the officials of Ireland on economic developments and policies underpinning the Extended Arrangement. Based on information available at the time of these discussions, the staff report was completed on September 12, 2013.
- **Staff Supplements** of September 18 and 24, 2013 updating information on recent developments.
- **Press Release** including a statement by the Chair of the Executive Board.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Ireland*
Memorandum of Economic and Financial Policies by the authorities of Ireland*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

# IRELAND

## ELEVENTH REVIEW UNDER THE EXTENDED ARRANGEMENT

September 12, 2013

## KEY ISSUES

**Policy implementation remains on track but recent weak GDP data point to a slower growth recovery.** Real GDP declined in the first quarter, reflecting a fall in exports and weak domestic demand. Nonetheless, fiscal results remain on track and sovereign and bank bond yields have risen relatively modestly in response to declining global risk appetite. A range of other economic indicators are more encouraging, suggesting lower but still positive growth in 2013, though uncertainty remains. Growth projections for 2014 are also lowered given weaker prospects for consumption recovery and for trading partner growth.

**Maintaining steady fiscal consolidation efforts remains central.** Key budgetary measures for 2013 have been implemented effectively and broad acceptance of important public sector pay and pension savings has been achieved. Nonetheless, continued firm implementation of Budget 2013 is required to achieve this year's fiscal targets. Further fiscal consolidation efforts were agreed for 2014–15, with cumulative efforts in line with program targets.

**After undue delay, banks are now beginning the resolution of impaired loans and this work must press forward to reduce arrears and related uncertainties**. Banks have begun to engage with mortgage borrowers in arrears to propose durable solutions. The establishment of the Insolvency Service and the removal of an unintended hurdle to repossession proceedings are, among other steps, expected to help facilitate loan resolution progress. Nonetheless, the authorities should keep the effectiveness of the resolution framework under review and close supervision of banks' efforts will remain essential. Preparations for balance sheet assessments of the three domestic banks to be completed in the Fall are advancing as planned.

**Employment has begun to pick up but high long-term unemployment remains a key challenge**. Resources for the activation of the long-term unemployed should be further augmented, including through private sector service provision. Facilitating SME examinership could aid resolution of SMEs in arrears, supporting their potential to invest and create jobs.

**Ireland is expected to return to reliance on market financing in 2014, yet further European support could make Ireland's recovery and debt sustainability more robust.** Irish banks face weak profitability that hinders their capacity to revive lending. European support to lower banks' market funding costs could help sustain domestic demand recovery in the medium term, protecting debt sustainability and financial market confidence.

# OVERVIEW

1. **The eleventh review of Ireland's EU-IMF supported program found policy implementation remains on track yet near-term growth prospects are weaker and significant fiscal, financial sector and unemployment challenges remain**. Discussions focused on:

- ***Staying the course of steady fiscal consolidation***. Ireland's improved standing in sovereign bond markets reflects the credibility gained from its sustained steady fiscal adjustment. Nonetheless, the general government deficit (excluding one-off guarantee payments) is tracking toward 6.8 percent of GDP in 2013 and gross public debt is projected to peak at 123 percent of GDP at year end. Accordingly, further consolidation in 2014–15 was agreed, which, consistent with earlier plans, is at a diminished pace compared with 2011–13.

- ***Pushing forward with loan resolution***. With the nonperforming loan (NPL) ratio climbing through 26 percent, the review focused on the Mortgage Arrears Resolution Targets (MART) framework and the balance sheet assessment (BSA) to be completed in the Fall. The review also discussed techniques to harness third-party support to lower banks' funding costs and enhance their ability to internally generate the capital needed to expand credit.

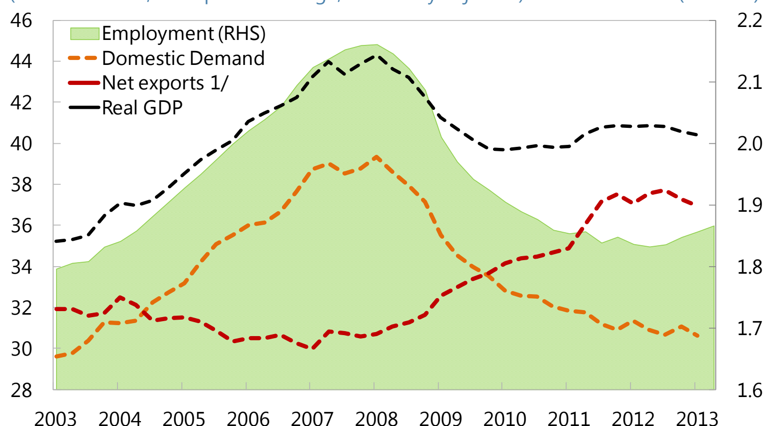
- ***Addressing long-term unemployment***. The unemployment rate has eased to 13.7 percent from 15 percent in early 2012, but the long-term jobless constitute some 58 percent of all jobseekers, posing a risk to Ireland's growth potential. Hence the review sought greater focus on improving employment services and training for the long-term unemployed.

# RECENT DEVELOPMENTS

2. **Growth is off to a weak start in 2013 and estimates were revised down for 2012, yet employment and other indicators are more encouraging:**

- ***Real GDP fell 0.9 percent y/y in Q1 2013***. The main drivers are uncertain owing to a large increase in the statistical discrepancy, by 1.6 percent of GDP. Falling goods exports are reported as the main factor, contributing -4.9 percentage points to growth, owing to both the prolonged recession in the euro area and the "patent cliff" in the pharmaceutical industry (Box 1, Staff Report for the Tenth Review). Domestic demand

**Real GDP Components and Employment**




Sources: CSO; Haver Analytics; and IMF Staff calculations.
1/Adjusted uniformly upward by €28 billion to fit on the left scale.

contributed -1.8 percentage points, with weak consumption and investment partly offset by stock accumulation. Lower imports cushioned the weakness in exports and domestic demand.

- ***Growth estimates for 2012 were revised down while there was a similar upwards revision to growth in 2011.***[1] The revised data are based on the latest corporation tax data for 2011 and updated Census results, as well as business survey data on industrial production and services. The downward revision to growth in 2012 to 0.2 percent y/y from 0.9 percent y/y previously reported reflected a lower contribution from net exports owing to revised deflators.[2] The upward revision to growth in 2011, from 1.4 percent y/y to 2.2 percent, reflected a smaller decline in domestic demand that was previously reported. Overall, nominal GDP in 2012 was little affected by these revisions.

- ***Recent export data have improved modestly and export PMIs have risen.*** Goods export volumes rose 2.3 percent q/q in Q2 2013 though this still left merchandise exports down 7 percent y/y in H1 2013, mainly driven by pharmaceuticals. Nonetheless, after showing weakness in H1, the PMI on new export orders rose to 53 in July-August.

**GDP Growth and Levels Comparison**

| | 2011 | 2012 |
|---|---|---|
| Real GDP growth (percent) | | |
| Original release | 1.4 | 0.9 |
| New release | 2.2 | 0.2 |
| Difference | 0.8 | -0.7 |
| Final domestic demand (percent) | | |
| Original release | -4.3 | -1.2 |
| New release | -3.0 | -1.1 |
| Difference | 1.3 | 0.1 |
| Net exports (% contrib. to growth) | | |
| Original release | 5.4 | 2.8 |
| New release | 5.7 | 1.6 |
| Difference | 0.3 | -1.2 |
| GDP deflator growth (percent) | | |
| Original release | 0.2 | 1.9 |
| New release | 0.7 | 0.7 |
| Difference | 0.5 | -1.3 |
| Nominal GDP (€ billion) | | |
| Original release | 159.0 | 163.6 |
| New release | 162.6 | 163.9 |
| Difference (percent) | 2.3 | 0.2 |

Source: Central Statistical Office.

- ***Employment rose 1.8 percent y/y in Q2, while nominal wages remained flat***. Job growth was recorded in nine of fourteen sectors, including construction which faced the highest rate of job destruction during the crisis, although public sector employment fell 1.4 percent y/y. The unemployment rate eased to 13.7 percent in Q2. While hourly wages edged up by ¼ percent y/y in H1 2013, a similar decline in average hours worked left weekly earnings flat.[3]

- ***A number of high frequency indicators also show positive signs.*** Consumer sentiment rose in June-July, aided by warm weather, and core retail sales grew 1.3 percent y/y in these months. The PMI for manufacturing crossed the expansion threshold of 50 in June and continued to improve through August. Finally, construction may be showing its first tentative signs of recovery as planning permits for new houses rose in Q1 after five years of decline; construction PMIs also improved, with the PMI for housing activity climbing above 50 in July.

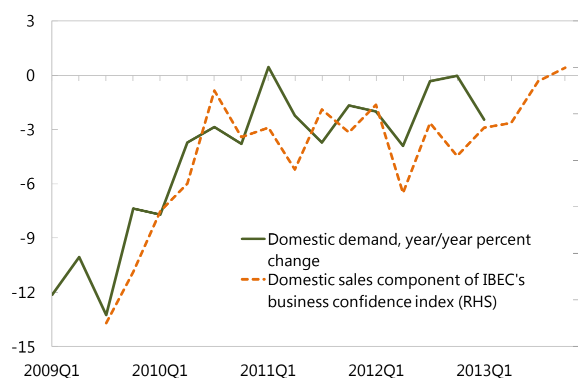
[1] There were also large revisions to historical data when GDP data for the first quarter of 2012 were released.

[2] A revision to the goods export deflator in 2011 implied lower real growth in goods exports in 2012, while the deflator for services was revised up in 2012, as the annual data are based on a comprehensive set of deflators, in contrast to the quarterly data, which is deflated using the CPI excluding mortgages series.

[3] The relatively modest decline in nominal wages in Ireland during the crisis is consistent with international evidence; see for instance Why Firms Avoid Cutting Wages: Survey Evidence from European Firms.

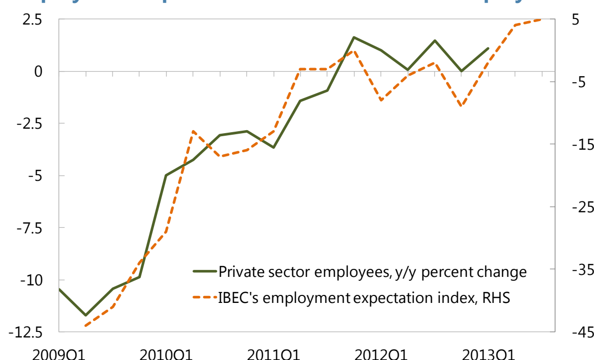
- ***Business sentiment surveys are positive for domestic demand and employment***. Latest survey results from the Irish Business and Employers Confederation, for Q2, suggest a continued recovery in sentiment, in particular among domestically-oriented firms. Based on past relationships, a second quarter of positive expectations for employment would suggest that recent private sector job growth is continuing.

**Domestic Demand Indicators**




Sources: IBEC's Business Sentiment Report (June 2013); and CSO.

**Employment Expectations and Private Sector Employees**



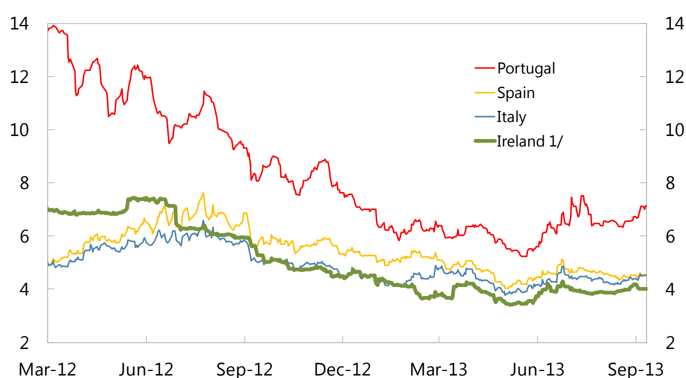

Sources: IBEC's Business Sentiment Report (June 2013); and CSO.

- ***Inflation remains well below the euro area average***. Helped by falling energy prices, HICP inflation was 0 percent y/y in August 2013, below euro area inflation of 1.3 percent y/y during the same period. Overall, Ireland's consumer prices have eased to 115.2 percent of the EU average in 2012, from 129.8 percent in 2008, with room for further improvements in competitiveness.

3. **Financial market conditions reflect an ebbing of global risk appetite, but the impact on bank funding costs has been contained**:

- ***The recent retracement of Irish sovereign bond yields has been broadly consistent with the experience of other countries in the euro area periphery***. After touching record lows in early May, the 10 year yield has risen 56 basis points, to 3.98 percent as of September 11. Market tensions dissipated in July after the settlement of the political crisis in Portugal and recent turbulence in emerging markets has had limited effect on Irish bond yields. No new bond has been issued by the Irish sovereign since the €5 billion ten-year issue in mid March. The regular monthly auction sold €0.5 billion of 3 month Treasury bills in July at a yield of 0.2 percent.

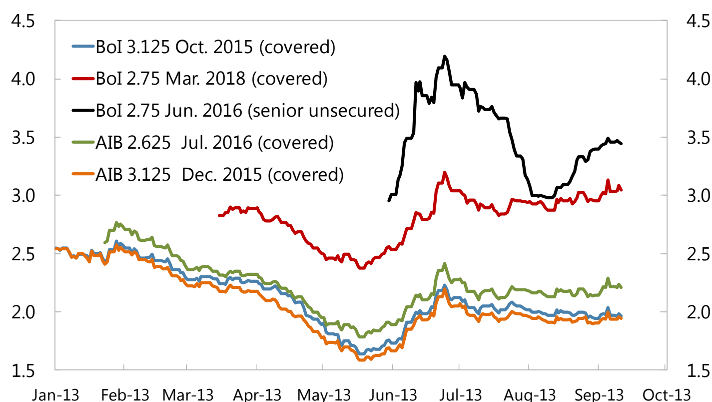
**Ten-Year Sovereign Bond Yields**
(Percent)




Source: Bloomberg.
1/ Prior to 15 March 2013 a treasury bond maturing in 2020 is used for Ireland.

- ***Bank bond yields have also risen but Eurosystem funding continues to decline***. From a trough in mid-May, yields on Bank of Ireland (BoI) and Allied Irish Banks (AIB) 3 year covered bonds have edged up some 40 basis points as of September 11. Since its May 30 issuance, the yield on BoI's 3 year senior unsecured bond has been more volatile, but overall has risen by 62 basis points, to 3.37 percent. Deposit rates continued to inch downward, however, and ECB borrowing by domestic banks fell from €39.6 billion at end March to €33.4 billion at end August, reflecting a paucity of new lending, further noncore asset deleveraging, modest amounts of new market funding, and a broadly stable deposit base.

**Bank Bond Yields**
(Percent)



Source: Bloomberg.

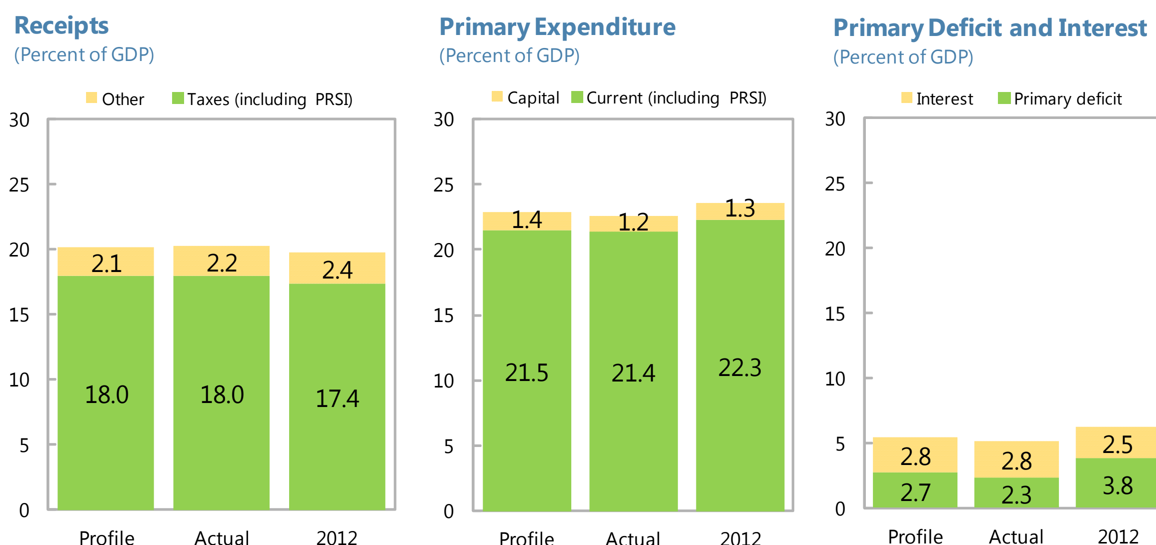
4. **Bank credit continues to contract, with overall lending conditions being mixed, yet there are signs of a strengthening in some property markets**:

- ***Banks loans outstanding contracted through end July, with household credit shrinking by 4.4 percent y/y and loans to nonfinancial corporations by 4.8 percent.*** Net repayments caused loans outstanding to SMEs (excluding financial intermediation and property related sectors) to fall 4.9 percent y/y in Q2. A survey by the Irish Small and Medium Enterprises Association for Q3 indicated that 57 percent of SMEs who applied for funding (requesting additional or new banking facilities) were refused by their bank. Conversely, the Irish Banking Federation reports mortgage loan approvals up 9.4 percent y/y in July.

- ***Driven by Dublin, residential property prices recorded their first annual increase in six years, and commercial property prices are also rising in some market segments***. Residential property prices rose 2.3 percent y/y in July, led by an 8 percent rise in Dublin while price declines continued outside Dublin at 1.5 percent y/y. The CPI shows residential rents rising 7.2 percent y/y in July, boosting rental yields, and residential property turnover rose 8 percent y/y in the first seven months of the year. In the commercial real estate segment, the SCSI/IPD index indicates a 5.3 percent y/y price increase in Q2, with rental yields of almost 9 percent in Dublin reportedly sparking strong overseas investor interest.

5. **The exchequer deficit through end August was in line with expectations**. Cumulative primary expenditure (excluding guarantee payouts resulting from the promissory note transaction) was 1 percent of GDP lower than in the first eight months of 2012 on account of outlay reductions in social protection, health, and education, and remained slightly below the authorities' profile. Cumulative revenues (after adjusting for one-offs) were ½ percent of GDP higher than a year earlier.

Robust corporate tax and local property tax receipts offset shortfalls in VAT, excise duties, and the deposit interest retention tax, keeping total tax revenues just shy of profile. At 2.3 percent of GDP, the exchequer primary deficit was 1.5 percent of GDP smaller than in the corresponding period of 2012, with the related performance criterion for end June 2013 met by a margin (Attachment II, Table 2).




Sources: Department of Finance; and IMF staff estimates.
Note: To facilitate comparability: (i) 2012 tax revenues do not include the €251 million corporation tax payment delayed from December 2011; (ii) outlays in respect of Irish Life (€1.3 billion) and credit unions (€250 million) are excluded from 2012 capital spending; (iii) proceeds from the sale of Bank of Ireland contingent capital notes (€1 billion) and Irish Life (€1.3 billion) are excluded from 2013 other receipts; and (iv) Eligible Liabilities Guarantee scheme payments linked to the promissory note transaction of €1 billion are excluded from 2013 current expenditure.

# MACRO-FINANCIAL OUTLOOK AND RISKS

6. **Balancing the weak GDP results for the first quarter against a range of more positive indicators, the growth projection for 2013 has been pared back by a ½ percentage point to 0.6 percent y/y, but uncertainties remain**. Most importantly, export growth has been cut by 1½ percentage points as data indicate a larger impact from the patent cliff and tepid recoveries in important trading partners. Lower imports dampen the impact on growth. Domestic demand is expected to be flat, with private consumption still contracting modestly owing to fiscal consolidation and household debt reduction, cushioned by employment growth and low inflation. Fixed investment is expected to expand by some 2 percent given improving business sentiment and the uptick in housing starts, but remains the most volatile GDP component. This projection will need to be further reviewed when Q2 national accounts data become available near end September.

7. **Weaker consumption and export growth are expected to dampen the pace of recovery, with growth now penciled in at 1.8 percent in 2014**. Export and consumption growth are expected to benefit from a projected rise in trading partner growth with employment growth contributing to incomes and confidence. Although consumption growth is still expected to become

37. **Given the significant volume of funding activity earlier this year, Ireland remains comfortably financed**. Syndicated bond sales in January and March totaled €7.5 billion to date in 2013. The authorities continue to target an end 2013 cash buffer covering 12–15 months of prospective financing needs, and they will take decisions on potential bond auctions later in 2013 in the light of market conditions. Under current conditions, the full-year issuance goal of €10 billion is well within reach. Looking ahead, staff estimates a 2014 Exchequer funding need of about €9 billion, and long term bond issuance could be similar assuming short term debt is mostly rolled over and a drawdown in the cash buffer covers the €6.8 billion bond redemption in January 2014.

38. **Post-program options to support durable market access on favorable terms remain under consideration**. The final agreement on the extension of EFSF/EFSM loan maturities by an average of seven years will ease financing needs from 2015 on, supporting Ireland's market access. The authorities continue to consider a financing backstop once the current program ends, which could include possible precautionary arrangements with the ESM and the IMF as means to support a durable return to market financing. Such backstops could cushion financing against a range of potential risks in the immediate post-program period. Discussions on such arrangements will continue at the twelfth review.

39. **Though subject to significant risks, the exceptional access criteria continue to be met**:

- ***Debt sustainability and the systemic risk exception***. Under the baseline macro framework, debt sustainability is expected to be maintained over the medium term, although subject to significant risks if growth does not strengthen or if further contingent liabilities materialize. Crucially, this relies on ongoing strong policy implementation, along with European policymakers' delivering on their commitments to reduce strains in countries facing stress and ensure financial stability in the euro area. As debt sustainability is not assured with a high probability, the program continues to be justified on the basis of the systemic international spillover risks posed by Ireland given continued euro area fragility.
- ***Adequate prospects to retain and expand market access***. In view of Ireland's strong program performance and commitments and its regained market access, there are adequate prospects to retain and expand access to private capital markets within the timeframe over which Fund resources will remain outstanding. There is, however, a risk of inadequate European support for potential remaining challenges in Ireland's financial sector, which would weaken the assurances of adequate and durable market access given Ireland's public debt vulnerabilities.
- ***Sound policies***. More broadly, Ireland's policy program is sound and adjustment is being delivered, providing reasonable prospects for program success. More effective policy action and delivery on commitments at the European level is needed to strengthen prospects for success.

# STAFF APPRAISAL

40. **The Irish authorities' have maintained their steadfast policy implementation yet recovery prospects are fragile**. National accounts data show declining economic activity in early 2013, yet employment and other indicators are more positive, leaving uncertainty around current economic developments. Budget developments remain on track and the much delayed mortgage resolution process is now underway, although mortgage arrears have continued to rise. Irish sovereign bonds have weathered the ebbing of global risk appetite and knock on effects to bank funding conditions have been manageable.

41. **Risks to Ireland's economic outlook remain significant**. Growth projections for 2013 and into 2014 have been lowered given recent declines in exports together with conditions suggesting that the pace of consumption recovery will be somewhat slower. Shortfalls in trading partner growth would threaten this recovery though recent indicators are promising. A continuation of recent initial improvements in the labor and housing markets is important to support domestic demand stability in the near term. Looking to the medium term, sustained recovery requires a revival in lending which hinges significantly on the effectiveness of efforts to resolve non-performing loans—a key area where progress has been slow—and improve bank profitability.

42. **Continued firm implementation of Budget 2013 is needed and Budget 2014 should maintain Ireland's track record of steady fiscal consolidation to protect Ireland's favorable market access**. The Irish authorities' fiscal management has remained strong in 2013, including smooth adoption of the local property tax and the welcome broad acceptance by public sector unions of further pay and pension savings. Nonetheless, buffers for the remainder of this year are narrow, demanding continued careful budget implementation. Ireland's steady consolidation efforts have been rewarded with high credibility and manageable market interest rates. Budget 2014 should protect this achievement by setting out adjustment in 2014–15 consistent with the €5.1 billion cumulative consolidation set out in the 2011 and 2012 Medium Term Fiscal Statements, while allowing full operation of the automatic stabilizers. An expenditure-led consolidation remains appropriate, including improved targeting of social supports and subsidies while protecting core public services and the most vulnerable.

43. **It is essential for durable recovery and job creation that the authorities ensure accelerated progress in mortgage resolution**. Mortgage resolution has progressed slowly in recent years, so it is important that banks are recently beginning to work with mortgage borrowers in arrears towards reaching sustainable solutions. Together, the recent reforms of repossession procedures, forthcoming case experience with the Insolvency Service, and reforms to improve engagement between lenders and borrowers, should facilitate converting these proposals into concluded solutions. Banks' efforts will also be motivated by targets for proposing and concluding solutions. Yet many difficult cases will need to be addressed and the practical impact of the recent reforms is unclear at this stage, posing significant risks to the pace and quality of resolution progress. The authorities must therefore be vigilant to ensure the mortgage resolution framework functions effectively in practice including through further reforms of the repossession framework to ensure borrowers have adequate incentives to engage on loan modifications and to adhere to modified debt service schedules. Suitably ambitious resolution targets are needed to reach the authorities' goal of substantially resolving mortgage arrears by end 2014 and the CBI must continue to supervise banks' efforts closely to ensure the sustainability of solutions.

44. **Sustained growth recovery will depend on a revival of bank lending that should be facilitated by enhanced European support**. Recent progress on reducing operational costs and improving net interest margins have brought the main banks near breakeven, yet stronger profitability is needed to support their capacity to lend. Moreover, a smaller bank faces more prolonged lack of profitability that needs to be addressed in a timely manner while also protecting debt sustainability and financial stability. Low official interest rates and the fragmentation of European bank funding markets are key contributors to Irish banks' profitability challenges. A credit enhancement facility to reduce banks' costs of market funding could bolster their profitability and enable them to contribute to Ireland's economic recovery.

45. **The bank balance sheet assessment now underway needs to be completed in a timely manner with robust results**. This assessment takes on particular significance given the uncertainty arising from weak bank earnings and the continued deterioration in asset quality. Through a granular review of banks' loan classification, provisioning, and risk weights, this assessment will take stock of developments since the stress tests in early 2011. The active role of independent third parties in executing and validating the exercise will support the robustness and credibility of the results, which will guide any further repairs needed and help inform banks' preparations for entering the banking union in 2014. Given Ireland's still fragile debt sustainability, an ESM direct recapitalization backstop for the 2014 stress tests would be desirable to protect market confidence and financial stability.

46. **Tackling long-term unemployment and supporting SME job creation remain essential policy priorities**. In line with the objectives in the *Pathways to Work 2013* strategy, resources assigned to activation should be further augmented and focused on the long-term unemployed, including through private sector service provision. Reforms to facilitate SME examinership are important to aid resolution of SMEs in arrears and bolster their potential to invest and create jobs.

47. **Staff supports the authorities' request for completion of the eleventh review**.

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# Ireland: Financial System Stability Assessment Update

This Financial System Stability Assessment on Ireland was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 7, 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Ireland or the Executive Board of the IMF.

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IRELAND

# Financial System Stability Assessment Update

Prepared by the Monetary and Financial Systems and European Departments

Approved by Ulrich Baumgartner and Michael Deppler

July 7, 2006

This Financial System Stability Assessment (FSSA) Update is based on the work of the Financial Sector Assessment Program (FSAP) team that visited Dublin March 2 to 14, 2006.

The key macro-relevant findings of the FSAP Update are:

- The Irish financial sector has continued to perform well since its participation in the Financial Sector Assessment Program in 2000. Financial soundness and market indicators are generally very strong.

- The outlook for the financial system is positive. That said, there are several macro-risks and challenges facing the authorities. As the housing market has boomed, household debt to GDP ratios have continued to rise, raising some concerns about credit risks. Further, a significant slowdown in economic growth, while seen as highly unlikely in the near term, would have adverse consequences for banks' non-performing loans. Stress tests confirm, however, that the major financial institutions have adequate capital buffers to cover a range of shocks.

- Good progress has been achieved in strengthening the regulatory and supervisory framework, in line with the recommendations of the 2000 FSAP. The strategy of creating a unified approach to risk with common elements across different sectors where appropriate, but differentiated where necessary, is being put into practice well. Improvements could nonetheless be made to enhance some aspects of supervision, especially as regards supervision of insurance and reinsurance.

The FSAP team comprised Mr. Mark O'Brien (Mission Chief), Mmes. Su Hoong Chang, Elena Duggar, Srobona Mitra (all MFD), Ms. Marialuz Moreno Badia (EUR), Mr. Jörg Genner (consolidated supervision expert, German Financial Supervisory Authority (BaFin)), and Ms. Brenda Sylvester (assistant, MFD). The mission received excellent cooperation and support from the authorities.

The main authors of this report are Mark O'Brien, Srobona Mitra, and Elena Duggar, with contributions from the rest of the FSAP team.

*FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

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## Glossary

| | |
|---|---|
| AML/CFT | Anti-Money Laundering and Combating the Financing of Terrorism |
| BP | Basis point |
| BU | Bottom-up |
| CARs | Capital adequacy ratios |
| CBFSAI | Central Bank and Financial Services Authority of Ireland |
| CBI | Central Bank of Ireland (now CBFSAI) |
| CDOs | Collateralized debt obligations |
| Code | Consumer protection code |
| CEBS | Committee of European Banking Supervisors |
| CRD | EU Capital Requirements Directive |
| CRT | Credit risk transfer |
| ECB | European Central Bank |
| EU | European Union |
| FATF | Financial Action Task Force |
| FCR | Financial conditions report |
| FSCCP | Financial services consultative consumer panel |
| FSCIP | Financial services consultative industry panel |
| FSAP | Financial Sector Assessment Program |
| FSR | Financial stability report |
| FX | Foreign exchange |
| IAIS | International Association of Insurance Supervisors |
| IFS | International financial services |
| IFSC | International Financial Services Center |
| IFSRA | Ireland Financial Services Regulatory Authority |
| ILP | Investment-linked policies |
| LGD | Loss-given default |
| LTVs | Loan-to-value ratios |
| NPLs | Nonperforming loans |
| ODCA | Office of the Director of Consumer Affairs |
| PDs | Probabilities of defaults |
| SAO | Statement of actuarial opinion |
| SSIAs | Special savings incentive schemes |
| TD | Top down |
| EU-13 | Non-Euro area EU members |
| EU-15 | Euro area, United Kingdom, Denmark, and Sweden |
| EU-25 | European Union |

## EXECUTIVE SUMMARY

**The Irish financial sector has continued to perform well since its participation in the Financial Sector Assessment Program (FSAP) in 2000**. Financial institution profitability and capitalization are currently very strong, with Irish banking sector profits amongst the highest in western Europe. Reflecting their good performance, the major Irish banks receive upper medium- to high-grade ratings from the international ratings agencies.

**While the outlook remains very strong for 2006–07, there are some macro-risks that could have implications for financial system asset quality**. 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. Moreover, a significant slowdown in growth, while seen as extremely unlikely in the near term, would have adverse consequences for employment, resulting in reduced demand for housing and a consequent slowing in the construction sector. Both corporate and household loan quality would be expected to deteriorate under such a scenario, although the likely magnitudes are uncertain due to the lack of recent experience with a major downturn in Ireland.

**That said, the financial system seems well placed to absorb the impact of a downturn in either house prices or growth more generally.** The results of stress tests undertaken through the Central Bank and Financial Services Authority of Ireland (CBFSAI) and the major lending institutions confirm that the major domestic lending institutions have adequate capital buffers to cover a range of large but plausible hypothetical shocks that reflect the above risks.

**Further, good progress has been achieved since the 2000 FSAP in strengthening the regulatory and supervisory framework**. The Irish Financial Services Regulatory Authority's (IFSRA) strategy of creating a unified approach to risk with common elements across different sectors where appropriate, but differentiated where necessary, is being put into practice well and is facilitating work prioritization and planning within the Authority. The insurance regulatory regime has also been significantly improved since the 2000 FSAP and continues to be further enhanced and developed. In parallel with these improvements, financial institutions have improved their own risk management practices, so that the financial system as a whole is better placed to identify and manage risks.

**The mission nevertheless identified some areas where improvements could be made to enhance supervision, or where evolving market conditions will require parallel ongoing strengthening.** In the mission's view, there will be a need to continuously review the adequacy of supervisory regulatory resources to take account of market and regulatory developments and the growth of the international financial services sector. There is scope to

undertake more robust on-site visits to insurers, especially as regards independent assessments of their risk management and corporate governance practices. The introduction of a formal regulatory regime for the reinsurance industry will also be a challenge. In light of significant further developments expected in the supervisory regime for both insurance and reinsurance, and given the recent revision of the IAIS Insurance Core Principles to cover reinsurance, a formal reassessment of the IAIS Principles seems warranted, once the EU Reinsurance Directive has been fully transposed.

**Box 1 summarizes the main recommendations stemming from the FSAP Update**. As indicated above, reflecting the general robustness of the financial system and the supervisory framework, these recommendations are primarily for further enhancements rather than reflecting a need to address fundamental weaknesses.

### Box 1. Ireland: FSAP Recommendations

***Financial stability framework/stress testing***

**1. Medium term**

- Continue to upgrade the CBFSAI's stress testing framework.
- Conduct coordinated bottom up stress testing exercises at least once every two years and investigate the potential for upgrading the templates used for bottom up stress tests, taking advantage of the richer models that banks are developing in preparation for Basel II.
- Consider extending the tests to the banks' foreign exposures, given the sizeable cross-border linkages of domestic credit institutions.

***Regulatory framework***

**1. Ongoing**

- Continue to develop the necessary expertise and ensure adequate staff resources for supervising an increasingly sophisticated financial system, especially taking into account ongoing regulatory developments (Basel II, Solvency II, and the regulation of reinsurance).

**2. Short-term**

- Enhance the current scope and intensity of the on-site supervisory program, in particular to strengthen the assessment of the risk management and corporate governance practices of insurers.
- Implement enhanced public disclosures by insurers, in line with the best practices established by the IAIS to allow for effective market discipline.
- Consider upgrading the position of the Prudential Director as regards IFSRA Board membership, on par with the Consumer Director.
- Strengthen monitoring of credit risk transfer activities by financial institutions.

**3. Medium term**

- Have a full reassessment of the IAIS Core Principles undertaken, once sufficient time has passed so that transposition of the EU Reinsurance Directive can be effectively assessed.

29. **Derivatives are growing in importance—with notional values approaching 900 percent of total assets in 2005—but data on credit risk transfer (CRT) activities are limited and available only with lags**. While CRT helps in risk dispersion, the quantitative techniques required to value and hedge these instruments are still evolving, exposing market participants in all jurisdictions to potentially large risks and increasing the need for careful monitoring. Understanding the extent and type of CRT activity in Ireland is also important given the increasing funding requirements in the context of rapid credit growth. The FSAP update team therefore recommends strengthened monitoring of credit risk transfer activities in Ireland.

**Stress tests**

30. **As part of the FSAP Update, the mission and the CBFSAI agreed on a series of stress tests to be carried out by: (i) a sample of systemically important lending institutions (bottom-up (BU) tests); and (ii) the CBFSAI (top-down (TD) tests).**[9] The institutions covered by both sets of tests comprise the set of large lending institutions judged to be potentially systemically important (nine banks and two building societies).

31. **The two main shock scenarios used for the tests were guided by the risks identified above.** These include strong external linkages of the Irish economy and the concentration of bank lending in the property market. The scenarios were calibrated using the CBFSAI's macroeconometric model using end-2005 balance sheet positions. The first shock scenario incorporates a sharp downturn in the housing market, a large increase in the interest rate, significant withdrawals of customer deposits, a fall in equity prices, and a depreciation of the Euro/U.S. dollar exchange rate. The second scenario involves a substantial increase in interest rates following a mild economic downturn.

32. **The TD tests are complicated by the extended period of strong economic performance in Ireland**. This makes it difficult to quantify the sensitivity of credit risk to economic developments, and thus the relationship between the scenarios and provisioning at the macro level. As a proxy for this relationship in the TD tests, the FSAP team therefore estimated the effect of macroeconomic shocks on provisioning levels in European industrial countries using panel data for EU-15 banks.

***Results***

33. **The TD and BU tests produced broadly consistent results, indicating that the banking system is resilient to a range of shocks, including those incorporating severe assumptions on credit risk.** Under both sets of tests the first shock scenario has the largest impact. Due to the downturn in GDP growth in both scenarios, bank asset growth (especially

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[9] See Appendix II for more details on the stress tests and summary tables of assumptions and results.

loan growth) slows considerably followed by declines in operating income growth and nominal profit growth, and a high increase in NPLs.

34. **There are some differences between the results of the BU and TD tests due to differences in approach under the testing frameworks**. The BU tests are more dynamic in structure, with the institutions able to incorporate such factors as assumptions on lags and ongoing trading income to offset part of the initial impact of the shock. The TD tests are more conservative, and to some degree less realistic, with the entire possible impact of a shock being written off capital with no offsets. Thus the TD tests may in some sense be interpreted as "worst case" estimate of the impact of a shock vis-à-vis the BU tests.

35. **The mission team's EU-15 model in conjunction with the first shock scenario implies an increase in NPLs by 80 percent, assuming that loss-given default (LGD) remains at 50 percent.** Because NPL levels are extremely low in Ireland, the impact of this increase on capital adequacy ratios (CARs) is limited; the scenario does not cause any bank's capital adequacy ratio to fall below the 8 percent minimum. However, were NPLs to rise to 3.13 or by almost 400 percent over three years, as suggested by the BU tests, then the CARs would be significantly hit (assuming no other adjustments to capital). Irrespective of the differences between the two sets of tests, both indicate that the banking sector seems resilient to severe shocks. Still, given the rapid credit growth in the Irish economy, credit risk is deemed the most important risk factor.

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 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.

37. **The TD stress tests on various market risks showed very small effects**. A 400 basis point (bp) tightening of interest rates brings down system CARs by only a small amount, with balance sheet effects on the market value of bond portfolio partially offset by a positive income effect on the banking and trading books. A separate test on an increase in wholesale rates to calculate repricing risk was not considered as meaningful as, with most loans being at variable rates, banks would easily be able to pass the increase on. The direct balance sheet effect of exchange rate changes is negligible, and the indirect foreign exchange-induced credit risk effect of a 30 percent euro appreciation is also small. Although a 30 percent fall in equity prices reduces CARs by 0.54, data on net open positions in equities are not available and the effect on CARs is an overestimation.

38. **Liquidity risks seem manageable** A test on liquidity risk assumed a withdrawal of private sector deposits benchmarked against the total value of liquid assets, and separately, a

haircut on liquid assets to reflect unexpected difficulties accessing wholesale funding sources. A 30 percent reduction in private sector deposits, arising for example from an idiosyncratic rumor that spreads to other banks, would exhaust 15 percent of liquid assets. The main wholesale liquidity test assumes a 10 percent haircut on sale of assets such as debt securities and government bonds held by banks. Beyond effects on profits/capital—losses arising from the haircut would push overall CAR down to just over 9 percent—the banks appear to have generally appropriate contingent liquidity arrangements to address tightening of access to wholesale markets.

39. **Although both the CBFSAI and the banks have been doing stress tests on a regular basis since 1999, the methods are still being developed and the frequency of the coordinated BU tests is relatively low**. In the FSAP update team's view, there is scope to further improve the quality of the tests over the medium term. Data issues will for the time being constrain the power of any stress tests, but the authorities could start developing the methodologies for such tests, which could guide decisions on the types of data that would be necessary.

40. **Possible areas for changes to the stress testing framework include**: using the experiences of other countries' banking systems with economic downturns to help in quantifying the link between the macroeconomic shock scenarios and loan-loss provisions in Ireland; increasing the frequency to the BU stress tests to at least once every two years; extending the tests to the banks' foreign country exposures, given the sizeable cross-border linkages of domestic credit institutions; and upgrading the templates handed to the banks for filling up BU results to include more details and tests, taking advantage of the richer models that banks may already be using in preparation for Basel II.

## B. The International Financial Services Sector

41. **The 2000 FSAP team found that linkages between the institutions providing international financial services (IFS) and the domestic financial system were limited, so that risks to the domestic system emanating from the institutions providing these services were negligible**. That said, some of the IFS providing institutions have always had ownership linkages with the major domestic banks. Further, the recent abolition of the favorable tax regime for the IFS institutions has lowered barriers to stronger financial linkages with the domestic financial sector.

42. **The FSAP update therefore included a review of the IFS sector in Ireland**. In line with the 2000 FSAP findings, IFS institutions still deal primarily with off-shore customers. As a result, possible avenues for contagion between these institutions and purely domestic Irish financial institutions remain limited. However, any soundness problems with the IFS institutions could result in reputational problems and even a decline in the activities in the sector (and thus lower employment and taxes, and underutilization of existing services infrastructure). For a more detailed summary of the findings of this review, see Appendix III.

## Appendix II. Stress Tests

86. **This Appendix describes the stress tests performed in the context of the 2006 FSAP Update of Ireland.** The exercises were carried out jointly by the Central Bank and Financial Supervisory Authority (CBFSAI) and a set of Irish financial institutions that were considered to be the main players in the banking sector, in consultation with the FSAP Update mission. The tests were aimed at assessing the resilience of the Irish banking sector to a set of hypothetical shocks that were considered extreme but with a positive, albeit small, probability of occurrence. The Appendix outlines the methodology, coverage, types and magnitudes of the shocks, and the results of the exercise.

### The tests and shock sizes

87. **The CBFSAI carries out a range of both Top-Down (TD) and Bottom Up (BU) stress tests using a framework developed in 1999.** The last set of BU tests and TD analyses were conducted in end-2003 and reported in the Financial Stability Report (FSR 2004). For the FSAP Update round, BU tests were conducted by 11 Irish retail institutions comprising 9 banks and 2 building societies that have 95 percent of the mortgage market and 88 percent of the non-government deposit market in Ireland, using two scenarios calibrated from a macroeconometric model developed by the central bank, using on- and off-balance sheet data for end-2005 data (Table 3). The CBFSAI, in consultation with the FSAP team, also conducted a set of sensitivity tests and scenario analyses (based on one of the scenarios for the BU tests) on the same set of retail institutions to validate the BU results. The central bank intends to publish the results of the 2006 stress testing round in their next Financial Stability Report.

88. **Both single factor sensitivity tests and a scenario analysis are considered in the TD tests.** The TD analyses use prudential data collected by the Financial Regulator, institutions' annual accounts, and the Central Bank's money and banking statistics. However, only the credit risk test for the TD exercise can be directly compared to the corresponding BU tests because the banks were only asked to do the scenario analyses, and were not requested to do sensitivity tests.

Table 3. Shock Scenarios Based on CBI's Macroeconometric Model

| Economic Activity (% volume changes, year on year) | 2006 | 2007 | 2008 |
|---|---|---|---|
| **BASELINE 1/** | | | |
| GDP | 4.8 | 5.2 | 4.7 |
| Private Consumption | 6.3 | 6.6 | 4.4 |
| Gross Fixed Capital Formation | 3.8 | 3.5 | 3.1 |
| Exports | 4.8 | 5.7 | 5.6 |
| Imports | 5.3 | 5.6 | 4.7 |
| Inflation (average % year-on-year change in HICP) | 2.2 | 2.1 | 2.1 |
| Unemployment (% of labor force) | 4.3 | 4.3 | 4.3 |
| House Price Inflation | 7.0 | 6.3 | 6.1 |
| **SHOCK SCENARIO 1 2/** | | | |
| GDP | 3.2 | -0.3 | -4.8 |
| Private Consumption | 6.0 | 4.3 | -0.4 |
| Gross Fixed Capital Formation | -5.8 | -13.6 | -7.9 |
| Exports | 3.2 | -3.9 | -7.5 |
| Imports | 3.0 | -4.9 | -5.0 |
| Inflation (average % year-on-year change in HICP) | 2.1 | 1.7 | 1.5 |
| Unemployment (% of labor force) | 4.5 | 6.6 | 9.7 |
| House Price Inflation | -13.0 | -8.7 | 1.1 |
| **SHOCK SCENARIO 2 3/** | | | |
| GDP | 3.6 | 1.0 | -2.0 |
| Private Consumption | 5.9 | 4.0 | 0.4 |
| Gross Fixed Capital Formation | -3.9 | -9.8 | -12.2 |
| Exports | 3.9 | -1.2 | -2.5 |
| Imports | 3.7 | -2.4 | -3.4 |
| Inflation (average % year-on-year change in HICP) | 2.1 | 1.8 | 1.9 |
| Unemployment (% of labor force) | 4.5 | 6.2 | 8.7 |
| House Price Inflation | -13.0 | -8.7 | 1.1 |

1/ Based on the projections in CBI's Quarterly Bulletin No. 1 2006, with the horizon extended to 2008.
2/ This scenario represents the model-based outturn if the economy were subjected to a series of shocks based on extreme realizations of historical data—sharp downturn in world trade by 6%, a significant (25%) appreciation of the Euro, a sharp reduction in foreign direct investment resulting in machinery and equipment investment being 25% lower than in the baseline (with a strong negative impact on Irish exports), a reduction in housing output to 50,000 units from the current 80,000 units. Policy interest rates are assumed unchanged. Separately, a 40% decline in house prices is built into this scenario based on real disposable income growth. Interest rates and the stance of fiscal policy held constant. The scenario takes effect beginning of 2006Q3. The joint probability of occurrence of the shocks is less than 1%.
3/ A less extreme scenario than the first. World trade is not explicitly modeled but appreciation of the euro of a lesser (10%) magnitude is included. Contraction of housing construction and of FDI is of the same magnitude but occurs more gradually than in the first scenario. There is a steady rise in nominal short-term interest rates, which was assumed by banks to yield a cumulative increase of either 1.25 percentage points or 2.50 percentage points above the current level.

89. **Since the CBFSAI's macroeconometric model does not incorporate the effect of macro shocks on banks' non-performing loans, the FSAP Update team estimated a cross-country provisioning model to conduct a credit risk test.**[13] A cross-country model was used to capture variation of output growth and unemployment rate between and across countries, especially those that had undergone recessions; this is not possible with Irish data given the extended upswing in the economy. A panel data model is estimated for 496 banks from EU-15 countries covering 1996–2004. Log of loan-loss reserves in percent of gross loans is regressed on bank size (log of loans/assets), and a set of macroeconomic variables—log of unemployment rate, growth rate of index of industrial production, long term interest rate, square of long term interest rate, and real house price inflation rate. Pooled OLS estimates suggested that provisions were most sensitive to changes in the unemployment rate (+), much less sensitive to output growth rate (-) and real house price inflation rate (-). The estimated coefficients were used to estimate increases in provisioning and, given the current loss-given-default, increases in probability of default proxied by non-performing loans.

90. **The CBFSAI, in consultation with the FSAP team, conducted the following additional TD tests**:

- Macro credit risk—several sensitivity tests assuming combinations of increasing NPLs and loss-given defaults.
- Credit risk associated with real estate prices—various house price scenarios were analyzed assuming different mortgage default rates, and assessed against existing profit and capital buffers.
- Interest rate risk—the effect of changes in interest rate on net interest income ('income effect') based on repricing gap data on banking and trading books, and on the balance sheet of banks using maturity of bond investments.
- Liquidity risk—the effect of a significant withdrawal of resident private sector deposits. A second test involves a reduction ('haircut') in value of liquid assets to proxy the effect of increased funding costs stemming from a generalized reduction banking system access to wholesale markets.
- Foreign exchange (fx) risk—indirect (credit risk) effects; direct fx risk is negligible.
- Equity price risk—given the small share of equities in banks' balance sheet, this risk is negligible.

[13] This model is similar to the panel data provisioning model developed in Kearns A., 2004, "Loan losses and the Macroeconomy: A Framework for Stress Testing Credit Institutions'' Financial Well-Being," Financial Stability Report, Central Bank of Ireland, using data on the 2003 Irish stress test participants.

## Results

### *Bottom-up results*

91. **A major outcome of the first shock scenario is a drastic reduction in asset growth, increase in non-performing loans but almost no change in profitability (ROA) from the baseline (Table 4).** Due to the sharp downturn in GDP growth in this scenario, bank asset growth (especially loan growth) slows considerably followed by declines in operating income growth and nominal profit growth. But return on assets *increases* above the baselines in 2006 and 2007 before taking a dip in 2008 to be almost similar to the baseline. This result could be due to the fact that even though nominal profits (before provisioning and taxes) grow at a pace much lower than the baseline, there is a dramatic fall in asset growth, pulling up returns on assets.

Table 4. Summary of BU Test Results

| | | | Weighted average impact from banks' baseline forecasts (percentage points) | | | | |
|---|---|---|---|---|---|---|---|
| **Scenario** | **Assumptions** | | **NPLs** | **Asset growth** | **Operating income growth** | **CAR** | **ROA** |
| Scenario 1 | All 11 banks: severe economic downturn | 2006 | 0.31 | -- | -- | 0.27 | 0.02 |
| | | 2007 | 1.19 | -10.76 | -7.46 | 1.00 | 0.03 |
| | | 2008 | 2.28 | -10.94 | -8.33 | 1.30 | 0 |
| Scenario 2 | 1. 6 banks: 1.25% increase in interest rates, 69.9% of total assets 1/ | 2006 | 0.41 | -- | -- | 0.33 | 0.03 |
| | | 2007 | 1.12 | -10.48 | -5.17 | 1.01 | 0.08 |
| | | 2008 | 2.54 | -11.77 | -7.51 | 1.43 | 0.09 |
| | 2. 5 banks: 2.50% increase in interest rates, 30.1% of total assets 1/ | 2006 | 0.13 | -- | -- | 0.24 | -0.01 |
| | | 2007 | 0.82 | -4.66 | -3.14 | 0.55 | 0 |
| | | 2008 | 0.86 | -7.42 | -5.77 | 1.06 | -0.02 |

1/ Two sets of results are reported, based on the interest rate increase taken or assumed by banks to run this test. Due to some confusion, some banks ran the test exercise with a 1.25 percentage point increase in interestrates while others assumed a 2.5 percentage point increase. There are 6 banks in the first set (with a 1.25 percent increase in interest rate) comprising 69.9 percent of the assets, and 5 banks in the second set.

92. **Non-performing loans increase considerably as percent of gross loans—with mortgage loans still showing the lowest NPLs—growing by more than 2.5 times the baseline over the three years.** However, the cover ratio—loan loss reserves in percent of non-performing gross loans—falls in the shock scenario. This was also a feature of the previous round of BU tests that the banks had participated in, and appears to be the result of banks assumptions on collateral values and collateral recovery rates. A fall in the cover ratio

implicitly assumes that even though the probability of default (proxied by actual non-performing loans) is rising due to the severe downturn, the loss given default is not.[14] Capital adequacy rises under the shock scenario even as it falls under the baseline (although the differences are very small). This is also true for the bank that has the minimum capital adequacy ratio (CAR) under the baseline. Owing to a full balance sheet treatment by banks in the BU tests, the CAR is boosted by factors that still help profits grow (albeit at a slower pace); these factors would be difficult to consider in the TD tests.

93. **Overall, the second shock scenario, as expected, has a milder effect on key ratios than the first.** Operating income growth, return on assets, and net interest margin are higher in 2008 under this scenario than for Scenario 1. However, there does not appear to be a relationship between interest rate rise and NPL-growth in this scenario.

***Top Down results***

94. **The mission team's EU-15 model in conjunction with the first shock scenario implies an increase in NPLs by 79 percent, assuming loss-given default (LGD) remains at 50 percent (Table 5).[15]** Because NPL levels are extremely low in Ireland, the impact of this increase on CARs is limited; the scenario does not cause any bank's capital adequacy ratio to fall below the 8 percent minimum. A more severe (but arbitrary) 100 percent increase in the NPL ratio would have a stronger impact but would still not have systemic implications. Irrespective of the differences between the two sets of tests, both indicate that the banking sector seems resilient to severe shocks. Still, given the rapid credit growth in the Irish economy, credit risk is deemed the most important risk factor.

95. **The banking sector seems resilient to severe assumptions on credit risk.** However, the underlying increase in non-performing loans predicted by the model (assuming LGD remains the same) is 1.57 compared to the BU tests' 3.13 in 2008 under Scenario 1. With the same LGDs—that is 50 percent—and NPLs between 2.61 and 3.48 percent in the TD case, three banks accounting for 9 percent of assets would fall below the minimum CAR of 8 percent. But the two tests are not exactly comparable given that the BU tests assumes an adjustment of many variables over three years with CARs actually increasing at the end of 2008. However, if the actual increase in NPLs in the BU tests (from 0.8 in 2006 to 3.13 in 2008) is written off 2006 regulatory capital, using 50 percent LGD, then CARs would fall by 1.04 percentage points, which is less than but roughly comparable to the TD test.

[14] For mortgage loans, however, the cover ratio rises slightly from about 18 percent in the baseline to about 20 percent under the shock scenario in 2008.

[15] To the extent that LGD is proxied by the coverage of NPLs by specific provisions, the LGD for the aggregate banking sector was 50 percent in 2005.

Table 5. Summary of TD Test Results

| Tests 1/ | Shocks and assumptions | Weighted average impact on CAR in pp | Number of banks < 8% |
|---|---|---|---|
| Credit risk | 1. Scenario 1: 3-year cumulative impact 2/<br>LGD remains the same at 50%<br>Increase in PD by 80% | -0.44 | 0 |
| | 2. Increase in PD by 100%, LGD=50% | -0.56 | 1 |
| | 3. Increase in PD by 100%, LGD=75% | -0.85 | 1 |
| | | *Banking book* | |
| Interest rate risk | 1. 200bp downward parallel shift | -0.05 | 0 |
| | 2. 400bp upward parallel shift | 0.11 | 0 |
| | | *Trading book* | |
| | 1. 200bp downward parallel shift | -0.01 | 0 |
| | 2. 400bp upward parallel shift | 0.02 | 0 |
| | | *Market value of bond assets* | |
| | 1. 100bp upward parallel shift | -0.12 | NA |
| | 2. 400bp upward parallel shift | -0.48 | NA |
| Liquidity risk | 1. 10% haircut on debt securities & government bonds | -1.52 | 2 |
| | 2. 20% haircut on debt securities & government bonds | -3.10 | 4 |
| | 1. 10% deposit withdrawal 3/ | 5 | NA |
| | 2. 30% deposit withdrawal 3/ | 14.9 | NA |
| | | *Fx-induced credit risk* | |
| Exchange rate risk 4/ | 1. Default rate: 10% of fx loans + LGD: 50% as a result of 30% depreciation in EUR versus all foreign currencies | -0.19 | 0 |
| Equity price risk | 30% fall in equity prices | -0.54 | NA |

1/ House price declines are excluded from this table, as the methodology for the test was different. See text for the summary results.
2/ Increase in PD based on the EU-15 cross-country econometric model.
3/ Resulting value of withdrawal/value of liquid assets in percent.
4/ The direct balance sheet impact of exchange rate change on net open fx position is negligible and not reported.

96. The TD stress tests on various market risks—including interest rate risk, equity price risk, and foreign exchange risks—showed very small effects. A 400 basis point (bp) increase in interest rates would lower the market value of the bond portfolio resulting in a 0.62 percentage point change in average CAR, and this would in any case be partially offset by small positive income effects in the banking and trading books. A 30 percent fall in equity prices results in -0.62 percentage point erosion of the average CAR. Indirect foreign exchange (FX) risk has a very small effect on CARs, even under the assumption of severe shocks.

97. **A test on liquidity risk assumed a withdrawal of private sector deposits and a haircut on liquid assets**. The withdrawal—due for example to idiosyncratic rumors that spreads to other banks—was benchmarked against the total value of liquid assets to see whether it could be met out of the existing stock of liquid assets. A 30 percent reduction in sight deposits would exhaust 15 percent of liquid assets. Separately, a haircut is applied to the stock of debt securities and government bonds held by banks to proxy the impact of the banks attempting to sell their entire liquid assets portfolio to meet sudden liquidity needs arising, for example, from sudden difficulties in accessing wholesale funding sources. A 10 percent haircut would push overall CAR to 9 percent.

98. **Recognizing that new mortgage borrowers were most at risk of falling into negative equity following a house price fall, the Central Bank designed an innovative test to check if the level of existing provisions could absorb the resulting increase in loss-given-defaults at different default rates.** Here, the LGD is calculated from the existing mortgage book and applied to various default rates. To set a benchmark for the typical LGD, a hypothetical average mortgage with 90 percent LTV was assumed to originate in each of the years for the last 10 years. Then each of these loans was amortized through the years till 2006, and the outstanding LTV for each mortgage loan is calculated by using current average house price.

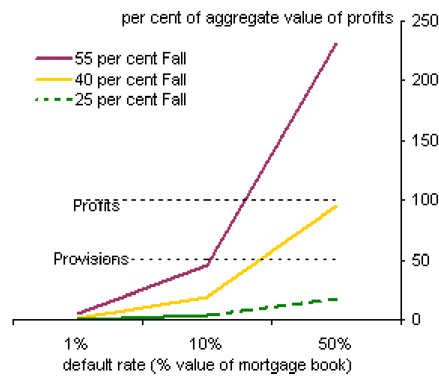
99. **Hypothetical (nominal) house price declines of 25 percent, 40 percent, and 55 percent were then applied to the outstanding LTVs to calculate the typical LGD if the mortgage were to default.** The actual mortgage loan book is then divided into buckets according to the years in which the loans were first originated. It is (very conservatively) assumed that all loans in each of the buckets had LTVs 90 percent or above at the time of origination.[16] The hypothetical LGD is then applied to the calculated LTV in each bucket under the assumptions of house price declines of 25 percent, 40 percent, and 55 percent

[16] Also refer to Box D of FSR (2004). As part of the reporting on BU test results, the banks were also asked to submit data on mortgages with <60 percent, 60–75 percent, and >92 percent LTVs. Between 26 and 33 percent of mortgages—depending on the method of calculation—had LTVs greater than 75 percent, and 1.8–6.1 percent had LTVs above 92 percent.

respectively. Under various assumptions of default rates, the value of the total loss as a percent of the aggregate value of the buffer created by profits is calculated.

100. **The test shows that the current capital buffer would absorb very high default rates and house price declines (Figure 9).** The graph below shows losses from mortgage loan defaults at various default rates and house price declines. The value of provisions set aside for mortgage loans was 12 percent of profits at end-2005; this would cover losses from a 25 percent fall in house prices and up to 10 percent default rates. If the 50 percent risk-weight for mortgage loans is considered as an additional capital buffer for unexpected losses, then this mortgage capital buffer along with mortgage provisions covers even a 55 percent fall in house prices and a 10 percent default.

Figure 9. House Price Falls and Aggregate Buffers 1/




1/ The kinks on the lines are due to a non-uniform x-axis scale.

## Appendix III. The International Financial Services Sector

### A. Introduction

101. **Over the last two decades, Ireland has been very successful in promoting itself as a centre for financial services companies**. This success is due to a variety of factors, including an attractive fiscal and regulatory environment and the availability of a highly educated workforce. As a result, about 450 international institutions are currently operating from Ireland, including over 50 percent of the top 50 global financial institutions. Although Ireland's international financial services companies deal primarily with cross-border customers, linkages with the domestic economy are increasing.

102. **An analysis of the international financial services (IFS) sector in Ireland, was undertaken as part of the FSAP Update**. The objective was to examine the linkages between the international financial institutions in Ireland and the domestic economy to assess whether or not they are increasing. The major strengths and vulnerabilities of credit institutions in the Irish IFS sector were also examined.

### B. Background

103. **The development of an IFS sector in Ireland began with the establishment of the International Financial Services Center (IFSC) in 1987**. The main incentive offered to investors at the time included a reduced corporate tax rate of 10 percent and relief from local municipal taxes, as well as from taxes on capital expenditure and rents on property. Institutions consequently entered the IFSC primarily to deal with cross-border customers.[17]

104. **There is no longer any distinction between IFSC and non-IFSC institutions from a taxation perspective**. In 1998, agreement was reached between the Irish authorities and the EU Commission to phase out the preferential IFSC regime by January 1, 2006. This phasing out was implemented, in conjunction with the introduction of a new 12.5 percent Irish corporate tax rate starting from January 1, 2003. As a result there is now no fiscal distinction between IFSC and non-IFSC institutions.[18] While the initial stimulus for the creation of the center was a favorable tax environment and the availability of a young and well-trained workforce, the IFS is now well established.

105. **From a modest start, the IFSC has grown to become of significant importance for the economy** (Figure 10). The IFS sector currently employs more than 21,000 people, or

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[17] Business transactions between Irish residents and IFSC companies were permitted at the higher tax rates.

[18] Nevertheless, the tax regime that now applies to IFS operations is one of the most attractive regimes available to financial companies considering locating operations in other countries.

INTERNATIONAL MONETARY FUND

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# IRELAND

December 2013

## TWELFTH REVIEW UNDER THE EXTENDED ARRANGEMENT AND PROPOSAL FOR POST-PROGRAM MONITORING

In the context of Twelfth Review Under the Extended Arrangement and Proposal for Post-Program Monitoring, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 13, 2013, following discussions that ended on November 7, 2013, with the officials of Ireland on economic developments and policies underpinning the IMF Arrangement. Based on information available at the time of these discussions, the staff report was completed on December 2, 2013.
- A **Staff Supplement** of December 12, 2013 updating information on recent developments.
- A **Press Release** including a statement by the Chair of the Executive Board.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Ireland*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

# IRELAND

December 2, 2013

## TWELFTH REVIEW UNDER THE EXTENDED ARRANGEMENT AND PROPOSAL FOR POST-PROGRAM MONITORING

## KEY ISSUES

**Steadfast policy implementation has been maintained through the final review of the program**. Budget execution has once more been solid in 2013, with the fiscal deficit expected to remain within the Excessive Deficit Procedure ceiling. Budget 2014 targets a balanced adjustment path, with a primary balance in 2014 and an overall deficit below 3 percent of GDP in 2015. Efforts continue to address the high level of nonperforming residential mortgages and SME loans and key bank diagnostics have been completed.

**Ireland has pulled back from a severe banking crisis with the support of the EU-IMF arrangements and broader European initiatives**. Though below initial projections, growth has exceeded the euro area average and indicators suggest a recovery may be emerging. Banking reforms have supported financial stability. While the crisis and bank support led to a substantial rise in the deficit and a sharp increase in public debt, phased consolidation—initiated prior to the Fund arrangement but subsequently maintained—has significantly improved the fiscal position. Market access has been regained, also benefitting from EFSF/EFSM maturity extensions, the Promissory Notes transaction, and the broader easing in euro area market tensions.

**Continued determined policy implementation is nonetheless needed on a range of fronts before Ireland can be judged to have fully recovered from the crisis**:

- ***Steady fiscal consolidation***. With the fiscal deficit still high and public debt very elevated, sizable further consolidation is needed in coming years to put debt firmly on a declining path and help ensure Ireland's return to market financing is lasting.
- ***Addressing mortgage arrears and completing bank repairs***. Very slow progress in addressing mortgage arrears hinders a revival over time in lending that is needed for domestic demand recovery to become sustained. Intensified efforts are needed to ensure banks and mortgage borrowers in arrears conclude durable solutions. Banks also need to rebuild their profitability, although, in the context of low ECB policy rates, they face challenges from the structure of their assets.
- ***Reducing high unemployment***. Efforts to improve employment services should continue, especially for the long-term unemployed, to ensure that they remain in the workforce and acquire marketable skills.

**After wide consultation, the Irish authorities have decided to not seek a financing backstop after the conclusion of their current EU-IMF arrangements**. Ireland concludes its Fund arrangement in a much strengthened position and the authorities intend to press on with addressing the significant challenges that remain. Nonetheless, continued European support, especially during Ireland's transition to the Single Supervisory Mechanism and the banking union, remains important.

# OVERVIEW

1. **The twelfth and final review of Ireland's EU-IMF supported program found policy implementation remains on track but significant challenges remain ahead**. Discussions focused on fiscal policy and on the bank diagnostics. Following further discussions on a potential EU-IMF financing backstop the authorities announced their decision not to request such arrangements from the ESM and IMF. The authorities' broader strategy to address remaining fiscal, financial sector and unemployment challenges and thereby ensure a durable return to market financing, as summarized in their attached Letter of Intent, was also discussed.

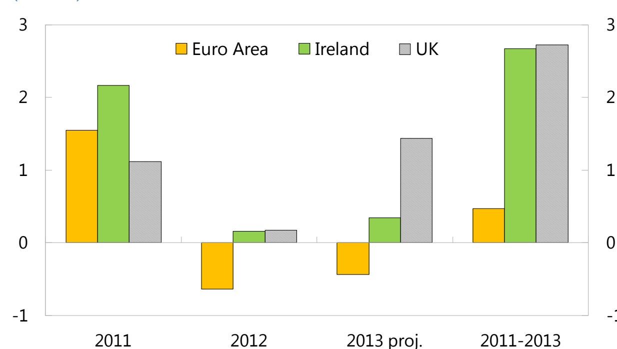
# PROGRESS AND REMAINING CHALLENGES

2. **Ireland has pulled back from a severe banking crisis with the support of the EU-IMF program**. The program that began in December 2010 followed an exceptionally deep banking crisis, as described in the staff report for the 2012 Article IV consultation. Policy implementation has been steadfast although progress under the program has been mixed:

- ***Growth has been slower than projected, although exceeding the euro area average***. After an export-led expansion of 2.2 percent in 2011, real GDP growth slowed to 0.2 percent in 2012 and turned negative in H1 2013 as exports were hit by the "patent cliff" in pharmaceuticals and by slow trading partner recovery (Box 1). Expected cumulative growth in 2011–13 of about 2¾ percent falls short of the 5¼ percent originally projected. However, expected euro area growth of ½ percent in 2011–13 falls short of the October 2010 WEO projection of 5.2 percent to a greater extent. Ireland's cumulative growth in 2011–13 is expected to match the UK.

**Real GDP Growth**

(Percent)

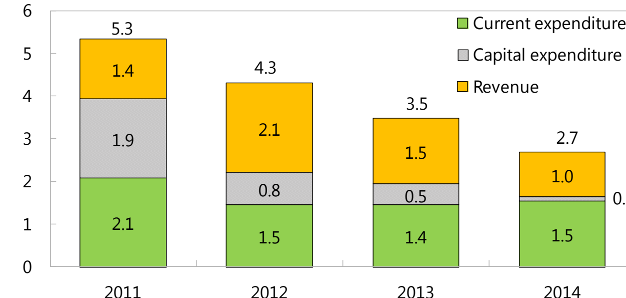



Source: IMF WEO; and IMF Staff estimates.

- ***Phased consolidation effort has significantly improved the fiscal position***. Even before the start of the program, Ireland undertook substantial fiscal consolidation, reducing the structural primary deficit by 5¼ percent of GDP in 2009–10. Subsequently, every fiscal target under the program has been met. As a result, Ireland is expected to reduce its structural primary deficit to ½ percent of GDP in 2013, a cumulative

**Composition of Fiscal Consolidation 1/**

(Billions of euro)




Source: IMF staff estimates.

1/ Of the €6 billion in measures included in Budget 2011, some €0.7 billion related to the sale of assets and debt service savings are not part of staff estimates of the consolidation effort. Revenues for 2012 include €0.5 billion in carryovers from the Universal Social Charge and other measures not envisaged under the original program, but implemented under Budget 2011. For 2014, the estimate of consolidation does not include additional deficit reductions of €0.45 billion identified in the Budget related to unemployment benefits, interest payments, and central bank dividends.

decline of around 4½ percentage points since 2010 and of 10 percentage points since the onset of the crisis. Fiscal measures implemented under the program total over €13 billion or 8 percent of GDP, two-thirds on the expenditure side.

- ***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.

- ***Financial stability has been supported by determined efforts***. These include a €24 billion (15 percent of GDP) top up of banks' capital in 2011, coupled with a significant restructuring of the system.[1] These PCAR banks reported an aggregate core tier 1 risk based capital ratio of 14.1 percent as of mid 2013 (although the balance sheet assessment indicates a somewhat lower ratio, ¶29). Provisions doubled between end 2010 and June 2013 to account for 90 percent of aggregate loan losses projected under the stress scenario of the 2011 stress test.[2] Domestic deposits have stabilized since mid 2011 even as deposit rates have declined. The loan-to-deposit ratio has come down from 190 percent at end 2010 to

**Aggregate Balance Sheet of PCAR Banks 1/**

(In billions of euro unless otherwise indicated)

| Balance Sheet | Q4 2010 € bn. | Q2 2013 € bn. | Percent change |
|---|---|---|---|
| Cash & due from Eurosystem | 6.3 | 9.1 | 42.9 |
| Net loans | 273.6 | 186.0 | -32.0 |
| o/w Mortgages (Ireland, gross) | 95.3 | 90.0 | -5.6 |
| Due from banks | n.a. | 8.7 | n.a. |
| Securities & derivatives | 58.9 | 64.7 | 9.7 |
| Other assets | 29.2 | 13.4 | -54.1 |
| Total assets | 368.1 | 281.8 | -23.4 |
| Due to Eurosystem | 90.1 | 33.7 | -62.6 |
| Due to banks | 27.0 | 19.1 | -29.5 |
| Deposits | 144.3 | 159.0 | 10.2 |
| Debt & derivatives | 72.1 | 37.9 | -47.4 |
| Other liabilities | 19.3 | 11.0 | -43.0 |
| Net equity | 15.3 | 21.1 | 37.7 |
| Total liabilities & equity | 368.1 | 281.8 | -23.4 |
| *Memorandum items:* | | | |
| Gross loans 2/ | 310.8 | 213.5 | -31.3 |
| Loan loss provisions | 14.3 | 28.2 | 97.0 |
| Gross NPLs | 33.5 | 56.8 | 69.4 |
| Gross NPLs to gross loans (%) | 10.8 | 26.6 | 15.8 |
| Provisions to gross NPLs (%) | 42.7 | 49.7 | 6.9 |
| Loans (net) to deposits (%) | 189.7 | 117.0 | -72.7 |

Sources: CBI; and IMF staff estimates.

1/ PCAR banks are Bank of Ireland, Allied Irish Banks, and Permanent tsb.
2/ Includes loans held for sale, classified on balance sheet as other assets.

[1] The 2011 Prudential Capital Assessment Review (PCAR) stress tested Allied Irish Banks (AIB), Bank of Ireland (BoI), and Permanent tsb (PTSB), together the PCAR banks. See the Financial Measures Programme Report, March 2011, of the Central Bank of Ireland (CBI).

[2] In calculating this ratio, the PCAR loss estimate is increased by €3.9 billion to reflect the subsequent decision to not transfer smaller land and development loans to the National Asset Management Agency (NAMA).

117 percent in June 2013 and PCAR bank reliance on Eurosystem support is down from a peak of over €90 billion to about €31 billion. Bank support involved a heavy burden on the public sector, with gross costs of €64.1 billion (40 percent of GDP). Recovery of these costs is at an early stage, including through the sale of Irish Life and CoCos in BoI.

- ***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.

- ***Competitiveness is improving even as structural reform progress has been slower than hoped***. Competitiveness deteriorated during the boom but subsequent declines in the CPI and unit labor costs left Ireland with only a moderate degree of real effective exchange rate overvaluation, in the range of 5–10 percent (see 2012 Article IV Staff Report, Annex I). Flat nominal wages and low inflation suggest improvements in competitiveness will continue in coming years. Structural reforms have aimed to improve competition within the legal and medical services sectors, strengthen competition enforcement including by increasing resources, enhance activation and training of the unemployed, and facilitate labor market adjustment in sectors hit hard by the crisis, although the implementation of some reforms is yet to be completed.[5]

- ***Market access has been regained***. Financial market conditions have improved markedly, reflecting a combination of the above policy efforts and European support through interest rate reductions, EFSF/EFSM maturity extensions, and the Promissory Notes transaction, together with the broader easing in euro area market tensions since mid 2012. Two government bond issues totaling €7½ billion in early 2013 were heavily subscribed by an investor base that was diversified by region and investor class. Spreads on Irish sovereign bonds have fallen to their lowest level since early 2010 and, since its issuance in March, the 10 year bond yield has fallen from 4.15 percent to about 3.5 percent recently, some 60 basis points below Italy and Spain.

[3] On the resolution regime, see Box 2 in Ireland: First and Second Reviews Under the Extended Arrangement.

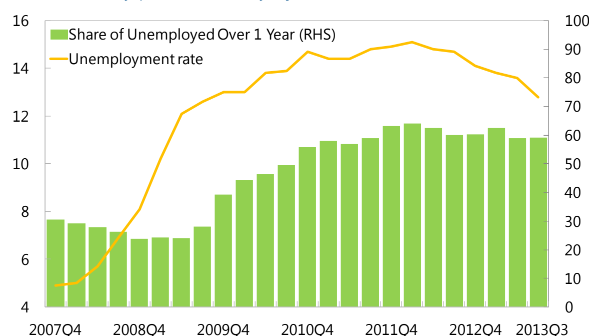
[4] See Annex II, Ireland—Ninth Review Under the Extended Arrangement.

[5] For elaboration on these reforms, see ¶36 of Ireland—Staff Report for the 2012 Article IV Consultation.

3. **Nonetheless, significant challenges remain that will require concerted action over the medium term before Ireland can be judged to have fully recovered from the crisis**:

- ***Heavy private sector debts weigh on the level of domestic demand***. By boosting savings, households have reduced their nominal debts by 16 percent in the past 4½ years, but debt burdens remain high at 198.3 percent of disposable income in 2013 Q2 with saving likely to remain above normal levels for some time. SMEs face financing constraints on investment and job creation, often reflecting debt incurred for past property investments.[6]
- ***Banks' progress in resolving high nonperforming loans (NPLs) has been very slow and weak profitability also hinders a revival of lending***. NPLs stand at 26½ percent of PCAR bank loans, led by commercial real estate loans (41 percent), Irish residential mortgages (34 percent) and business and SME loans (19 percent). This high share of NPLs raises the cost of market funding including through overcollateralization requirements and drains management resources that could be used for new lending. High unemployment and other shocks have led to arrears over 90 days on 12.9 percent of mortgages for principal dwellings, while the figure for mortgages on buy-to-let properties is 21.2 percent. However, banks' progress in resolving NPLs has been very slow, prompting the CBI to establish targets for the resolution of residential mortgages and SME loans.[7] Even after significant profitability improvements in the first half of 2013—reflecting the removal of the Eligible Liabilities Guarantee (ELG) scheme, reductions in staffing and branch numbers made in 2012, and declines in deposit rates—bank profitability remains weak, limiting banks' capacity to generate the capital needed to sustain lending. The greatest challenge is faced by the smaller PTSB which is not expected to break even after provisioning expenses until 2017.
- ***The fiscal deficit remains high and putting public debt firmly on a downward path requires sizeable further fiscal consolidation***. Despite the major primary adjustment under the program, a rising interest bill has kept the fiscal deficit at 6½ percent of GDP (excluding one-off guarantee payments related to the liquidation of the Irish Bank Resolution Corporation, IBRC), and with debt projected at 124 percent of GDP at end 2013 further consolidation is needed while allowing room for recovery.
- ***High long-term unemployment, if unaddressed, could depress growth for years***. Reflecting a combination of job creation and emigration, unemployment eased from 15.1 percent in early 2012 to a still high 12.8 percent by Q3 2013. However, the long-term jobless constitute some 58.4 percent of all jobseekers, eroding labor force participation and work skills.

**Unemployment Rate and Duration**
(Quarterly, percent, seasonally adjusted)




Sources: Haver Analytics; and IMF staff calculations.

[6] See Box 4 in Ireland—Eleventh Review Under the Extended Arrangement.

[7] Factors behind prolonged mortgage forbearance are outlined in ¶19 of the Tenth Review.

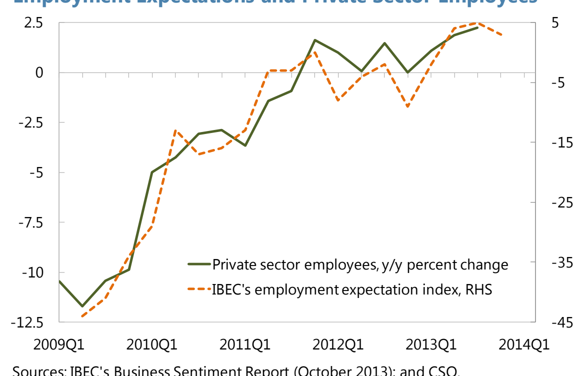
# RECENT DEVELOPMENTS

4. **An output rise in Q2 2013 reversed only part of the sharp dip in Q1 but a range of indicators paint a more positive picture for the second half of the year**:

- ***Real GDP grew by 0.4 percent q/q in Q2 but still contracted 1.2 percent y/y***. Exports rebounded in Q2 to increase 1 percent y/y, led by services export growth of 3.6 percent. Final domestic demand contracted 0.3 percent q/q in Q2, to be down by 1.1 percent y/y, as a 0.7 percent q/q rise in private consumption was outweighed by weak investment and public consumption. Nonetheless, fixed investment ex-aircraft grew 11.8 percent y/y, driven by equipment spending and construction.

- ***Employment rose 3.2 percent y/y in Q3, the fastest increase in six years***. Job growth was recorded in 8 of 14 sectors, including construction, though public sector employment fell. Surveys of employers, together with the further decline in the unemployment rate in October, suggest that private sector job growth is continuing.

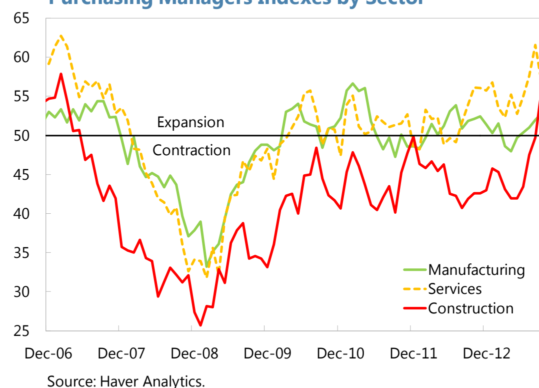
**Employment Expectations and Private Sector Employees**




Sources: IBEC's Business Sentiment Report (October 2013); and CSO.

- ***Signals of a broad-based recovery are provided by high frequency indicators in the second half***. Goods exports rose 4.9 percent q/q in Q3. The manufacturing PMI continued to rise through October to 54.9, the services PMI reached its highest level since March 2007, and the construction PMI for October is now firmly in expansion territory, with the overall index increasing to 59.4, the highest level observed since January 2006. Consumer sentiment also reached the highest level in 6 years in October and although core retail sales were flat in October, they are up 0.3 percent y/y in the first ten months of 2013.

**Purchasing Managers Indexes by Sector**



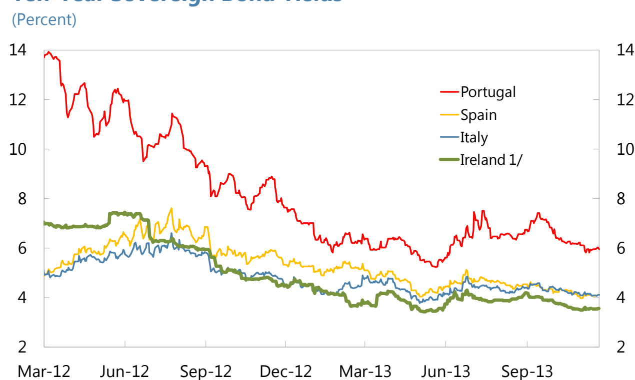

Source: Haver Analytics.

- ***Inflation remains low***. Helped by falling energy prices, harmonized index of consumer prices inflation was essentially flat y/y in October (-0.1) and below euro area inflation of 0.7 percent y/y during the same period.

- ***House prices are rising nationally, with strong growth in Dublin and increases emerging elsewhere, even as bank credit continues to contract***. Household credit outstanding shrank by 4.2 percent y/y in October and loans to nonfinancial corporations fell by 4.7 percent. Nonetheless, mortgage draw downs rose 12.5 percent y/y in Q3 and mortgage approvals increased 22.2 percent y/y in October. Residential property prices rose

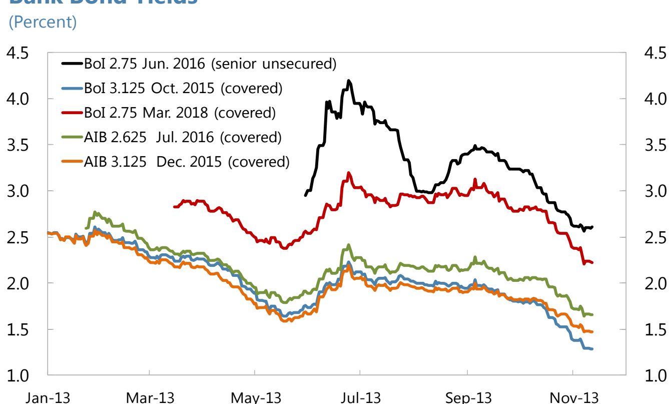
6.1 percent y/y in October, led by a 15 percent y/y gain in Dublin while elsewhere house prices have edged up by 3.5 percent since March. Renewed house price increases and declining household indebtedness are contributing to a rebuilding of household net worth, although it remains some 34 percent below peak levels.

5. **Financial market conditions continued to improve, benefitting from international developments**. Yields eased following the Federal Reserve's postponement of the tapering, the German election outcome, and the recent ECB easing decision. In view of its relatively strong funding position, the National Treasury Management Agency (NTMA) decided to suspend its monthly Treasury bill auctions for the final quarter of 2013 and to defer consideration of any further medium/long-term bond issuance until early 2014.




Source: Bloomberg.
1/ Prior to 15 March 2013 a treasury bond maturing in 2020 is used for Ireland.

6. **Funding conditions for banks have enjoyed a positive spillover from the strength of the Irish sovereign bond market in recent months**. Secondary market yields on three-year covered bonds from BoI and AIB have fallen by about 75 basis points since early September. Domestic banks have also issued €3 billion in bonds since September, with high bid-to-cover ratios and geographically diversified demand indicating strong investor interest.[8] After declining significantly, bank deposit rates have stabilized below 1 percent in recent months. ECB borrowing by domestic banks fell from €39.6 billion at end March to €30.8 billion at end October.




Source: Bloomberg.

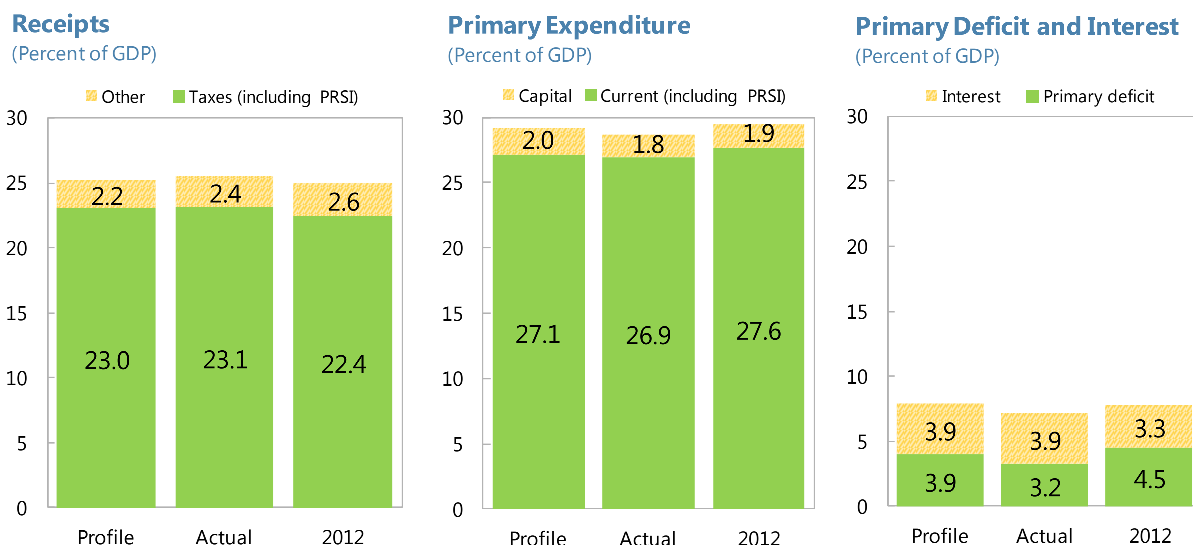
7. **NAMA continues to make progress towards its debt redemption targets and is preparing for the challenges of integrating IBRC loans**. In the year through mid-October NAMA generated cash receipts totaling €3.9 billion of which €2.9 billion was from asset disposals. From its inception, NAMA has generated total cash receipts of about €14.5 billion of which €9.7 billion was from asset disposals, helping to bring cumulative redemptions of its senior bonds to €7 billion to date out of a total of €30 billion by 2020. NAMA recorded a profit of

[8] BoI and AIB issued €1.5 and €0.5 billion of covered bonds, respectively. AIB also issued €0.5 billion of senior unsecured debt. PTSB's €0.5 billion asset backed security issuance is the first of this type since 2007.

€53 million in the first half of 2013, notwithstanding cumulative impairment provisions of €3.6 billion (14½ percent of gross loans and receivables). To support asset sales, NAMA has advanced €375 million in vendor financing and has spent €500 million in capital investment to date. Preparations are being made to acquire IBRC loans up to the value of the €12.9 billion floating charge acquired as part of the Promissory Notes transaction in the event the Special Liquidator is unable to sell IBRC's assets to the market. Loan servicing previously conducted by IBRC on behalf of NAMA on debt with a principal of €41 billion is being migrated to a loan servicing company, and staff and IT systems from IBRC are being integrated.

8. **The exchequer deficit remained on track through end October**. Cumulative primary expenditure (excluding ELG payments linked to the Promissory Notes transaction) was 0.7 percent of GDP lower than in the same period of 2012 on account of lower outlays in social protection, health, and education. Both current and capital spending remained below the authorities' profile as well. Cumulative revenues (after adjusting for one-offs) were 0.7 percent of GDP higher than a year earlier. Revenues remain marginally above budget projections as over-performance on corporate income tax, Pay Related Social Insurance, and stamp duties offset shortfalls in VAT and excise duties that have until now been weighed down by weak domestic demand. The exchequer primary deficit at end October was 3.2 percent of GDP, 1.3 percent of GDP smaller than in the corresponding period of 2012, and the end September performance criterion was met by a margin of 0.8 percent of GDP (Table 12).

### Cumulative Exchequer Outturn vs. Authorities' Profile, January–October 2013




Sources: Department of Finance; and IMF staff estimates.
Note: To facilitate comparability: (i) 2012 tax revenues do not include the €251 million corporation tax payment delayed from December 2011; (ii) outlays in respect of Irish Life (€1.3 billion) and credit unions (€250 million) are excluded from 2012 capital spending; (iii) proceeds from the sale of Bank of Ireland contingent capital notes (€1 billion) and Irish Life (€1.3 billion) are excluded from 2013 other receipts; and (iv) Eligible Liabilities Guarantee scheme payments linked to the promissory note transaction of €1 billion are excluded from 2013 current expenditure.

trade interlinkages, most notably with the euro area and UK, the risk of significant potential spillovers should Ireland face financing pressures remains, especially as Ireland is perceived in markets as having performed well under its EU-IMF supported program. Such spillover risks would be heightened in period of international financial volatility, when linkages for spillovers can strengthen—this was evident most recently during the period of uncertainty around tapering by the US Federal Reserve.

- ***Adequate prospects to retain and expand market access***. In view of Ireland's strong program performance and commitments and its regained market access, there are adequate prospects to retain and expand access to private capital markets within the timeframe over which Fund resources will remain outstanding, yet this access remains at some risk over time:

  - **On a range of indicators Ireland currently has gained solid market access**. Since mid 2012, Ireland has issued debt ranging from Treasury bills to bonds at 5 year, 8 year, and 10 year maturities, and has also sold longer-term amortizing bonds designed for the domestic pensions industry. The 10 year benchmark issue on March 13, 2013 raised €5 billion on the back of total bids of €13 billion from about 400 investors, the majority of whom were European, especially UK, German, Nordic and French, with further uptake by Irish residents and US investors. Investors included fund managers, banks, pension funds, and insurance companies. Ireland enjoys yields significantly below those of Italy and Spain which have strong market access.

  - **Market access is expected to be retained, subject to risks linked to the fragility of debt sustainability**. The volume of market financing needed appears manageable in 2014–15, and while these requirements increase from 2016 onward they are still not a major share of the debt stock. It appears reasonable to expect Ireland to retain market access in the baseline scenario of declining debt ratios, while recognizing that the risks to debt sustainability from growth and contingent liabilities also imply risks to market access. In particular, there is a risk of inadequate European support for potential remaining challenges in Ireland's financial sector during the ECB's Comprehensive Assessment in 2014, despite the availability of the ESM direct recapitalization instrument under the November 15 ECOFIN Council statement, which would weaken the assurances of adequate and durable market access given Ireland's public debt vulnerabilities.

- ***Sound policies***. Ireland's policy program is sound and adjustment is being delivered, providing reasonable prospects for success. More effective policy action and delivery on commitments at the European level is needed to strengthen prospects for success.

# STAFF APPRAISAL

43. **Steadfast policy implementation has been maintained through the final review of Ireland's program and signs of nascent recovery are emerging.** The first half of the year was characterized by mixed signals, with weak GDP figures partly related to the "patent cliff" affecting pharmaceutical exports occurring alongside significant growth in private sector employment.

More recently a range of indicators signal that Ireland is completing its EU-IMF supported program with the potential for a more sustained recovery.

44. **Significant risks to Ireland's growth prospects and to debt sustainability remain nonetheless, requiring concerted policy implementation progress**. Setbacks to the recoveries in major trading partners would hurt exports, with adverse effects on confidence and domestic demand. Sustaining a recovery into the medium term will increasingly depend on a revival of lending to households and SMEs, which would be at risk if banks fail to address high nonperforming loans and weak profitability. High nonperforming loans imply that contingent liabilities in the financial sector remain a risk to debt sustainability and these risks rise in an environment of weak growth owing to declining loan performance and collateral values. Accordingly, as recognized by the authorities' ongoing preparation of a Medium Term Economic Strategy, Ireland must maintain determined efforts to address its high public debt and deficit levels, heavy private sector debt burdens, financial sector repair needs, and substantial long-term unemployment before it can be judged to have fully recovered from the crisis.

45. **Steady fiscal consolidation, which has been a hallmark of the program and key to restoring Ireland's policy credibility, needs to continue**. Budget execution has once more been solid in 2013, including the smooth introduction of the local property tax and the social cohesion demonstrated by reaching the Haddington Road agreement on public sector pay and pensions. Budget 2014 sets out a path with a balanced pace of adjustment in coming years that is expected to put public debt on a declining trajectory, though subject to risks from growth prospects and contingent liabilities. Continued sound implementation of fiscal consolidation will be especially critical after the completion of the program. Looking to the medium term, the further consolidation needed should be centered on reforms of health, education, and social protection spending that realize durable savings while protecting core services and the most vulnerable. Revenue increases should focus on broadening the tax base.

46. **Intensified efforts are needed to reach the goal of largely completing sustainable solutions for mortgage arrears by end 2014**. Although the rise in mortgage arrears appears to be slowing, the stock of distressed mortgages remains unacceptably high. The initiation of operations by the Insolvency Service is a welcome step to create new resolution options and establish useful precedents for solutions. Banks report they are meeting CBI targets for proposing solutions, yet there are concerns that a portion will not prove sustainable. Moreover, after a prolonged period of forbearance, restarting the engagement between banks and borrowers needed to conclude solutions is proving difficult. Making progress will involve both providing supervisory guidance to ensure that banks adjust their solutions to address household's circumstances in a lasting manner, while also providing households and buy-to-let investors with appropriate information and incentives to engage. In particular, timely and predictable repossession procedures are needed to help promote engagement on loan modifications and also help ensure that such modifications can provide lasting resolution at manageable cost. For cases where retaining ownership is not sustainable, enhanced support to facilitate mortgage to rent and other solutions that contain social costs is appropriate.

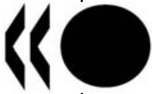
47. **The quantitative and qualitative findings of the bank BSA should inform the CBI's supervisory work and banks' preparations for the ECB's upcoming Comprehensive Assessment**. The Balance Sheet Assessment independently assessed loan classification, quantified incurred loan losses, and reviewed risk weights. It is vital that the CBI ensures that banks increase provisioning for some portfolios in line with the findings of the assessment, which will also improve incentives for loan workout. Nonetheless, uncertainties remain, including owing to the limited experience with loan resolution in Ireland and also with respect to the potential findings of a forward-looking assessment of profitability and loan losses. Given Ireland's still fragile debt sustainability, an ESM direct recapitalization backstop to the ECB's Comprehensive Assessment would be desirable to protect market confidence and financial stability.

48. **Reviving lending in coming years remains important to sustain a recovery in domestic demand, where external support could play a critical role**. Encouragingly, the two larger domestic banks appear to be returning to the profitability needed to support lending, although risks remain to their profitability prospects. However, PTSB is not expected to break even after provisioning expenses until 2017 given its heavy exposure to tracker mortgages, limiting its potential to rebuild its market position and attract private investment. With other banking systems in the euro area also facing challenges that hinder credit expansion, a European solution to better align bank funding costs with official interest rates would facilitate recovery in the euro area as well as Ireland.

49. **Reducing high unemployment must remain an overarching policy priority**. Initiatives to promote credit to SMEs, with the support of European partners, are positive for investment and job creation. Yet it is also important to ensure SMEs are creditworthy through banks completing resolution of SME loans in arrears and also by facilitating SME restructuring where needed, including by considering further streamlining the role of courts in SME examinership. Efforts to strengthen employment services for jobseekers should continue in order to achieve adequate engagement, with further redeployment of staff needed in addition to bringing in private sector providers. Timely initiatives to achieve the strategic priorities set out in the review of Further Education and Training are critical to better align training with the needs of the economy and especially to ensure the long-term unemployed gain skills enabling them to return to work.

50. **On the basis of the progress made under Ireland's program, staff supports the authorities' request for completion of the twelfth review**. Staff also recommends that Ireland be brought back to the standard 12-month consultation cycle for Article IV consultations upon expiration of the Extended Arrangement. In accordance with Executive Board Decision No. 14747(10/96), Ireland shall be placed on a 12-month consultation cycle because it currently has an outstanding Fund credit exceeding 200 percent of quota. In light of the amount of the outstanding credit, and given that the authorities have decided not to request a successor arrangement from the Fund, the Managing Director also recommends the initiation of post-program monitoring.

**Unclassified** **ECO/WKP(2006)20**



Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

**09-Jun-2006**

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**ECONOMICS DEPARTMENT**

**ECO/WKP(2006)20**
**Unclassified**

# IRELAND'S HOUSING BOOM: WHAT HAS DRIVEN IT AND HAVE PRICES OVERSHOT?

## ECONOMICS DEPARTMENT WORKING PAPER No. 492

**By**
**David Rae and Paul van den Noord**

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**Abstract**

**Ireland's housing boom: what has driven it and have prices overshot?**

The Irish housing market is very buoyant. The housing boom is driven by strong economic growth, dynamic demographics and low interest rates. However, large tax advantages and relatively lenient credit policies by banks have also played their part, and prices may have become overvalued. To the extent that high house prices reflect favourable tax treatment, they may lead to economic inefficiencies by drawing excessive resources into residential construction. While a soft landing appears the most likely prospect, a disorderly correction of house prices would pose risks for macroeconomic and possibly financial stability. In this context, one policy lever available to the government would be a phased removal of the tax advantages associated with housing. In addition, banks should remain cautious in their lending and provisioning policies.

This paper relates to the 2006 Economic Survey of Ireland (www.oecd.org/eco/surveys/ireland).

JEL classification: E2; R21; R31.

Key words: House prices; housing market; residential construction; property tax.

* * * * *

**Résumé**

**L'envolée du marché irlandais du logement**

Le marché de l'immobilier est très dynamique en Irlande. L'essor du logement s'explique par la forte croissance économique, la dynamique démographique et la faiblesse des taux d'intérêt. Cependant, les importants avantages fiscaux et les politiques de crédit relativement libérales des banques ont aussi joué leur rôle et les prix sont désormais peut-être surévalués. Dans la mesure où les prix élevés de l'immobilier reflètent un régime fiscal favorable, ils peuvent conduire à des inefficiences économiques en attirant des ressources excessives dans la construction résidentielle. Tandis qu'un atterrissage en douceur apparaît très probable, une correction désordonnée de ces prix ferait peser des risques sur la stabilité macroéconomique, voire financière. Dans ce contexte, un des leviers d'action à la disposition des autorités serait une suppression graduée des avantages fiscaux associés au logement. En outre, les banques devraient être incitées à faire preuve de prudence dans leurs politiques de prêt et de provisionnement.

Ce document de travail se rapporte à l'Étude économique de l'Irlande 2006 (www.oecd.org/eco/études/irlande).

Classification JEL : E2 ; R21 ; R31.

Mots clés : Immobilier ; marché du logement ; construction résidentielle ; taxe foncière.

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# Ireland's housing boom: what has driven it and have prices overshot?

by David Rae and Paul van den Noord[1]

House prices across the industrialised world have surged since the mid-1990s – with the notable exceptions of Germany and Japan which are both still grappling with the aftermath of real estate busts in the early 1990s. In many countries, housing demand is underpinned by an easy monetary stance (Otrok and Terrones, 2005), while over a longer period tight zoning regulations have exacerbated the upward movement in property prices in and around growth centres (Glaeser *et al.*, 2005). Yet Ireland stands out by its extraordinarily strong increase in house prices over the past decade. It is important to understand what has been driving this increase in order to judge the likelihood, timing and size of any fall. A sharp decline in house prices would be a concern for homeowners and could have serious consequences for macroeconomic and financial stability. Meanwhile, the booming market combined with the tax treatment of housing may be impacting on the economy's productive potential by diverting a large amount of resources into residential construction. It may also be acting as a brake on labour supply by making it more expensive for people to immigrate and settle in the country.

This paper argues that *most* of the increase in Irish house prices is justified by the economic and demographic driving forces. It should be remembered that in 1993 the average Irish house cost a mere €75 000, which was extraordinarily low for a European country. Since then, remarkable growth in incomes, low interest rates, strong population growth, especially among the younger house-forming age groups, a surge in immigration and changing living patterns have all contributed to the boom. However, prices have probably over-shot to some extent, and taxation may have contributed to fuelling the speculative boom. Looking ahead, the most likely scenario is that prices stabilise and the housing market stays flat for some years. But there is some risk that house prices will fall, and the market is certainly exposed should the economy be hit by a negative shock. This chapter looks at the past and the future of the housing market and discusses the role that policy can play going forward.

## Forces driving the housing market

Ireland's house prices have risen dramatically since the mid-1990s. From 1995 to 2005 the price of second-hand houses more than tripled in real terms (Figure 1, left panel). House price inflation eased temporarily in 2001 but it has reignited since. Compared with other countries, the Irish housing boom has been extraordinarily vigorous: both in real and nominal terms the increase in house prices since the mid-1990s has been the highest in the OECD, with the United Kingdom and Spain ranking second and third respectively.

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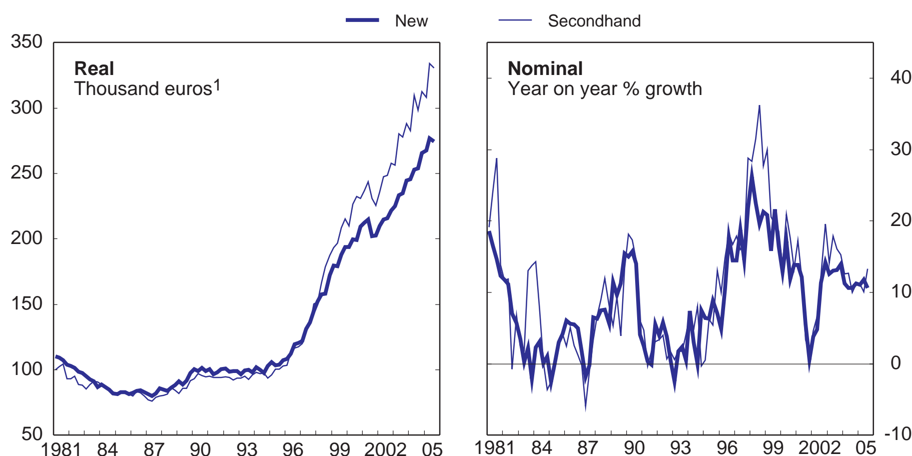
1. This paper was originally prepared for the *OECD Economic Survey of Ireland* published in March 2006 on the responsibility of the Economic and Development Review Committee. The authors are grateful to colleagues in the OECD for their helpful comments, especially Boris Cournède, Peter Hoeller, Andrew Dean and Val Koromzay. Special thanks go to Desney Erb for her technical assistance. The authors can be contacted at david.rae@oecd.org and paul.vandennoord@oecd.org.

**Figure 1. House price growth remains high**




1. Nominal prices deflated using the harmonised consumer price index (base 2005).

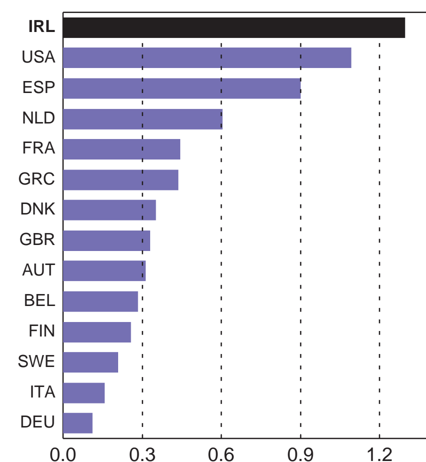
*Source*: Department of the Environment, Heritage and Local Government, *Quarterly Housing Statistics* and OECD, Main Economic Indicators database, May 2006.

More favourable demand factors in comparison with developments elsewhere have surely played a role in shaping the buoyant price developments in Ireland. Growth in real disposable income since the mid-1990s has been stronger than in any other industrial country and real interest rates were among the lowest (Figure 2). The decline in inflation has also contributed by front-loading mortgage repayments. Furthermore, demographic trends were particularly favourable to housing demand in the 1990s, including strong population growth, a sharp fall in household size from a high level, a rapid acceleration in the growth of population in the household formation cohort and sizeable net immigration. Other demographic developments include the increase in the number of double income households and higher divorce rates. Another factor is the number of baby boomers investing in the buy-to-let market because of increasing worries about inadequate pension provisions for retirement.

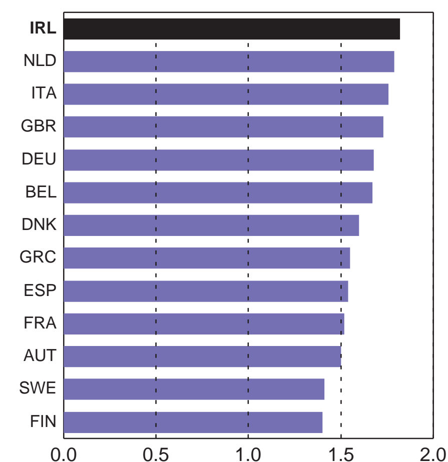
In addition, the tax treatment of housing in Ireland has been more favourable for home ownership than in most other EU countries (van den Noord, 2005). This is reflected in a low user cost of capital. The user cost for homeowners is analogous to the cost of rental accommodation for tenants. It includes the after-tax mortgage interest rate net of capital gains, the opportunity cost associated with equity financing (usually the after-tax deposit rate), property tax (if any) and depreciation. There have been extended periods when the user cost has been negative, in particular in the late-1970s and from the mid-1990s onwards, implying a strong incentive to invest in housing.[1] The main driving factor keeping the user cost negative has been the untaxed capital gains (on owner-occupied homes), whereas the importance of income tax deductions has diminished with the gradual decline in marginal income tax rates and a series of other tax reforms (Box 1). Since taxation of capital gains has an important negative influence on the user cost, its absence could have acted as a catalyst for the upward spiral in house prices.

**Figure 2. Forces shaping house prices**

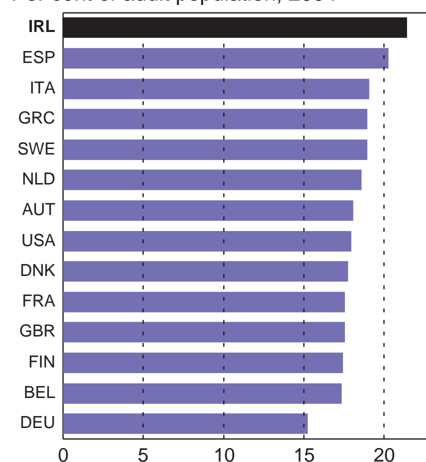
**Population growth**
Per cent, average 1996-2004



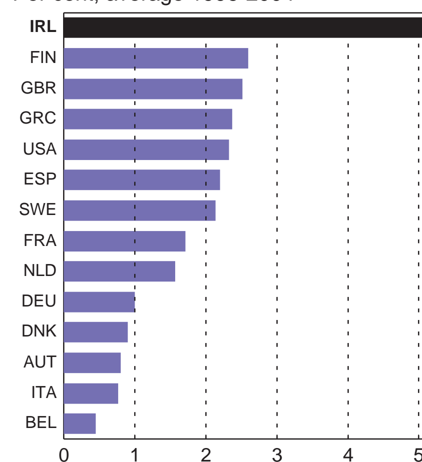

**Adult population per dwelling**[1]
Persons, 2004[2]




**Population at household formation age (25-34)**
Per cent of adult population, 2004[1]




**Growth in real disposable household income per capita**
Per cent, average 1996-2004




1. Adult population covers persons from age 20 onwards.
2. 2003 for Austria, Finland, France, Greece and Italy.

*Source*: OECD (2005), Labour Force Statistics and Economic Outlook 78 databases; European Mortgage Federation (2005), *Hypostat 2004*.

**Box 1. Tax breaks for housing and policy flip-flops**

Ireland has some of the most generous tax provisions for owner-occupied housing, largely because it is the only OECD country that allows households a tax deduction for mortgage interest payments at the same time as *not* taxing property values, capital gains or imputed rent (Barham, 2004 and van den Noord, 2005).[1] The following provisions are the most important ones:

- Ireland introduced a residential property tax in April 1983. The rate was 1½ per cent for properties above a certain value and where the owner's income exceeded a certain rate. The 1994 Budget adjusted these price and income thresholds, but those measures were scrapped in the following budget, with a return to the previous system. The property tax was abolished altogether two years later. A private residence of up to one acre is exempt from capital gains tax, which is large enough to cover virtually all houses.

- Mortgage interest can be deducted against income tax. Prior to 1974 there was no limit as the full cost of mortgage interest could be deducted at the marginal tax rate. A ceiling was introduced in 1974 and increased on two occasions, in 1993 and 2003. Both these increases followed prolonged periods in which interest repayments normally exceeded the ceiling. Mortgage interest relief was phased in at the standard rate of tax (as opposed to the marginal rate) in 1994. This saw a reduction in the benefit accruing to homeowners with the deductibility rate falling from 48% in 1993 to 26% in 1997. Meanwhile, the imputed rental income is not taxed, unlike rental income to a third party.

- A package of tax measures was introduced in 1998 in an attempt to deflate what appeared to be a housing bubble. Stamp duty on new houses that were not owner-occupied was increased, while stamp duty on second-hand houses was reduced; capital gains tax on disposals of qualified residential land was reduced; and tax breaks for rental income were removed. These were successful in stopping house price inflation – possibly too successful, as they were reversed in the 2002 Budget. Meanwhile, another package of measures was introduced in 2000 in order to discourage investors from buying rental property. This included a 9% stamp duty on the purchase of property for rent. That also worked but had the predictable side effect of driving up rents, so it was abolished just a year later. Stamp duty was changed again in the 2005 Budget, this time lowering the tax for first-time buyers.

1. Finland, Portugal and Spain are the only other countries which, like Ireland, give a tax deduction for mortgage interest payments but do not tax imputed rent or capital gains on the principal owner-occupied dwelling. However, all three have municipal taxes on property values ranging from 0.4% to 1%. The size of the tax bias in Ireland has been reduced over time as the ceiling on mortgage interest deductibility has not kept pace with the increase in house prices. Updating the estimates by van den Noord (2005) shows an overall tax wedge of –0.57% for the first seven years and –0.36% thereafter, giving Ireland the fifth-largest tax bias in the EU15.

Access to mortgage finance is also less restrictive in Ireland than elsewhere, especially compared with continental Europe (Table 1). Financial market liberalisation during the 1980s and 1990s has supported demand by allowing a rapid expansion in credit. The full effects of liberalisation were beginning to be felt in the mid-1990s, just at the time when housing demand was growing fast. Loan-to-value ratios have risen from an average level of 60% in the 1980s to around 80% at present. The trend towards securitisation of bank loans is another factor. In general, securitisation makes interest rates on new borrowing more responsive to financial market developments. It also enhances competition, which lowers the costs of taking out a mortgage and makes it easier for households to access their capital through housing equity withdrawals (Catte *et al.*, 2004). The adoption of the euro has been another important influence in helping to increase the elasticity of supply of mortgages. The exchange rate risk disappeared, removing one of the obstacles to the freer flow of funds within the euro area. This means that the domestically-based Irish banks have a hugely expanded pool of funds available. The removal of the exchange rate risk premium, by lowering interest rates, has also acted to stimulate demand for mortgages. Finally, most mortgages in Ireland are variable rate loans, so the reduction in short-term interest rates (until recently) has further boosted demand.

**Table 1. Mortgage and housing market indicators**

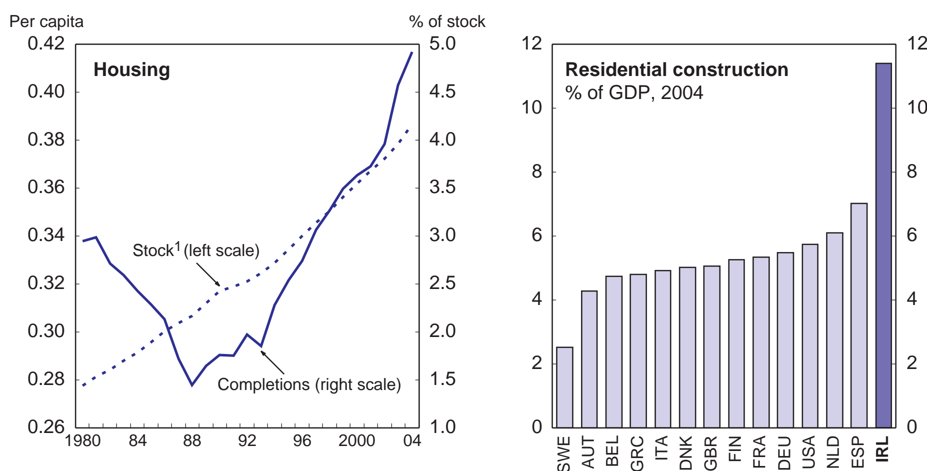
| | Residential mortgage debt (% of disposable income, 2003)[1] | Typical loan-to-value ratios of new loans (%) | Typical loan term (years) | Variable interest rates (% of all loans, 2002)[2] | Securitisation of mortgages | Home ownership rate (%, 2002)[2] |
|---|---|---|---|---|---|---|
| **Ireland** | **106** | **70-100** | **20** | **85** | **Limited** | **77** |
| Australia | 120 | 90-100 | 25 | 73 | Yes | 70 |
| Austria | .. | .. | 20-30 | .. | .. | 56 |
| Canada | 77 | 70-80 | 25 | 25 | Yes | 66 |
| Denmark | 188 | 80 | 30 | 15 | Yes | 51 |
| Finland | 71 | 75-80 | 15-18 | 97 | Limited | 58 |
| France | 40 | 80 | 15 | 20 | Limited | 55 |
| Germany | 83 | 70-80 | 25-30 | 72 | Limited | 42 |
| Italy | 20 | 50 | 15 | 56 | No | 80 |
| Japan | 58 | 80 | 25-30 | .. | No | 60 |
| Netherlands | 208 | 87 | 30 | 15 | Yes | 53 |
| New Zealand | 129 | .. | .. | .. | .. | 65 |
| Norway | 24 | 70 | 15-20 | .. | No | 77 |
| Portugal | 33 | .. | 15 | .. | .. | 64 |
| Spain | 67 | .. | 15 | 75 | Yes | 85 |
| Sweden | 98 | 80-90 | <30 | 38 | Limited | 61 |
| United Kingdom | 105 | 75 | 25 | 72 | Yes | 69 |
| United States | 78 | 80 | 30 | 33 | Yes | 68 |

1. 2002 for Norway and Portugal, 2005 estimate for Ireland.
2. Or latest year available.

*Source:* OECD (2005), *OECD Economic Outlook*, No. 78, Paris; OECD (2004), *OECD Economic Outlook*, No. 75, Paris, June; Tsatsaronis, K. and H. Zhu (2004), “What Drives Housing Price Dynamics: Cross Country Evidence”, *BIS Quarterly Review*, Bank for International Settlements, Basel, March; Ahearne, A.G. *et al.* (2005), "House Prices and Monetary Policy: A Cross-Country Study", *International Finance Discussion Papers*, No. 841, Board of Governors of the Federal Reserve System, September; Central Bank and Financial Services Authority of Ireland.

The rise in housing demand triggered a strong response in supply, which again is unprecedented by international standards (Figure 3). House construction and residential permits per capita are among the highest in the OECD. Around a third of the housing stock is younger than ten years old. Half of the stock is detached houses, with apartments accounting for just 6%. The enormous increase in housing supply was accompanied by significant increases in real construction costs and land prices. The significant cost increases did not deter the supply of housing, which was aided by more relaxed zoning rules. Yet, despite the massive increase in the housing stock, it will almost certainly increase further in the medium term (even ignoring the effect of population growth) given that in Ireland there are significantly more adults per dwelling than in other OECD countries. If preferences in Ireland were similar to those in other EU countries, this would, *ceteris paribus,* lead to falling numbers of (adult) persons per dwelling. This gap has undoubtedly been a factor in the buoyant demand for housing and a driving force behind the escalation of house prices, and is likely to act for several more years. Indeed, the high cost of accommodation in Ireland may be discouraging people from forming an independent household (Fitz Gerald, 2005).

**Figure 3. Residential construction is booming**




1. OECD estimate of stock of permanent dwellings, end of year.

*Source*: Department of the Environment, Heritage and Local Government (2005), *Annual Housing Statistics, Bulletin 2004*, The Stationery Office, Dublin and OECD (2005), Economic Outlook 78 database.

## Are house prices overvalued?

The question of whether the fundamentals can fully explain the Irish housing boom can be addressed by different methods. One approach is to use an econometric model and see if house prices deviate from their long-term equilibrium level. Another is to treat housing as an asset that reflects the discounted present value of its future earnings. However, these indicators need to be complemented by other evidence such as price-to-rent ratios, measures of affordability and benchmarking against other countries. A range of evidence is discussed below.

### *An econometric model of house prices*

Econometric models can be used to estimate the "fundamental" price, as determined by demand factors, such as real disposable income and real interest rates, and supply factors. A price level in excess of the fundamental price could be a sign that prices are inconsistent with demand and supply conditions and instead may be driven by irrational expectations of future capital gains. In such a house price bubble, home buyers consider that a house that would normally be too expensive for them (or much more expensive than renting) is worth buying because they will be compensated by significant further price increases (Meen, 2000 and Case and Shiller, 2003).

After tracking each other closely for many years, the prices of new and second-hand houses began to diverge in the mid-1990s. Since 1995, average second-hand house prices have risen by around 340%, compared with 240% for new houses. The different trajectories are not surprising as the two types of housing are not perfect substitutes (for example, the average new house is smaller and further from the city centre) and the supply of new houses can expand more rapidly than existing dwellings, the supply of which is less elastic. Because the markets are so closely related but are not perfect substitutes, the prices of new

and second-hand houses are modelled together in a joint estimation framework based on a cointegration error-correction approach. Long-run or equilibrium prices are assumed to depend on real per capita disposable income, *y*, the real after-mortgage interest rate, *r*, and the stock of each type of dwelling, *H*. The basic estimation framework is shown below:

$$p_t^{sh} / p_t^c = \alpha_1 + \beta_1 y_t - \gamma_1 r_t - \theta_1 \left(h_t^{sh} - pop_t^{25-44}\right) + \lambda_1 \left(pop_t^{25-44} / pop_t\right).$$

$$p_t^{new} / p_t^c = \alpha_2 + \beta_2 y_t - \gamma_2 r_t - \theta_2 \left(h_t^{new} - pop_t^{25-44}\right) + \lambda_2 \left(pop_t^{25-44} / pop_t\right).$$

where lower case letters denote natural logarithms, $p^n$ is the price of new houses, $p^{sh}$ is the price of second-hand houses and $p^c$ stands for consumer prices, here measured by the core harmonised consumer price index (HICP; excluding food and energy). The housing stock, $h_t$, is based on a cumulation of housing completions net of depreciation (see Box 2 for a more precise description of the variables). In the estimation described below, the stock of new dwellings was not found to be a statistically significant determinant of the price of new dwellings, and therefore was dropped from the estimation. To some extent this is not surprising as supply is fairly elastic. The demographic variable (the share of the population that is around the household-formation age) is included to capture the hypothesis that a younger population is likely to put extra pressure on the housing market.

The two equations are estimated on quarterly data from 1977 to 2004 using the Seemingly Unrelated Regressions (SUR) estimator. Short-run error correction models are then estimated, again using SUR. The final results from the system are:

***Second-hand house prices: long run***

$$p_t^{sh} / p_t^c = \underset{(3.88)}{6.811} + \underset{(48.4)}{1.6883}\, y_t - \underset{(9.16)}{1.9289}\, r_t - \underset{(6.63)}{1.6785}\left(h_t^{sh} - pop_t^{25-44}\right) + \underset{(6.36)}{2.9862}\left(pop_t^{25-44} / pop_t\right)$$

***New prices: long run***

$$p_t^n / p_t^c = -\underset{(10.4)}{2.6130} + \underset{(57.6)}{1.5279}\, y_t - \underset{(14.8)}{2.0471}\, r_t$$

***Second-hand prices: short run***

$$\Delta\left(p_t^{sh} / p_t^c\right) = \underset{(0.16)}{0.0119}\Delta\left(p_t^{sh} / p_t^c\right)_{t-1} + \underset{(1.58)}{0.1127}\Delta\left(p_t^{sh} / p_t^c\right)_{t-2} + \underset{(3.47)}{0.2517}\Delta\left(p_t^{sh} / p_t^c\right)_{t-3}$$

$$+ \underset{(5.76)}{0.9916}\Delta y_t + \underset{(2.13)}{0.4052}\Delta y_{t-4}$$

$$- \underset{(6.405)}{0.4817} ECM_{t-1} + \underset{(4.37)}{0.3382} ECM_{t-1}^{new\ prices} + \underset{(3.35)}{0.0403} DUM$$

$$R^2 = 0.5127; \quad s.e. = 0.0238; \quad DW = 1.75$$

***New prices: short run***

$$\Delta\left(p_t^n / p_t^c\right) = \underset{(2.21)}{0.1584}\Delta\left(p_t^n / p_t^c\right)_{t-3} + \underset{(2.56)}{0.1939}\Delta\left(p_t^n / p_t^c\right)_{t-6} + \underset{(5.57)}{0.7948}\Delta y_t + \underset{(2.74)}{0.4171}\Delta y_{t-4}$$

$$- \underset{(2.82)}{0.1708} ECM_{t-1}^{negative} - \underset{(1.03)}{0.0598} ECM_{t-1}^{pos} - \underset{(1.11)}{0.00326} + \underset{(4.14)}{0.0408} DUM$$

$$R^2 = 0.4927; \quad s.e. = 0.0199; \quad DW = 1.81$$

The main findings are that:

- The long-run income elasticity is estimated to be 1.5 for new houses and 1.7 for second-hand houses. Both estimates are higher than the ones estimated by Fitz Gerald *et al.* (2003) and IMF (2004), which are 1.07 (for new houses) and 1.20 (for a weighted-average of new and second-hand houses) respectively. The demographic variable affects second-hand house prices in the expected way, but is not significant in the equation for new houses.
- The interest rate semi-elasticity is around –2.0 in both cases. This also is larger than estimates in other recent studies.
- The per capita housing stock has a significant negative impact on the price of second-hand houses.
- The short-run income elasticities are high in both equations, meaning that prices respond quickly to changes in household incomes.
- For new house prices, the error-correction coefficient is asymmetric. It implies that house prices rise more easily than they fall. More precisely, negative disequilibria (prices below fundamentals) tend to be corrected by a subsequent increase in prices. In contrast, if prices are above fundamentals they tend not to drop but to "wait for fundamentals to catch up" (see O'Donovan and Rae, 1997, for evidence of a similar effect in New Zealand).
- The error-correction coefficient for new house prices enters the equation for second-hand house prices with a positive sign. This means that disequilibrium in the market for new houses spills over into the market for second-hand houses.
- A dummy variable (DUM) was included to capture a confidence crisis in 2001 associated with the announced (but rapidly withdrawn) introduction of a flat-rate 9% stamp duty (to replace the existing progressive rate schedule with a top rate of 9%) and a 2% anti-speculative property tax. The coefficient implies that the policy change led to a temporary fall in house price inflation by around 10 percentage points, although it may also be picking up other factors such as the hit to confidence coming from the bursting of the high-tech bubble.
- In terms of the statistical properties of the equations: *a)* the fit is relatively good for such a volatile variable, with a standard error around 2% in both equations; *b)* the error-correction coefficients are relatively large and statistically significant, implying that the long run equations are cointegrated (this is confirmed by a direct ADF test of the residuals from the long-run equations); *c)* there are no signs of mis-specification from residual tests of autocorrelation, heteroscedasticity and non-normality; and *d)* the coefficient estimates are relatively stable over time.

**Box 2. Description of the data**

House prices are average sales prices recorded by the Department of Heritage and Local Government. They are not adjusted for quality or composition (an alternative quality adjusted index is constructed by TSB Permanent Bank but this starts only in 1996). They are deflated by the core HICP (HICP excluding food and energy). Series for the stock of dwellings and pre-tax mortgage interest rates have been provided by the Economic and Social Research Institute (ESRI). The total dwelling stock is based on summing up dwelling completion figures, adjusting for depreciation and benchmarking to census estimates in 1991, 1996 and 2002. This is split between new and second-hand houses as follows. The stock of new houses is estimated by summing completions (less depreciation) and assuming that 15% of new houses "fall" from the new to the second-hand market each year. That is, the half-life of a new house before it becomes part of the "established" or second-hand stock is approximately 4-5 years. The stock of second-hand houses is equal to the total stock (as estimated by ESRI) minus the new stock. The after-tax mortgage interest rate has been computed as the pre-tax mortgage interest rate multiplied by one minus the relevant marginal income tax rates as published in Barham (2004). The real after-tax rate is the nominal after-tax rate minus the core HICP inflation rate. Real disposable household income is taken from the OECD Economic Outlook database. Demographic variables (population by age) are from the Central Statistics Office.

An extended three-equation model was also tested. This had an additional equation for dwelling investment because the housing stock is likely to be an endogenous variable, and in particular to be a function of house prices. The additional equation did not materially alter the estimates in the house price equations so the results are not reported here (available on request from the authors).

Actual and fitted values are shown in Figure 4. The long-run equation can be used to estimate the fundamental price levels. The result, shown in Figure 5, suggests that house prices have been above their fundamental level since early 2003. By the end of 2004, given interest rates prevailing at that time, second-hand house prices were around 10% overvalued and new house prices around 20% higher than their fundamental level. If long-term interest rates were to return to a more reasonable estimate of their long run level (*i.e.* 2 percentage points higher than at the end of 2004) then the overvaluation would be 16% and 26% respectively.

In sum, the model and similar econometric estimates suggest that prices have overshot their fundamental value. It is worth noting, however, that around 80 to 90% of the increase in house prices since 1995 is justified by the fundamentals – rising incomes, lower interest rates, demographic factors, etc. The remainder appears to be speculative froth. All econometric models are subject to considerable uncertainty, due to modelling error, omitted variable bias and so forth, but the estimate from this model is broadly consistent with a similar analysis conducted by the IMF (2004). Some alternative econometric models presented in the Irish Central Bank's *Financial Stability Report 2005* show an estimated over-valuation ranging from essentially zero to more than 70%, highlighting that it is necessary to look at more than one indicator and to make judgements about which indicators may be more reliable than others. Alternative evidence is discussed below.

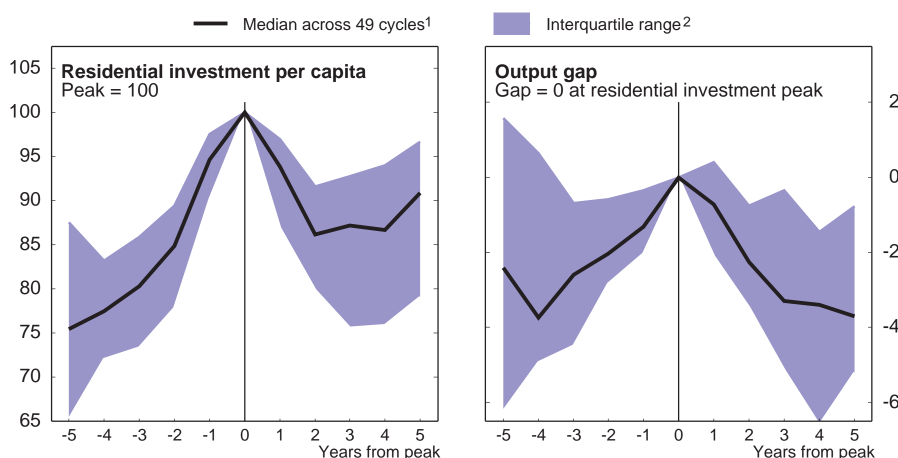
**Box 3. Has residential construction ever had a soft landing?**

Residential investment is characterised by a pronounced boom-bust cycle. This box looks at how often a construction boom has been followed not by a slump but by a soft landing.

Between 1960 and 2004, 49 residential construction booms have occurred in 23 countries for which data is available. A boom is defined (rather generously) as a rise in the level of real per capita residential investment of at least 15% over a five-year period. In order to avoid identifying false peaks and data blips, a peak is defined as the highest point in a window of the preceding four years and the subsequent three years. By construction, the latest peak that can be identified is 2002; the analysis therefore omits the housing booms that are currently underway. In the cycles that have been identified, the average increase in real per capita residential investment from trough to peak is around 40%. The largest occurred in Korea from 1973 to 1978 (where investment rose by 160%). The trough-to-peak increase has exceeded 50% in 16 cases.

The downturn that follows is usually rapid. On average in the first year after the peak, 40% of the increase during the trough-to-peak upswing is reversed, with another 40% lost in the second year (Figure 11). Investment stabilises at that level for two years, before beginning to recover about five years after the peak.

**Figure 11. Has there ever been a soft landing?**




1. In each cycle, real per capita residential investment is scaled so that the peak equals 100.
2. The shaded area shows the middle two quartiles (*i.e.* half the countries fall in this range).

*Source*: OECD (2005), Economic Outlook 78 database.

How common are soft landings? If a soft landing is defined as a relatively small reduction in the investment rate, they are not especially common. There have been only four cases where the decline in per capita residential investment has been smaller than one-third of the increase that occurred during the boom years (these are the Netherlands after 1978, Belgium after 1990, the United Kingdom after 1998 and Finland after 2000). Soft landings are more common if they are defined as *gradual* declines, *i.e.* where it takes at least three years to hit the trough. There have been around 20 examples of these. But all of these were comparatively deep declines. If a soft landing is defined as something that is *both mild and gradual*, there has not been a single case out of the 49 boom-bust cycles.

It is also revealing to look at the behaviour of monetary policy before and after the construction peaks. Of the 34 booms for which there is also data on short-term interest rates, monetary policy tightened before the investment peak in only a little over half of all cases. Thus, there appear to be factors other than a tightening of monetary policy that have been responsible for many of the downturns.

Stress testing by the central bank suggests that the banking system has adequate capacity to absorb a modest fall in residential construction and house prices. However, it is more exposed to a negative shock that reduces residential and commercial property prices simultaneously as more than half of the banking sector's loan book relates to property. Hence, it would be worthwhile for banks to err on the side of caution. Loan provisions are currently in line with international norms, despite Ireland's financial risks possibly being higher than in other countries.[4]

### *Longer-term economic efficiency*

Aside from the question of whether house prices are currently overvalued, there are also issues of longer-term welfare related to the housing market. Given the high price level, the share of the average household budget that is spent on housing is high by international standards. This suggests there may be over-investment in housing and a corresponding under-investment in more productive assets.

The scarcity of accommodation in Ireland is partly a matter of misallocation of resources. To the extent that the increased stock of dwellings is absorbed as secondary or vacant dwellings, there are fewer dwellings available to meet the rise in the number of households driven by the changing age structure of the population. This has also put pressure on the resources of the building industry. Moreover, as noted by Fitz Gerald (2005) the high demand for secondary homes makes it more expensive for individuals to live and run businesses in the regions. The provision of the necessary infrastructure for new dwellings, such as sewerage and water connections, is very expensive, especially in urban areas. Where such dwellings are held vacant for investment purposes,[5] there is not an occupier to generate tax revenues to help defray the costs. Moreover, the government's social housing policy may be putting undue pressure on property prices (Box 4).

**Box 4. Housing support may not be provided in the most cost-effective way**

The government has substantially increased expenditure on housing support for people on low incomes. In 2004, public social expenditure on housing was more than 1½ per cent of national income – around four times the OECD average. It is unclear whether this money is well spent. There are around 15 different schemes but the government appears to have a strong preference for encouraging home ownership rather than providing rent assistance (Fahey, 2004). In 2004, only 16% of total expenditure went towards rent subsidies (housing benefits); approximately two-thirds went to capital expenditure, especially the construction and maintenance of local authority housing. Local authorities rent out 107 000 units at an average rent of just € 32 per week, so it is no surprise that there is a long waiting list for such housing. Expenditure on social and affordable housing schemes in 2004 amounted to € 1.88 billion and benefited 12 145 households. This subsidy is therefore equivalent to € 155 000 per household. Instead of building new houses for these families, that sum could cover all their rent for 10 to 15 years depending on the type and location of the rental accommodation. In its latest attempt to encourage home ownership, the government announced in 2005 that a further 10 000 houses would be built under its Affordable Housing scheme. People who would otherwise have to spend more than 35% of their net disposable income on a mortgage can apply to buy one of 10 000 new houses at up to a third off market value. The scheme is income tested, and is available to households earning up to around 130% of the average wage. This is in addition to the tenant purchase scheme under which social housing tenants can buy their properties at a considerable discount.

Policy needs to shift to a more tenure-neutral stance. The private rental sector, which currently is small by European standards, could expand if the government shifted more resources towards rent assistance instead of constructing houses and selling them or renting them and controlling the system through queues. Constructing houses and selling them at a low price seems especially ineffective as government assistance only takes into account a household's current, but not permanent income. It has aspects of a lottery, and its irreversibility makes it impossible to adapt to changes in situation or to households' often transitory needs. It is also a high-cost measure, so that less is available for lower cost, but more effective measures. Subsidising low-rent housing, while not suffering from irreversibility to the same extent, still often does not cater to the poorest households as it can be difficult to dislodge renters whose incomes have risen above the threshold for being placed in a low-rent flat. In addition, the owners of social housing parks usually have little incentive to maintain the property. Providing assistance by a housing benefit or housing vouchers would be entirely tenure neutral if households were free to use their means-tested benefits to cover rent or a mortgage. Means-tested housing benefits necessarily increase marginal effective tax rates on low-income earners but Ireland has relatively low marginal rates (at least on first earners) and therefore has more scope than most countries to deliver its housing policy through the income support system and let households make their own choices about whether to own or rent from the private or social sectors.

Furthermore, the level of house prices could reduce the growth potential of the economy by discouraging potential migrants, shifting the balance of labour market growth from employment to wages, with a consequent deterioration in competitiveness. Rises in house prices lead to unambiguous welfare gains for current home owners while immigrants, first time buyers and those with lower labour market skills miss out.

***Tax policy issues***

Some landowners are reaping large capital gains as a result of the major investment in infrastructure by the state and the rezoning of land for development. It would be appropriate for part of this windfall to be siphoned off by taxation to partly fund the infrastructure investment that creates the gain in the first place. The higher development levies that have been implemented go some way in this direction but they do not affect existing home owners. In contrast, the state is intervening in a number of different ways to encourage demand for housing, thereby pushing up the price. The tax relief on mortgage payments and the under-pricing of infrastructure encourage higher demand and higher prices, especially for land. Restrictive zoning, while popular with existing suburban residents, fuels an artificial shortage and encourages urban sprawl. Hence there is a strong argument for a property tax. But this has so far proved unacceptable to the public. As a softer alternative, some have advocated a property tax on vacant or second dwellings only (Fitz Gerald, 2005). This would help defray infrastructure costs, reduce demand and therefore reduce price pressures, thereby enhancing the productive potential of the wider economy. A very important side effect is that it would reduce the share of this potentially most volatile element in the housing stock.

**Box 5. Summary of recommendations**

- Phase out the strong bias towards housing that is embedded in the tax system. For example, mortgage interest should not be tax deductible unless a tax on imputed rental incomes or a broader capital gains tax is introduced.
- Introduce a property tax in order to fund local infrastructure and services, and as a way of redistributing some of the windfall gains that accrue to people living close to new roads and public transport links.
- Encourage banks to be sufficiently prudent in their lending and loan-loss provisioning practices.
- Social housing policy should become more tenure-neutral by scaling back house building and providing more by way of income support and/or housing vouchers.

Relationship with and oversight by international stakeholders

# LINE OF INQUIRY: R6b

Quality and effectiveness of European policies and regulations

I

*(Acts whose publication is obligatory)*

# DIRECTIVE 2006/48/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

## of 14 June 2006

## relating to the taking up and pursuit of the business of credit institutions (recast)

**(Text with EEA relevance)**

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the first and third sentences of Article 47 (2) thereof,

Having regard to the proposal from the Commission,

Having regard to the Opinion of the European Economic and Social Committee [1],

Having regard to the Opinion of the European Central Bank [2],

Acting in accordance with the procedure laid down in Article 251 of the Treaty [3],

Whereas:

(1) Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions [4] has been significantly amended on several occasions. Now that new amendments are being made to the said Directive, it is desirable, in order to clarify matters, that it should be recast.

(2) In order to make it easier to take up and pursue the business of credit institutions, it is necessary to eliminate the most obstructive differences between the laws of the Member States as regards the rules to which these institutions are subject.

(3) This Directive constitutes the essential instrument for the achievement of the internal market from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions.

(4) The Commission Communication of 11 May 1999 entitled 'Implementing the framework for financial markets: Action plan', listed a number of goals that need to be achieved in order to complete the internal market in financial services. The Lisbon European Council of 23 and 24 March 2000 set the goal of implementing the action plan by 2005. Recasting of the provisions on own funds is a key element of the action plan.

(5) Measures to coordinate credit institutions should, both in order to protect savings and to create equal conditions of competition between these institutions, apply to all of them. Due regard should however be had to the objective differences in their statutes and their proper aims as laid down by national laws.

(6) The scope of those measures should therefore be as broad as possible, covering all institutions whose business is to receive repayable funds from the public, whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities and to grant credits for their own account. Exceptions should be provided for in the case of certain credit institutions to which this Directive cannot apply. The provisions of this Directive should not prejudice the application of national laws which provide for special supplementary authorisations permitting credit institutions to carry on specific activities or undertake specific kinds of operations.

(7) It is appropriate to effect only the essential harmonisation necessary and sufficient to secure the mutual recognition of authorisation and of prudential supervision systems, making possible the granting of a single licence recognised throughout the Community and the application of the principle of home Member State prudential supervision. Therefore, the requirement that a programme of operations be produced should be seen merely as a factor enabling the competent authorities to decide on the basis of more precise information using objective criteria. A measure of flexibility should nonetheless be possible as regards the requirements on the legal form of credit institutions concerning the protection of banking names.

(1) OJ C 234, 22.9.2005, p. 8.
(2) OJ C 52, 2.3.2005, p. 37.
(3) Opinion of the European Parliament of 28 September 2005 (not yet published in the OJ) and Decision of the Council of 7 June 2006.
(4) OJ L 126, 26.5.2000, p. 1. Directive as last amended by Directive 2006/29/EC (OJ L 70, 9.3.2006, p. 50).

Section 5

**Large exposures**

*Article 106*

1. 'Exposures', for the purposes of this Section, shall mean any asset or off-balance-sheet item referred to in Section 3, Subsection 1, without application of the risk weights or degrees of risk there provided for.

Exposures arising from the items referred to in Annex IV shall be calculated in accordance with one of the methods set out in Annex III. For the purposes of this Section, Annex III, Part 2, point 2 shall also apply.

All elements entirely covered by own funds may, with the agreement of the competent authorities, be excluded from the determination of exposures, provided that such own funds are not included in the credit institution's own funds for the purposes of Article 75 or in the calculation of other monitoring ratios provided for in this Directive and in other Community acts.

2. Exposures shall not include either of the following:

(a) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the 48 hours following payment; or

(b) in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is the earlier.

*Article 107*

For the purposes of applying this Section, the term 'credit institution' shall cover the following:

(a) a credit institution, including its branches in third countries; and

(b) any private or public undertaking, including its branches, which meets the definition of 'credit institution' and has been authorised in a third country.

*Article 108*

A credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10 % of its own funds.

*Article 109*

The competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, in accordance with this Directive, and for that of monitoring those exposures in the light of each credit institution's own exposure policies.

*Article 110*

1. A credit institution shall report every large exposure to the competent authorities.

Member States shall provide that reporting is to be carried out, at their discretion, in accordance with one of the following two methods:

(a) reporting of all large exposures at least once a year, combined with reporting during the year of all new large exposures and any increases in existing large exposures of at least 20 % with respect to the previous communication; or

(b) reporting of all large exposures at least four times a year.

2. Except in the case of credit institutions relying on Article 114 for the recognition of collateral in calculating the value of exposures for the purposes of paragraphs 1, 2 and 3 of Article 111, exposures exempted under Article 113(3)(a) to (d) and (f) to (h) need not be reported as laid down in paragraph 1 and the reporting frequency laid down in point (b) of paragraph 1 of this Article may be reduced to twice a year for the exposures referred to in Article 113(3)(e) and (i), and in Articles 115 and 116.

Where a credit institution invokes this paragraph, it shall keep a record of the grounds advanced for at least one year after the event giving rise to the dispensation, so that the competent authorities may establish whether it is justified.

3. Member States may require credit institutions to analyse their exposures to collateral issuers for possible concentrations and where appropriate take action or report any significant findings to their competent authority.

*Article 111*

1. A credit institution may not incur an exposure to a client or group of connected clients the value of which exceed 25 % of its own funds.

2. Where that client or group of connected clients is the parent undertaking or subsidiary of the credit institution and/or one or more subsidiaries of that parent undertaking, the percentage laid down in paragraph 1 shall be reduced to 20 %. Member States may, however, exempt the exposures incurred to such clients from the 20 % limit if they provide for specific monitoring of such exposures by other measures or procedures. They shall inform the Commission and the European Banking Committee of the content of such measures or procedures.

3. A credit institution may not incur large exposures which in total exceed 800 % of its own funds.

4. A credit institution shall at all times comply with the limits laid down in paragraphs 1, 2 and 3 in respect of its exposures. If in an exceptional case exposures exceed those limits, that fact shall be reported without delay to the competent authorities which may, where the circumstances warrant it, allow the credit institution a limited period of time in which to comply with the limits.

*Article 112*

1. For the purposes of Articles 113 to 117, the term 'guarantee' shall include credit derivatives recognised under Articles 90 to 93 other than credit linked notes.

2. Subject to paragraph 3, where, under Articles 113 to 117, the recognition of funded or unfunded credit protection may be permitted, this shall be subject to compliance with the eligibility requirements and other minimum requirements, set out under Articles 90 to 93 for the purposes of calculating risk-weighted exposure amounts under Articles 78 to 83.

3. Where a credit institution relies upon Article 114(2), the recognition of funded credit protection shall be subject to the relevant requirements under Articles 84 to 89.

*Article 113*

1. Member States may impose limits more stringent than those laid down in Article 111.

2. Member States may fully or partially exempt from the application of Article 111(1), (2) and (3) exposures incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with this Directive or with equivalent standards in force in a third country.

3. Member States may fully or partially exempt the following exposures from the application of Article 111:

(a) asset items constituting claims on central governments or central banks which, unsecured, would be assigned a 0 % risk weight under Articles 78 to 83;

(b) asset items constituting claims on international organisations or multilateral development banks which, unsecured, would be assigned a 0 % risk weight under Articles 78 to 83;

(c) asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would be assigned a 0 % risk weight under Articles 78 to 83;

(d) other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would be assigned a 0 % risk weight under Articles 78 to 83;

(e) asset items constituting claims on and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers;

(f) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, Member States' regional governments, local authorities or public sector entities, which securities constitute claims on their issuer which would be assigned a 0 % risk weighting under Articles 78 to 83;

(g) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution;

(h) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of certificates of deposit issued by the lending credit institution or by a credit institution which is the parent undertaking or a subsidiary of the lending credit institution and lodged with either of them;

(i) asset items constituting claims on and other exposures to institutions, with a maturity of one year or less, but not constituting such institutions" own funds;

(j) asset items constituting claims on and other exposures to those institutions which are not credit institutions but which fulfil the conditions referred to in Annex VI, Part 1, point 85, with a maturity of one year or less, and secured in accordance with the same point;

(k) bills of trade and other similar bills, with a maturity of one year or less, bearing the signatures of other credit institutions;

(l) covered bonds falling within the terms of Annex VI, Part 1, points 68 to 70;

(m) pending subsequent coordination, holdings in the insurance companies referred to in Article 122(1) up to 40 % of the own funds of the credit institution acquiring such a holding;

(n) asset items constituting claims on regional or central credit institutions with which the lending credit institution is associated in a network in accordance with legal or

7. EXPOSURES TO CORPORATES

7.1. **Treatment**

41. Exposures for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 6 in accordance with the assignment by the competent authorities of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

*Table 6*

| Credit quality step | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| Risk weight | 20 % | 50 % | 100 % | 100 % | 150 % | 150 % |

42. Exposures for which such a credit assessment is not available shall be assigned a 100 % risk weight or the risk weight of its central government, whichever is the higher.

8. RETAIL EXPOSURES

43. Exposures that comply with the criteria listed in Article 79(2) shall be assigned a risk weight of 75 %.

9. EXPOSURES SECURED BY REAL ESTATE PROPERTY

44. Without prejudice to points 45 to 60, exposures fully secured by real estate property shall be assigned a risk weight of 100 %.

9.1. **Exposures secured by mortgages on residential property**

45. Exposures or any part of an exposure fully and completely secured, to the satisfaction of the competent authorities, by mortgages on residential property which is or shall be occupied or let by the owner, or the beneficial owner in the case of personal investment companies, shall be assigned a risk weight of 35 %.

46. Exposures fully and completely secured, to the satisfaction of the competent authorities, by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of residential property which is or shall be occupied or let by the owner shall be assigned a risk weight of 35 %.

47. Exposures to a tenant under a property leasing transaction concerning residential property under which the credit institution is the lessor and the tenant has an option to purchase, shall be assigned a risk weight of 35 % provided that the competent authorities are satisfied that the exposure of the credit institution is fully and completely secured by its ownership of the property.

48. In the exercise of their judgement for the purposes of points 45 to 47, competent authorities shall be satisfied only if the following conditions are met:

(a) the value of the property does not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macro-economic factors affect both the value of the property and the performance of the borrower;

(b) the risk of the borrower does not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility does not materially depend on any cash flow generated by the underlying property serving as collateral;

(c) the minimum requirements set out in Annex VIII, Part 2, point 8 and the valuation rules set out in Annex VIII, Part 3, points 62 to 65 are met; and

(d) the value of the property exceeds the exposures by a substantial margin.

49. Competent authorities may dispense with the condition contained in point 48(b) for exposures fully and completely secured by mortgages on residential property which is situated within their territory, if they have evidence that a well-developed and long-established residential real estate market is present in their territory with loss rates which are sufficiently low to justify such treatment.

50. When the discretion contained in point 49 is exercised by the competent authorities of a Member State, the competent authorities of another Member State may allow their credit institutions to assign a risk weight of 35 % to such exposures fully and completely secured by mortgages on residential property.

9.2. **Exposures secured by mortgages on commercial real estate**

51. Subject to the discretion of the competent authorities, exposures or any part of an exposure fully and completely secured, to the satisfaction of the competent authorities, by mortgages on offices or other commercial premises situated within their territory may be assigned a risk weight of 50 %.

52. Subject to the discretion of the competent authorities, exposures fully and completely secured, to the satisfaction of the competent authorities, by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises may be assigned a risk weight of 50 %.

53. Subject to the discretion of the competent authorities, exposures related to property leasing transactions concerning offices or other commercial premises situated in their territories under which the credit institution is the lessor and the tenant has an option to purchase may be assigned a risk weight of 50 % provided that the exposure of the credit institution is fully and completely secured to the satisfaction of the competent authorities by its ownership of the property.

54. The application of points 51 to 53 is subject to the following conditions:

(a) the value of the property must not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macro-economic factors affect both the value of the property and the performance of the borrower;

(b) the risk of the borrower must not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility must not materially depend on any cash flow generated by the underlying property serving as collateral; and

(c) the minimum requirements set out in Annex VIII, Part 2, point 8, and the valuation rules set out in Annex VIII, Part 3, points 62 to 65 are met.

55. The 50 % risk weight shall be assigned to the Part of the loan that does not exceed a limit calculated according to either of the following conditions:

(a) 50 % of the market value of the property in question;

(b) 50 % of the market value of the property or 60 % of the mortgage lending value, whichever is lower, in those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions.

56. A 100 % risk weigh shall be assigned to the Part of the loan that exceeds the limits set out in point 55.

57. When the discretion contained in points 51 to 53 is exercised by the competent authorities of one Member State, the competent authorities of another Member State may allow their credit institutions to risk weight at 50 % such exposures fully and completely secured by mortgages on commercial property.

58. Competent authorities may dispense with the condition contained in point 54(b) for exposures fully and completely secured by mortgages on commercial property which is situated within their territory, if they have evidence that a well-developed and long-established commercial real estate market is present in their territory with loss-rates which do not exceed the following limits:

(a) losses stemming from lending collateralised by commercial real estate property up to 50 % of the market value (or where applicable and if lower 60 % of the mortgage lending value (MLV)) do not exceed 0,3 % of the outstanding loans collateralised by commercial real estate property in any given year; and

(b) overall losses stemming from lending collateralised by commercial real estate property must not exceed 0,5 % of the outstanding loans collateralised by commercial real estate property in any given year.

59. If either of the limits referred to in point 58 is not satisfied in a given year, the eligibility to use point 58 shall cease and the condition contained in point 54(b) shall apply until the conditions in point 58 are satisfied in a subsequent year.

60. When the discretion contained in point 58 is exercised by the competent authorities of a Member State, the competent authorities of another Member State may allow their credit institutions to assign a risk weight of 50 % to such exposures fully and completely secured by mortgages on commercial property.

10. PAST DUE ITEMS

61. Without prejudice to the provisions contained in points 62 to 65, the unsecured part of any item that is past due for more than 90 days and which is above a threshold defined by the competent authorities and which reflects a reasonable level of risk shall be assigned a risk weight of:

(a) 150 %, if value adjustments are less than 20 % of the unsecured part of the exposure gross of value adjustments; and

(b) 100 %, if value adjustments are no less than 20 % of the unsecured part of the exposure gross of value adjustments.

62. For the purpose of defining the secured part of the past due item, eligible collateral and guarantees shall be those eligible for credit risk mitigation purposes.

63. Nonetheless, where a past due item is fully secured by forms of collateral other then those eligible for credit risk mitigation purposes, a 100 % risk weight may be assigned subject to the discretion of competent authorities based upon strict operational criteria to ensure the good quality of the collateral when value adjustments reach 15 % of the exposure gross of value adjustments.

64. Exposures indicated in points 45 to 50 shall be assigned a risk weight of 100 % net of value adjustments if they are past due for more than 90 days. If value adjustments are no less than 20 % of the exposure gross of value adjustments, the risk weight to be assigned to the remainder of the exposure may be reduced to 50 % at the discretion of competent authorities.

65. Exposures indicated in points 51 to 60 shall be assigned a risk weight of 100 % if they are past due for more than 90 days.

11. ITEMS BELONGING TO REGULATORY HIGH-RISK CATEGORIES

66. Subject to the discretion of competent authorities, exposures associated with particularly high risks such as investments in venture capital firms and private equity investments shall be assigned a risk weight of 150 %.

67. Competent authorities may permit non past due items to be assigned a 150 % risk weight according to the provisions of this Part and for which value adjustments have been established to be assigned a risk weight of:

(a) 100 %, if value adjustments are no less than 20 % of the exposure value gross of value adjustments; and

(b) 50 %, if value adjustments are no less than 50 % of the exposure value gross of value adjustments.

4 MAY 2006 [ISSUED TO CRO IMPLEMENTATION GROUP]

EXTRACT FROM "CREDIT INSTITUTION AND INVESTMENT FIRMS – CAPITAL REQUIREMENTS DIRECTIVE"

In respect of PSEs located in other jurisdictions, the Financial Regulator will follow the principle of mutual recognition in recognising the risk weight conveyed on such entities by the local regulator.

### 7.3 The publication of lists

In the case of both local authorities (and regional governments) and PSEs, the question arises as to whether the Financial Regulator should adopt a list-based or criteria-based approach. At present, a list is maintained (see Appendix 6 of the Resident Offices Return). The advantage of such an approach is that it provides clarity in terms of the risk weight that attaches to certain counterparties, and thereby consistency of approach across institutions. The disadvantage is that the list can become out of date and much of the regulator's time can be taken up in considering the case for adding names to the list.

An alternative approach is to adopt a criteria-based definition. Counterparties that meet certain criteria would qualify for the preferential treatment and the onus would be on the institution to evaluate any given counterparty against the criteria. Criteria could be crafted to classify as PSEs:

- Bodies owned by the central or regional government or local authorities which perform regulatory or other non-commercial functions; and
- Bodies that carry out non-commercial functions on behalf of central or regional government or local authorities.

**While the pros and cons of the two approaches are finely balanced, the Financial Regulator considers the criteria-based approach to be the more appropriate. It is, however, willing to review this decision in light of industry feedback.**

### 7.4 The treatment of residential real estate

Under the Directive, capital requirements for mortgage lending depend upon whether an institution is on the standardised or IRB approach to credit risk.



Under the standardised approach, the risk weight for residential mortgage lending falls from 50% to 35% provided the following conditions are met:

- The loan is secured by a 'substantial margin';
- The risk of the borrower is not materially dependent upon the performance of the property, but rather the capacity of the borrower to repay the debt from other sources.

In this regard, there are two important national discretions, one implicit the other explicit. The first is what is meant by a 'substantial margin'. The most obvious way to think about this is a loan to value ratio. Exposures up to a certain LTV would attract the 35% risk weight. Beyond that level, a higher risk weight would apply. Three further issues stem from this:

- What LTV cut-off should be chosen?
- What risk weight should apply to lending above that cut-off?
- Does the higher risk weight apply to the whole loan, or merely the marginal lending above the threshold?

The second discretion relates to the second condition. National supervisors can waive this requirement if they have evidence that a well-developed and long-established residential real estate market is present in their territory with loss rates sufficiently low to justify such a treatment. The effect of not implementing this discretion could be to prevent lending in support of residential investment property from availing of the 35% risk weight, as in many cases repayment of the loan will be dependent to some degree on the rental stream from the property. The Directive is silent as to the treatment of ineligible residential real estate, but in all likelihood it would attract the same capital charge as other retail lending (75% risk weight).

The Financial Regulator is unable at this stage to set out its proposals in respect of the issues above. Given the importance of residential mortgage lending in the balance sheets of most domestic and a number of foreign-owned institutions, this issue

requires careful analysis on a number of fronts; in particular the current composition of institutions' loan books, recent trends and new product innovations and prospects for the market as a whole. This issue is also of significant interest to our colleagues in the Central Bank, because of the potential macro-economic and financial stability implications of any change in the required regulatory capital for residential real estate. In addition, the recently announced increase in risk weighting for the portion of a mortgage that exceeds 80% of the property value will have to be taken into account.

It is for these reasons that the Financial Regulator is still considering its position in respect of exposures in the form of residential real estate.

### 7.5 The treatment of Commercial Real Estate

The Directive contains a number of discretions that allow competent authorities to grant a favourable treatment to exposures secured by commercial real estate (CRE). Many of these discretions exist in the current Directive, in particular, the discretion to permit exposures secured by CRE to be risk-weighted at 50% rather than 100%. In line with its existing treatment, the Financial Regulator does not propose to exercise this discretion for CRE lending in Ireland. Furthermore, as in the case of the recently announced increase in the risk weighting of certain exposures secured by residential real estate, the Financial Regulator is currently considering to what extent there may be certain types of CRE lending where a risk weight of 100% does not adequately cover the intrinsic risk of these transactions. Such exposures could include loans to support the acquisition, development and construction phases of certain types of speculative commercial property lending, where there are no pre-sale or pre-letting agreements in place. **The Financial Regulator seeks feedback from the industry on this matter.**

The Financial Regulator will continue to recognise the use by other regulators of the 50% risk weighting discretion. Thus lending by Irish institutions supported by CRE located in these jurisdictions may be risk weighted at 50%. This is in order to preserve competitive equality.



### 7.6 Recognition of External Credit Assessement Institutions (ECAIs)

Under the standardised approach, institutions can slot their corporate, bank and sovereign exposures into a series of risk buckets based upon the assessments of eligible external credit assessment institutions, or ECAIs. CEBS recently finalised its guidance in this regard, both in terms of how the recognition process will work and how the assessments of ECAIs will map into the risk weight buckets.

The Financial Regulator understands that four of the largest international rating agencies - Standard and Poors, Moodys, Fitch and Dominion - will be seeking recognition in all or the majority of EU Member States, including Ireland. In this context, a joint assessment process is currently being developed within the EU to deal with these anticipated applications. This is expected to produce a single assessment (of both eligibility and mapping) for each rating agency in or around June /July this year, which Member States may choose to adopt as they see fit. At this stage, the Financial Regulator sees no reason why we would demur from the findings and recommendations of this joint assessment.

The Financial Regulator believes that the joint assessment process will be sufficient to cover all ECAIs which are or may be relevant in the Irish market. Furthermore, the Financial Regulator will adopt indirect (mutual) recognition of ECAIs recognised by other Member States. Beyond this, the Financial Regulator sees no demand for additional ECAI recognition. Consequently, it will not be implementing CEBS' proposal to allow individual institutions the option of submitting an application in respect of ECAI recognition.

### 7.7 Definition of Retail

The Capital Requirements Directive introduces a new category of exposure - retail - to which a 75% risk weighting applies. Article 79(2) states that, to be eligible for the retail exposure class, the following conditions must be met:

(i) the exposure must be to an individual person or persons, or to a small or medium sized entity (SME).

# THEME: R7

Effectiveness of the policy and institutional responses post crisis

# LINE OF INQUIRY: R7a

Assessment of what has been done, work-in-progress and what remains outstanding from the recommendations of previous reports

**CENTRAL BANK OF IRELAND**

# ITEM 27

## A DOCUMENT SUMMARISING ALL THE CHANGES IMPLEMENTED OR ARISING FROM THE RECOMMENDATIONS OF THE IRISH BANKING CRISIS, REGULATORY AND STABILITY POLICY 2003 TO 2008 BY PATRICK HONOHAN GOVERNOR OF THE CENTRAL BANK, MISJUDGING RISK: CAUSES OF THE SYSTEMIC BANKING CRISIS IN IRELAND BY PETER NYBERG, SOLE MEMBER OF THE COMMISSION OF INVESTIGATION (BANKING INQUIRY), A PRELIMINARY REPORT ON THE SOURCES OF IRELAND'S BANKING CRISIS BY MAX WATSON AND KAUS REGLING AND REVIEW OF THE DEPARTMENT OF FINANCE BY ROB WRIGHT FOR THE PERIOD 2008 TO 2013.

# A DOCUMENT SUMMARISING ALL THE CHANGES IMPLEMENTED OR ARISING FROM THE RECOMMENDATIONS OF THE IRISH BANKING CRISIS, REGULATORY AND STABILITY POLICY 2003 TO 2008 BY PATRICK HONOHAN GOVERNOR OF THE CENTRAL BANK, MISJUDGING RISK: CAUSES OF THE SYSTEMIC BANKING CRISIS IN IRELAND BY PETER NYBERG, SOLE MEMBER OF THE COMMISSION OF INVESTIGATION (BANKING INQUIRY), A PRELIMINARY REPORT ON THE SOURCES OF IRELAND'S BANKING CRISIS BY MAX WATSON AND KAUS REGLING AND STRENGTHENING THE CAPACITY OF THE DEPARTMENT OF FINANCE - REPORT OF THE INDEPENDENT REVIEW PANEL BY ROB WRIGHT, FOR THE PERIOD 2008 TO 2013.

**Introduction**

The Committee of Inquiry into the Banking Crisis has requested that the Central Bank of Ireland (Central Bank) provide a document summarising all the changes implemented or arising from the recommendations of the *Irish Banking Crisis: Regulatory and Financial Stability Policy 2003-2008* by Patrick Honohan, Governor of the Central Bank, *Misjudging Risk: Causes of the systemic banking crisis in Ireland* by Peter Nyberg, sole member of the Commission of Investigation (Banking Inquiry), *A Preliminary Report on the Sources of Ireland's Banking Crisis* by Klaus Regling and Max Watson and *Strengthening the Capacity of the Department of Finance – Report of the Independent Review Panel* by Rob Wright for the period 2008 to 2013.

This note provides an account, in summary form, of the changes that have taken place in the Central Bank since 2008. It deals primarily with those changes that resulted from the analysis of the various reports on the banking crisis. Of course, there were other changes both in policies and practices which were introduced over the last five years. An account of these changes is provided in the Annual Reports of the Central Bank.[1] In addition, from 2011 onwards, the Central Bank published Annual Performance Statements of Financial Regulation. Section 1 provides an Executive Summary. The weaknesses (and inferred recommendations) of the regulatory approach during this period as identified by the various reports on the banking crisis are discussed in Section 2. In addition it notes that while the organisational structure of the Central Bank was not a fundamental causal factor, its unwieldy

[1] Copies of the Annual Reports are available at Central Bank of Ireland - Corporate Publications.

organisational structure revealed difficulties in a range of issues. Section 3 provides a summary of the main changes that have taken place in the Central Bank. It includes the fundamental structural changes arising from the Central Bank Reform Act of 2010, changes in the supervisory approach which takes account of many of the issues raised in the various reports and the changes in the performance of the Central Bank's macro prudential role.

## 1. Executive Summary

The main changes since 2008 include:

- the creation of a single unitary body – the Central Bank of Ireland – with responsibility for both central banking and financial regulation. Its functions, *inter alia*, are to ensure that the central banking and financial regulation roles are integrated and co-ordinated and that the powers conferred on the Central Bank are properly exercised and discharged;
- a significant change in the regulatory approach including the introduction risk based supervision supported by the Probability Risk and Impact SysteM – PRISM;
- the restructuring of the Banking Supervision Directorate, to best engage with SSM and to provide for a revised engagement model which supports a best practice approach and the guiding principles of SSM to ensure a safer, sounder and more stable banking system;
- the establishment of a dedicated policy and risk Directorate which recognised the impact on frontline supervision when resources are diverted to policy and other support functions;
- the creation of an Enforcement Directorate to support a policy of a credible threat of enforcement action;
- the enhancement of resources and skills, including increased staff numbers and improvement in the skills of specialist staff;
- restructuring of key internal committees, both on micro- and macro-prudential regulation; and
- a rejuvenation of the culture of the organisation.

## 2. Weaknesses/recommendations identified from the Reports on the banking crisis

The Nyberg Report[2] contained a number of potential lessons from the banking crisis. However, while other Reports did not provide specific recommendations, they identified weaknesses[3] in financial regulation from which the basis for recommendations could be inferred. These include:

i. weaknesses in four specific areas regarding the organisational structure of the Central Bank and Financial Services Authority of Ireland (CBFSAI), namely: the mandate, structure, culture and the engagement with third parties. Part of the statutory mandate of the CBFSAI was to promote the growth of the Irish financial sector and this was seen as a conflict with its responsibility to promote the stability of the financial sector. Regarding the structure, while some of the reports noted that the design of CBFSAI was not, *per se*, a major issue, the organisation lacked credibility and did not encourage a focus on macro-prudential risks. Moreover, while it was recognised that the framework reflected in part the desire to ensure stronger competition in banking and to make sure that households got the benefit of this increased competition, there seems to have been little strengthening of prudential supervision. In particular, it was noted that the Prudential Director was not an *ex officio* member of the board of the Financial Regulator. In addition, there were some questions raised about the ultimate lines of command in the organisation. According to one report, "there were issues that the Regulator's partially interlocking relations with the Central Bank seem to have left open to interpretation[4]" Regarding the culture the organisation, it was noted that there was a lack of constructive challenge to issues emanating in the CBFSAI;

ii. drawbacks of the implementation of the principles-based regulation[5] which relied on "making sure that appropriate governance structures and systems were in place in banks and building societies"[6];

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[2] See pages ix and x of the Nyberg Report.

[3] See pages 10-14 of Document 23, *The Process of Supervisory Engagement with each of the relevant banks during the period 2003 to 2013.*

[4] Regling and Watson, page 37.

[5] For a discussion on principles-based regulation see Document 22, *A Document Detailing the Principles behind the Regulatory Regime and the Communication of same to the banks for the period 2003 to 2013.*

[6] See page 44 of the Honohan Report. It noted further that under this approach the "presumption was that this was the key to sound prudential decisions. To this extent, the underlying philosophy was oriented towards trusting a properly governed firm; it was potentially only a short step from that trust to the emergence of a somewhat diffident attitude on the part of regulators so far as challenging the decisions of firms was concerned." In this context, it should be noted that Nyberg indicated that a main lesson is to make sure that both in private and public institutions "there exist both fora and incentives for leadership and staff to openly discuss and challenge strategies and their implementation" (page x).

iii. an under-resourced approach to bank supervision that, by relying on good governance and risk-management procedures, neglected quantitative assessment and the need to ensure sufficient capital to absorb the growing property-related risks;

iv. an unwillingness by the Financial Regulator to take on board sufficiently the real risk of a looming problem and act with sufficient decisiveness and force to head it off in time. "Rocking the boat" and swimming against the tide of public opinion would have required a particularly strong sense of the independent role of a central bank in being prepared to "spoil the party" and withstand possible strong adverse public reaction;

v. weakness in the enforcement of financial regulations; and

vi. a number of specific issues raised in the Reports including concentration risks, credit register, sectoral limits, compliance statements, stress tests, loan loss provisions, liquidity ratios and resolution procedures .

## 3. Summary of Implemented Changes arising from the Reports

### *3.1 Organisational /Structural Reform*

The Central Bank Reform Act 2010 created a single unitary body – the Central Bank of Ireland – with responsibility for both central banking and financial regulation. The Central Bank Reform Act 2010 absorbed financial regulatory functions back into the Central Bank and dissolved IFSRA, its Board and the statutory post of Consumer Director[7]. In particular, it also removed the provision for the Central Bank to promote the growth of the financial sector.

The main changes to the Central Bank include the following:

i. the re-constituted Central Bank is a unitary organisation with responsibility for, *inter alia*, regulation and oversight of banking in Ireland, both at an individual institution level ("micro-prudential") and at a system-wide financial stability level ("macro-prudential");

ii. the 2010 Act provides for a single unitary Board – the Central Bank Commission – to manage and control the affairs and activities of the Central Bank;

iii. the Commission's primary functions are to ensure that the central banking and financial regulation functions of the organisation are integrated and co-ordinated and

[7] The role of providing consumer information has since transferred to the Competition and Consumer Protection Commission (formerly the National Consumer Agency). However it should be noted that the Central Bank retains responsibility for Consumer Protection. Consumer Protection remains part of the Central Bank's statutory mandate, highlighted by its mission statement of 'safeguarding stability, protecting consumers'.

that the powers and functions conferred on the Central Bank are properly exercised and discharged;

iv. the Commission has adopted its own terms of reference, which sets out how it can best deliver on its responsibilities. This sets out that the Commission engages with management members on issues of strategic importance to the Central Bank (other than European System of Central Banks (ESCB) functions) and advises, supports and constructively challenges them as appropriate. It also contributes to the formulation of strategy to allow the Central Bank to achieve its statutory functions and reviews the Central Bank's performance in relation to this strategy;

v. the Deputy Governor (Financial Regulation) is a member of the Central Bank Commission and is also a member of the board of the Single Supervisory Mechanism;

vi. the Deputy Governor (Central Banking) is a member of the Central Bank Commission;

vii. the revamped Financial Stability Committee is chaired by the Governor;

viii. the membership of the senior management team with responsibility for the various regulatory areas in the Central Bank, which in addition to the CEO of the Financial Regulator, comprised two directors in the pre-crisis period, has been increased to six directors in addition to the Deputy Governor (Financial Regulation); and

ix. in 2010 two dedicated directorates were created within the organisation, viz the Policy and Risk Directorate and the Enforcement Directorate.

Credit Institutions Supervision Directorate

A restructuring of the Banking Supervision Directorate, was undertaken to best engage with SSM and to provide for a revised engagement model which supports a best practice approach and the guiding principles of SSM, and to ensure a safer, sounder and more stable banking system.

**Banking Supervision: Supervision Division**

The responsibilities of supervisory teams remain sizeable further to the implementation of the SSM, with the Supervision Division required to continue to assess the strategies, key risks, processes, procedures, governance and control structures of the banks. In conducting this work, supervisors are required to continue reviewing and analysing the banks' various regulatory reports, ICAAP/ ILAAP, and risk appetite statements etc., and are required to verify and challenge the banks' estimates, risk assessment outcomes, the

outcome of stress tests and to determine overall risk priorities. Supervisors are also expected to continue to hold regular and ad hoc meetings with the supervised banks at various levels of staff seniority, conduct on-going risk analysis, on-going analysis of approved risk models, and analyse and assess banks' recovery plans.

**Banking Supervision: Inspections Division**

The inspection tasks are to be much more intensive than those hitherto performed under PRISM, with a larger breadth and depth in terms of scope required. The purpose of inspections is, through the performance of in-depth investigations, to assess the:

- level, nature and features of the inherent risks and the risk culture;
- appropriateness and quality of the bank's corporate governance and internal control framework;
- control systems and risk management processes, focusing on detecting weaknesses or vulnerabilities that may have an impact on the capital and liquidity adequacy of the bank;
- quality of balance sheet items and the financial situation of the bank; and
- compliance with banking regulations.

**Banking Supervision: Analysis Division**

This division was structured horizontally to create clear linkages, relationships, organisational workflows and seniority of engagement between the Central Bank and SSM. The collaboration of horizontal divisions located in Directorate General Micro IV ('DGIV') and within the NCAs contributes to the effectiveness of the SSM in prudential decision making by providing well founded expertise on specific items. The ten divisions in DGIV are: Risk Analysis, Supervisory Policies, Planning and Coordination of Supervisory Examination Programmes, Centralised On-site Inspections, Internal Models, Enforcement and Sanctions, Authorisations, Crisis Management, Supervisory Quality Assurance, and Methodology and Standards Development. The responsibilities of the Analysis Division are closely aligned with that of DGIV. For the horizontal division, the SSM approaches that have already been articulated by DGIV senior management require further strengthening of our analytics capability, backed by robust data, and resulting in insightful analysis and, where required, decisive action. Within the horizontal division, internal models work is similar to that undertaken up to now in banking supervision. The

horizontal division also plays a crucial role in assessing risks across the Irish banking system and ensuring that they are understood and proactively addressed.

Policy and Risk Directorate

The establishment of a dedicated Policy and Risk Directorate[8] recognised the impact on frontline supervision when resources are diverted to policy and other support functions. The Honohan Report noted that in banking supervision "management resources were regularly diverted from day-to-day supervisory tasks to deal with policy development work and work related to the Committee of European Banking Supervisors" and that "key staff were diverted into activities such as the implementation in Ireland of the many new and technically demanding international requirements introduced over the period and participation in various EU and ECB groups". The dedicated Directorate acts as a second line of defence to the supervisory directorates. The aim of the Directorate is to ensure that the Central Bank is better able to assimilate, analyse and act on the risks posed to financial stability and financial consumers by about 10,000 regulated entities in Ireland. This Directorate is responsible for the design and development of the Central Bank's regulatory risk system known as PRISM (see below). In addition, the Directorate's responsibilities include the development of corporate governance codes, governance structures and policies, codes and guidelines concerning the practice of lending to related parties by credit institutions. Moreover, the Directorate represents the Central Bank at European Commission/Council working groups and sub-groups of the European Banking Authority. It is also responsible for the development of prudential banking policy to strengthen the supervisory framework for credit institutions.

Enforcement Directorate

The need for credible enforcement and the consequential benefits of adopting a robust enforcement regime was outlined in the Honohan Report[9]. The establishment of a standalone

[8] The Directorate comprises the Prudential Policy Division, Risk, Governance and Accounting Policy Division and Markets Policy Division.

[9] Honohan Report, page 56: "When a new agency is created it is important that it quickly establishes its credibility and reputation as an enforcer. This creates expectations as to how the rules, codes, regulations and principles will be enforced which will, in turn, influence behaviour. If the regulated firm anticipates prompt regulatory action if it infringes a principle, code, rule or regulation and also that the action will increase in severity if it is repeated, the regulated firms will strive to minimise such infractions".

Enforcement Directorate in 2010 has significantly contributed to the resolution of one of the inherent weaknesses in the pre-crisis regulatory framework, namely the lack of use and lack of value placed on the role of enforcement as a necessary component of an efficient and effective regulatory framework The Central Bank subsequently acquired significantly enhanced supervisory and enforcement powers under the Central Bank (Supervision and Enforcement) Act 2013 and may impose a monetary sanction upon an entity of the greater of €10 million or an amount equal to 10 per cent of the turnover of an entity or €1 million on a natural person.[10] In addition to the increased monetary sanctions, the 2013 Act provides the Central Bank with the power, upon finding that an entity is committing or has committed a prescribed contravention, to suspend their authorisation, in respect of one or more of its activities, where appropriate. The Central Bank also has the power to revoke the authorisation of an entity. Since 2010 the Central Bank has concluded a total of 62 administrative sanctions procedure cases, against entities across the regulated industries, (including banks) imposing approximately €27.5 million in monetary sanctions.[11] Details of these actions can be found on the Central Bank website (http://www.centralbank.ie/regulation/industry-sectors/payment-institutions/Pages/reg-actions-admin.aspx).

Enhancement of Resources and Skills

There have been a number of changes to the composition of the banking supervision divisions in the period since the crisis. Following the crisis, the structure of banking supervision reflected the approach to supervision under the Eligible Liabilities Guarantee Scheme. Subsequently a significant amount of scrutiny and related changes to the approach to banking supervision was undertaken under the auspices of the Trioka programme. Recently in response to the establishment of the Single Supervisory Mechanism, the Central Bank created a three divisional supervisory function with responsibility for: banking supervision; on-site inspections supervision; and banking supervision analytics.

Both the Honohan and Nyberg Reports noted that resources for the supervision of banks in the Financial Regulator were far below what was required. The Central Bank recognised that there was a need to ensure adequate resources to undertake the function of supervision effectively. Since the crisis the number of supervisors has been significantly increased: from 2003 to 2010 staff within prudential regulation as a whole increased by 259 to 438 (within

[10] Prior to the commencement of the 2013 Act, the maximum penalty that the Central Bank could impose on an entity was €5 million and €500,000 on natural persons.

[11] Remarks prepared by Director of Enforcement Derville Rowland for the Compliance Ireland Seminar 12 December 2014.

banking supervision there was a rise of 68)[12]. As at 31 December 2014, there are 522 staff in Prudential Supervision (of which 107 are in Banking Supervision). It was recognised that there was a need for additional staff with appropriate technical and commercial skills. In this regard, the Central Bank has recruited a considerable number of staff with industry knowledge (including *inter-alia*, treasury and credit analysts[13], quantitative specialists, financial analysts, business model analysts and enforcement solicitors) and continues to invest in training all staff. In addition the Central Bank has established a panel of external risk advisors comprising experienced professionals who have a long and well established record of operating at a senior level in a financial services environment. These experts are a resource available to both the organisation and to individual staff members.

Committee Structure

In order to focus and coordinate both macro-prudential and micro-prudential regulation, the Central Bank restructured a number of key internal committees. The Central Bank's Financial Stability Committee has been restructured and meets more regularly. It is now chaired by the Governor and includes senior staff from across relevant central banking and regulatory departments. Two financial regulation committees chaired by the Deputy Governor, (Financial Regulation), have been established: the Supervisory Risk Committee which meets on a fortnightly basis, to discuss the escalation of supervisory cases and supervisory risks; and a Policy Committee which meets on monthly basis to discuss a range of issues including supervisory and regulatory policy.

Culture

The Central Bank has sought to rejuvenate the internal culture of the organisation and in furtherance of this objective it has, amongst other things, developed a core set of Principles and Behaviours[14] which have been embedded in the organisation. These include the following principles: primacy of the public interest, working with integrity, encouraging vigorous debate, constructive challenge and effective mitigation, collaborating and working

[12] See Document 19, *FTE Headcount split between consumer and prudential supervision in the Financial Regulator for the period 2003 to 2010.*

[13] *The recruitment of credit and treasury specialists in 2009 was crucial in the establishment of credit and treasury teams to conduct both desk top and site analysis of banks.*

[14] These core competencies were restructured under the Priority Behaviour for staff and the Central Bank also introduced a robust performance management system.

as a team to achieve our goals, being accountable for our performance and operating effectively and efficiently. In his statement to the Oireachtas Banking Inquiry, the Governor noted that "there is an extensive and continuing programme of cultural renewal engaging all staff and using many tools (clearer definition of mission; performance management; all-staff meetings; monthly cascade briefings; investment in IT systems; leadership training etc.) in order to ensure a more effective working environment (more conducive to, among other things, constructive challenge)"[15].

Engagement with Third Parties

Actions taken to strengthen and enhance engagement with key external stakeholders include the Central Bank's comprehensive Memorandum of Understanding with the Department of Finance and the Protocol with the auditors of Regulated Financial Service Providers. The Auditor Protocol provides a framework which allows the Central Bank and the auditing profession to exchange relevant information on a timely basis with the aim of enhancing both the regulatory and statutory audit processes.[16]

*3.2 Regulatory approach under the reformed Central Bank*[17]

Most of the issues raised in the various reports were dealt with via a new regulatory approach under which the Central Bank has worked to deliver a more assertive, risk-based and challenging approach to supervision. There has been a paradigm shift in the regulatory approach of the Central Bank. The supervisory strategy is outcome focused, demanding decisive follow-through by both supervisory staff and supervised institutions. There are four strands, in effect, to the Central Bank's "more assertive risk-based" approach. First, there is a closer attention to the implementation of its risk-based system of supervision and a greater focus on risk identification and integration with macro-prudential analysis into institution specific supervision. Second, the Central Bank does not rely on senior management within regulated institutions in the same way that the Financial Regulator did. In fact reliance on management is far more sceptical and far less trusting than was the case before the crisis.

[15] Introductory Statement by Governor Honohan at Oireachtas Banking Inquiry 15 January 2015.
[16] Press release on introduction of Auditor Protocol 6 December 2011.
[17] See Document 23, *The Process of Supervisory Engagement with each of the relevant banks during the period 2003 to 2013.*

Third, there is a greater focus on outcomes. Fourthly, the Central Bank has adopted a policy of a "credible threat of enforcement[18]" to accompany the approach to regulation.

In the period since the publication of the reports the Central Bank has worked to deliver a more assertive, risk based and challenging approach to banking supervision and has demonstrated a will, both at an individual and institutional level, to question, intervene and act. This culture not only applies in the Central Bank's supervision of individual institutions but also in the context of macro-prudential or financial stability oversight.

One of the weaknesses of regulation had been, as noted in the Honohan Report that "it relied on the deferential view that, as long as there was a good governance structure, decisions of the people actually running the banks could normally be trusted to keep the banks safe and sound, and their decisions did not need to be second-guessed". The Honohan Report noted that "even if armed with the necessary information to be effective there would have had to be a greater degree of intrusiveness and assertiveness on the part of regulators in challenging the banks". In light of this, the Central Bank now examines carefully banks' commercial direction. For example, the Central Bank challenges banks on the availability of the requisite skills, the depth of research into new markets, their product design and development, the contingency planning for unforeseen developments, and their appetite for risk. The Central Bank also presses the banks on how they will take account of funding pressures in their financial forecasts.

A key focus of supervision has been, and continues to be, assessing governance, systems, controls and compliance with rules and requirements of regulated entities. Compared with the period 2003 – 2008, the Central Bank is now more forward looking in assessing business models and strategies of regulated firms to form a judgement on the associated risks so that the Central Bank can intervene early. This approach is designed to address the concern expressed in the Honohan Report that "overall supervision was focused on procedural aspects of how the bankers did their job, and did not seek to second-guess the business models of the banks, by, for example, requesting additional provisioning or capital buffers against increasingly risky loans".

[18] Introductory statement by Matthew Elderfield, Head of Financial Regulation, to the Joint Committee on Economic Regulatory Affairs, 14 April 2010.

The Central Bank is determined to avoid falling again into "a pattern of inconclusive engagement with regulated entities on prudential matters, and lack of decisive follow-through"[19]. Where the Central Bank identifies risks in a credit institution, it will insist on action to mitigate that risk. Whether the Central Bank requires immediate action or a clear plan and timeframe to address the matter depends on the nature, scale and potential impact of the risk or shortcomings. Having identified actions required it is critical that these are all followed up to ensure that undertakings and commitments are delivered on and the issue is fully resolved. Where institutions cannot, or do not, take appropriate actions, the Central Bank will use its supervisory powers to force a resolution. These powers are wide ranging (e.g., requiring specific action by the firm, requiring independent third party review and recommendations, capital add-ons, directions to cease certain business).

PRISM

This approach is embodied in a key tool that has been developed by the Central Bank- Probability Risk and Impact SysteM (PRISM) - which provides a structural framework for firm supervision. PRISM is the methodology used by the Central Bank for determining and assessing on an on-going basis the nature, impact and scope of risks to which financial institutions are exposed. There are four Impact categories, High, Medium High, Medium Low and Low which are applied to the range of supervised banks (those licensed by the Central Bank and those operating on a branch basis from other jurisdictions). The supervisor is required to apply, at a minimum, the engagement model appropriate for their firm's impact category as specified under PRISM. While PRISM prescribes a minimum supervisory plan of activities on a specified frequency, supervisors can, and do, go beyond the minimum in performing supervision of the banks. Risk assessment under PRISM is judgment based comprising qualitative and quantitative assessments as appropriate. Supervisors are required to provide a rationale on the PRISM system to support their probability risk rating. There are four risk ratings, High, Medium High, Medium Low and Low to which supervisors can apply more nuanced judgement by applying a "+" or "-" which provides a potential 12-point risk rating scale. These ratings are non-numeric and, as such, support the philosophy of judgment based supervision. PRISM has ten probability risk categories: credit; market; operational; insurance; capital; liquidity; governance; strategy/business model; environment and conduct. Several categories have sub-categories, such as credit risk, which is broken down into

[19] See Honohan Report, Section 5.32, page 75.

inherent risk, quality of control and concentration. Inherent risk and quality of controls are assessed within the same risk category to determine a net risk rating. Each risk category is assigned a rating by the supervisor which reflects the risk[20] of failure from that risk category. The ten risk categories form the basis of the overall probability risk rating. Standardized weightings are assigned to each of the ten risk categories. For further details see *PRISM Explained* published by the Central Bank, in November 2011.

In summary the Central Bank's supervisory approach is multi-layered and includes specifically in relation to banks, *inter alia*, the following:

- review of financial returns and a follow up with the institutions on the overall development of the banks' loan books;
- review of governance and control arrangements (including internal audit) in the banks to ensure that there are appropriate processes and controls in place to manage credit and other risk;
- detailed business model assessments to assess the sustainability of the banks' profit generation and quality of strategic planning;
- detailed file reviews to assess the quality of underwriting, sustainability of restructuring (for distressed loans), level of provisioning, adherence to Central Bank guidelines, adherence to the banks' own internal policies and procedures;
- distressed credit operations reviews for both commercial/SME lending and mortgage lending, which includes improvements in the banks' abilities to resolve distressed debt issues. More recently, the Central Bank has also supplemented internal resources with external audit experts to undertake detailed audits of mortgage arrears;
- overarching the above is the Supervisory Review and Evaluation Process (SREP), which ultimately determines the regulatory minimum capital requirements for the banks and includes explicit consideration of credit risk; and
- finally, all risks and issues are raised and discussed with senior bank management and the bank boards as appropriate, to ensure that they are understood and resolved in a timely fashion.

Single Supervisory Mechanism

Of course, further changes to the Central Bank's regulatory approach have come about with the advent of the Single Supervisory Mechanism (SSM). Since 4 November 2014, the

[20] Each risk element is assessed on the probability of that risk threatening the ability of the Central Bank to achieve its supervisory objectives.

regulatory approach is driven by methodologies agreed by the SSM. Under the SSM the ECB now directly supervises "significant institutions" which includes AIB, Bank of Ireland, Permanent TSB and Ulster Bank. Less significant institutions will continue to be supervised by national competent authorities, including the Central Bank. All euro area credit institutions will now be supervised in line with the Supervisory Manual approved by the SSM. This is aimed at ensuring a consistent supervisory approach and that the strong supervisory standards introduced by the Capital Requirements Directive and Regulation will be applied in a consistent way, hence providing a level playing field. Day-to-day supervision of significant institutions will be conducted by Joint Supervisory Teams, comprising staff from both the ECB and the Central Bank. For less significant institutions, day-to-day supervision will conducted by the Central Bank, but subject to SSM oversight. Key issues will be brought to the Supervisory Board for discussion and approval which means that issues affecting banks in Ireland will be discussed at a European level and will more often be subject to comparison with European peers.

***Specific Issues raised in the Reports***

In addition to the general regulatory weakness identified above, the reports drew attention to the following specific issues where they considered the Regulator's approach to be inadequate.

*In their report, Regling and Watson note the lack of timely information on concentration of lending to individuals or connected borrowers.*[21]

On 1 January 2011, the Central Bank introduced a *Code of Practice on Related-Party Lending* which introduced statutory requirements in relation to lending by banks and building societies to related parties. The Code, which replaced previous non-statutory requirements, broadened the definition of a related party and reduced the maximum amount that can be loaned to an individual related party and the aggregate amounts that can be loaned to all related parties. Related parties include a director, senior manager or significant shareholder of the credit institution or an entity in which the credit institution has a significant shareholding, as well as a connected person of any of the aforementioned persons. The Code has been introduced to seek to prevent abuses arising from exposures to related parties and to address possible conflicts of interest in this area. It requires that such lending is on an arm's length

[21] See paragraph 6, page 38 of the Regling and Watson Report.

basis, is limited to a percentage of the institution's own funds, and is subject to appropriate and effective management oversight and limits.[22]

*In their report Regling and Watson suggest the establishment of a credit register.*[23]

A decision to establish a central credit register has been taken. The central credit register will be managed by the Central Bank. When operational, this will provide valuable credit risk information to credit institutions. The initial phase of the central credit register will focus on the consumer credit market and is expected to become operational by mid-2016. A later phase will address commercial credit and is tentatively scheduled to be operational by end-2017.

*The Honohan and Nyberg Reports refer to possible use of sectoral limits*

The issue of setting sectoral limits on lending was raised in both the Nyberg and Honohan Reports.[24] Issues relating to credit limits have been under consideration in the Central Bank for some time. Both the advantages and disadvantages of credit limits have been considered and it was recognised that in the period when new credit extended was relatively low, any further tightening would be inappropriate. While the Central Bank has introduced some sectoral capital add-ons in the past, further sectoral capital add-ons are not considered useful in present circumstances.[25] Recently the Central Bank has opted to use other macro-prudential instruments it considers more suitable to increase the resilience of the banking and household sectors to the property market and to reduce the risk of bank credit and house price spirals from developing in the future. The measures introduce proportionate limits for loan-to-value and loan-to-income measurements for both primary dwelling houses and buy- to-let mortgages[26]. The limits are supplementary to individual banks' credit policies and are not designed as a substitute for lenders' responsibilities to assess affordability and lend prudently on a case-by-case basis.

*Both Honohan and Nyberg Reports referred to the issue of Directors' compliance statements*

The issue of Directors' compliance was raised in both the Honohan and Nyberg reports in relation to the weaknesses of the regulatory approach of the Financial Regulator. The Central

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[22] Press release for Code of Practice on Related Party Lending.
[23] See paragraph 6, page 38 of the Regling and Watson Report.
[24] See page 105 of the Honohan Report and page 70 of the Nyberg Report.
[25] See 'Macro-prudential policy for residential mortgage lending', Consultation Paper 87, October 2014.
[26] See Central Bank Regulations on Residential Mortgage Lending.

Bank has a discretionary power since 2004 (Section 25 of the Central Bank Act 1997 as inserted by Section 26 of the CBFSAI Act 2004) to request Compliance Statements from regulated financial service providers whenever it considered it appropriate. The Central Bank has used this power to request Compliance Statements from banks under its Corporate Governance Code for Credit Institutions and Insurance Undertakings and issued Guidelines in this regard in August 2011. The Central Bank has been receiving Compliance Statements from banks since 2012 in respect of financial year-ends December 2011 and subsequent years. Directors of banks confirm to the Central Bank that, to the best of their knowledge, the institution has materially complied with its obligations and requirements under the Central Bank's Corporate Governance Code or if the institution has failed to materially comply with the Code then they identify the instances of non-compliance separately in an annex to their Compliance Statement.

*Stress Tests*

Both the Nyberg and Honohan Reports raised issues relating to stress tests[27]. The Central Bank has carried out a number of stress test exercises in recent years.

The Financial Measures Programme included a *Prudential Capital Assessment Review* which conducted a detailed bottom-up stress test and a forward looking capital requirement assessment of AIB, BOI, PTSB, EBS, Anglo and Irish Nationwide in 2011. In 2011 AIB, BOI and PTSB also took part in the European Banking Authority (EBA) *2011 European Wide Stress Tests.* The 2013 Financial Measures Programme *Balance Sheet Assessment* (BSA) included a detailed loan file review of the covered banks' loan books to assess the classification of loans and the adequacy of provisions. The findings of the BSA were communicated to the banks and resulted in a significant increase in provisions taken by the banks in 2013. In 2014 AIB, BOI and PTSB took part in the ECB's *Comprehensive Assessment* which included both an *Asset Quality Review* (AQR) and Stress Test. The AQR was similar to the previously conducted BSA and assessed classification and provision adequacy. The AQR then fed into the joint EBA and ECB's stress tests in 2014[28].

*Loan-Loss Provisions*

[27] See page 94 of the Honohan Report and paragraph 4.4.7, page 67 of the Nyberg Report.
[28] See Press Release of the stress test results dated 26 October 2014.

The Honohan Report refers to the issue of loan-loss provisions[29]. As noted above, following the Balance Sheet Assessment, loan-loss provisions were increased. However, it should be noted that the Central Bank does not have the legal power to require more provisions within the context of the application of International Financial Reporting Standards (IFRS). However, under Pillar 2 of the Capital Requirements Directive the supervisor may require institutions to apply a specific provisioning policy or treatment of assets *in terms of own funds requirements*'. Notwithstanding this, the Central Bank issued detailed impairment provisioning guidelines for credit exposures and disclosures in December 2011 which were subsequently updated in May 2013. The Central Bank expects the banks to comply with these guidelines. While the Central Bank has been effective in driving the banks to increase provisions the Central Bank's powers relate to capital – whereby the Central Bank can increase the regulatory minimum if it determines that the banks are not holding sufficient capital and/or are insufficiently provisioned from a credit risk perspective.

*Issue of Liquidity Reserve Requirements*

The Honohan Report raised the issue of liquidity requirements. It noted that liquidity "reserve requirements should have been higher, or that ceilings should have been imposed on banks' loan-to-deposit ratio"[30]. The regulatory liquidity requirements regime has materially changed since the crisis. This has been driven by the Central Bank's own work (e.g., Prudential Liquidity Assessment Review (PLAR) 2011 and PRISM implementation) and also international developments (e.g., Capital Requirements Directive IV (CRDIV)). The banks now report much more granular information and liquidity requirements are being set relative to a Liquidity Coverage Ratio. The implementation of a Net Stable Funding Ratio is also in train. Loan-to-deposit ratio requirements were set as part of the Financial Measures Programme. However, this led to some distortion in the deposit market, and the measures were replaced with de-leveraging targets. Nonetheless loan-to-deposit ratios are actively monitored and the sustainability of the banks' funding profiles are assessed through business model reviews, liquidity assessments and reviews of regulatory returns.

*Resolution Procedures*

The Nyberg Report mentioned the issue of resolution and takeover of weak banks[31].

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[29] See page 106 of the Honohan Report.
[30] See page 106 of the Honohan Report.
[31] See page 72 of the Nyberg Report.

The Central Bank and Credit Institutions (Resolution) Act 2011 gives the Central Bank wide powers for the resolution of authorised credit institutions. These powers were used in resolving the difficulties experienced by a number of credit unions in recent years, including, for example, Newbridge Credit Union Limited and Berehaven Credit Union. A new directorate with specific responsibility, headed by the Director of Resolution and Corporate Affairs was established in 2014. The Central Bank has also been assigned the role as the national resolution authority under the EU Bank Recovery and Resolution Directive (BRRD).

*3.3 Macro-Prudential Issues*

The weaknesses identified in the reports relating to macro-prudential issues included the operation of the Financial Stability Committee (FSC); the commentary in the Financial Stability Reports; and the integration of financial stability with supervision.

Financial Stability Committee

The FSC has been restructured and strengthened and is now chaired by the Governor. Its role is both to advise the Governor and to inform key internal management on financial stability issues. This includes:

- regular monitoring and assessment of risk-relevant developments in economic and financial markets both domestically and internationally (to include discussion of regular Macro-Financial Reviews);
- development and assessment of micro-prudential and systemic risk indicators, such as stress-testing methodologies, regular surveillance and assessment of strengths and vulnerabilities of the overall financial system, based on micro-prudential and macro-prudential indicators; and
- analysis and discussion of arrangements for domestic crisis management and resolution, ensuring that legal requirements for crisis management are in place and contributing to European cross-border crisis management initiatives.

Commentary on Financial Stability

The Central Bank publishes its Macro-Financial Review bi-annually. It provides a systematic overview of macro-financial conditions in Ireland and forms part of the Central Bank's internal discussions about financial stability. It is made available to the public to heighten awareness of the current condition of the financial sector.

The Central Bank recognises that it is important to set a realistic tone regarding the state of the domestic banking system and the uncertain internal and external environment. The Macro-Financial Review is focused on the banking sector, its operating environment, and its main counterparts (households, firms, and the sovereign). In addition the Review provides an analysis of the insurance and funds sectors. Moreover, the Review presents new data to ensure that the messages are well supported by analysis. To this end, aggregate liquidity data, risk concentrations, and analysis of asset quality are presented. The domestic financial stability assessment identifies a series of vulnerabilities, risks, and possible mitigating actions and policy tools and their development.

Integration of Financial Stability with Supervision

The work of the Financial Stability Division is informed and enhanced by a high level of regular interaction with the supervision departments addressing a concern raised in the Honohan Report that closer interaction between the staff involved in these respective areas is required. Staff from the Financial Stability Division are part of the Supervisory Review and Evaluation Process (SREP), regular supervisory challenge meetings and prudential analytics work. In addition the Financial Stability Division works closely with the Central Bank's Cross-Sector Team in Risk, Governance and Accounting Policy division to produce environmental risk assessments for each regulated sector, e.g., retail banking. These assessments provide a macro financial and sector specific assessment for supervisors in their risk based supervisory activities. These assessments are updated twice a year through PRISM.

Much of the empirical assessment conducted by the Financial Stability Division underpins the conjunctural assessments which are prepared as a core output of the financial stability review process and which have formed the core of past Macro-Financial Reviews released by the Central Bank. These reviews are an integral aspect of the macro-prudential policy of the Central Bank forming the basis for mitigating actions to be undertaken by the Central Bank. As such, the Financial Stability Division provides as rigorous and independent a risk assessment as possible."[32] There is also, as a matter of form, the sharing of information

[32] Speech by Jonathan McMahon at the launch of the Central Bank's *Banking Supervision – Our New Approach*, June 2010.

between the financial stability and supervision divisions including information on liquidity and funding profiles of banks.

An advantage of the integrated approach between macro-prudential and micro-prudential parts of the Central Bank is that it allows policy to be pursued in unison and policy trade-offs that arise to be internalised and discussed within a single institution.[33] The new approach of close co-operation between micro- and macro-prudential supervision has been demonstrated by the recent the recent cross-organisational work underpinning the 2015 Regulations for Housing Loan Requirements.

[33] Address by Stefan Gerlach to the ERSI 'Macro Prudential Policy in Ireland' 28 February 2012 .

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2011

# Fitness and Probity Standards (Code issued under Section 50 of the Central Bank Reform Act 2010)

# THEME: R7

Effectiveness of the policy and institutional responses post crisis

# LINE OF INQUIRY: R7b

Assessment of whether further changes are required

Some of the improvements in the public finances are above the levels expected. Consideration could now be given to:

- **Use the unexpected gains in the improvements in Irish public finances to repay national debt.**
- **Decisions on whether to increase expenditure, reduce tax or repay debt, to incorporate an increased focus on the debt dynamics of sustainable fiscal paths and the tipping points.[7]**

## 4. Introduce new rules to ensure fiscal responsibility

An important challenge for parliamentary democracies is how to handle the incentives for Governments and opposition parties prior to elections to propose an expansion of public expenditure programmes and to reduce taxation.

EU fiscal rules provide some constraints on fiscal policies but there is a question mark over their effectiveness in preventing governments in times of economic growth from over expanding an economy. Existing EU rules may be designed to suit larger EU states and this may imply a weakness for smaller open economies. This can lead to boom-bust policies.

For a small open economy such as Ireland, inappropriate fiscal policy can be particularly damaging. Consideration could therefore be given to:

- **Securing all-party agreement on new binding rules to ensure fiscal responsibility.**

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[7] See, Greenlow, D., Hamilton, J.D., Hooper, P., Mishkin, F.S., Crunch Time: Fiscal Crises and the Role of Monetary Paper, US Monetary Policy Forum New York, Feb. 22, 2013.